

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

ESCO TECHNOLOGIES INC  
Form 10-Q  
May 09, 2007

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 MARCH 31, 2007

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  
(State or other jurisdiction of  
incorporation or organization)

43-1554045  
(I.R.S. Employer  
Identification No.)

9900A CLAYTON ROAD  
ST. LOUIS, MISSOURI  
(Address of principal executive offices)

63124-1186  
(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 classes of common stock, as of the latest practicable date.

| Class                                     | Outstanding at April 30, 2007 |
|---|-------------------------------|
| -----                                     | -----                         |
| [Common stock, \$.01 par value per share] | 25,944,354 shares             |

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

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<br>March 31,<br>----- |              |
|--|--|--------------|
|  | 2007<br>----                             | 2006<br>---- |
| Net sales                                    | \$ 129,068                               | 122,884      |
| Costs and expenses:                          |  |              |
| Cost of sales                                | 83,021                                   | 80,514       |
| Selling, general and administrative expenses | 31,432                                   | 26,703       |
| Amortization of intangible assets            | 2,909                                    | 1,536        |
| Interest (income) expense, net               | (217)                                    | (100)        |
| Other (income) and expenses, net             | (93)                                     | (1,548)      |
|  | ---                                      | -----        |
| Total costs and expenses                     | 117,052                                  | 107,105      |
| Earnings before income taxes                 | 12,016                                   | 15,779       |
| Income tax expense                           | 2,398                                    | 8,436        |
|  | -----                                    | -----        |
| Net earnings                                 | \$ 9,618                                 | 7,343        |
|  | =====                                    | =====        |
| Earnings per share:                          |  |              |
| Basic  | \$ 0.37                                  | 0.29         |
|  | =====                                    | =====        |
| Diluted                                      | \$ 0.36                                  | 0.28         |
|  | =====                                    | =====        |

See accompanying notes to consolidated financial statements.

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

Six Months Ended  
March 31,  
-----

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|  | 2007<br>----     | 2006<br>----   |
|--|------------------|----------------|
| Net sales                                    | \$ 227,881       | 213,470        |
| Costs and expenses:                          |                  |                |
| Cost of sales                                | 154,366          | 144,501        |
| Selling, general and administrative expenses | 60,816           | 50,189         |
| Amortization of intangible assets            | 5,046            | 2,049          |
| Interest (income) expense, net               | (555)            | (817)          |
| Other (income) and expenses, net             | (607)            | (1,926)        |
|  | ----             | -----          |
| Total costs and expenses                     | 219,066          | 193,996        |
| Earnings before income taxes                 | 8,815            | 19,474         |
| Income tax expense                           | 578              | 9,926          |
|  | ---              | -----          |
| Net earnings                                 | \$8,237<br>===== | 9,548<br>===== |
| Earnings per share:                          |                  |                |
| Basic  | \$ 0.32<br>===== | 0.37<br>=====  |
| Diluted                                      | \$ 0.31<br>===== | 0.36<br>=====  |

See accompanying notes to consolidated financial statements.

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

|  | March 31,<br>2007<br>---- | September 30,<br>2006<br>---- |
|--|---------------------------|-------------------------------|
| ASSETS   |                           |                               |
| Current assets:  | (Unaudited)               |                               |
| Cash and cash equivalents  | \$ 28,045                 | 36,819                        |
| Accounts receivable, net   | 91,362                    | 83,816                        |
| Costs and estimated earnings on long-term contracts, less progress billings of \$5,337 and \$4,405, respectively | 3,046                     | 1,345                         |
| Inventories  | 59,270                    | 50,984                        |
| Current portion of deferred tax assets   | 39,129                    | 24,251                        |
| Other current assets   | 15,863                    | 10,042                        |
|  | -----                     | -----                         |
| Total current assets   | 236,715                   | 207,257                       |
| Property, plant and equipment, net   | 71,129                    | 68,754                        |
| Goodwill   | 144,430                   | 143,450                       |
| Intangible assets, net   | 67,366                    | 59,202                        |
| Other assets   | 9,367                     | 10,031                        |
|  | -----                     | -----                         |
| Total assets   | \$ 529,007                | 488,694                       |

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|  | =====      | =====    |
|--|------------|----------|
| LIABILITIES AND SHAREHOLDERS' EQUITY   |            |          |
| Current liabilities:   |            |          |
| Short-term borrowings and current maturities of long-term debt   | \$ -       | -        |
| Accounts payable   | 47,421     | 39,496   |
| Advance payments on long-term contracts, less costs incurred of \$18,633 and \$19,532, respectively                          | 7,035      | 7,367    |
| Accrued salaries   | 12,792     | 13,932   |
| Current portion of deferred revenue  | 14,146     | 3,569    |
| Accrued other expenses   | 11,058     | 11,531   |
|  | -----      | -----    |
| Total current liabilities  | 92,452     | 75,895   |
| Deferred revenue   | 3,761      | 7,458    |
| Pension obligations  | 13,113     | 13,143   |
| Deferred tax liabilities   | 18,361     | 3,750    |
| Other liabilities  | 11,953     | 12,014   |
| Long-term debt   | -          | -        |
|  | -----      | -----    |
| Total liabilities  | 139,640    | 112,260  |
| 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 29,063,694 and 29,030,995 shares, respectively | 291        | 290      |
| Additional paid-in capital   | 239,381    | 236,390  |
| Retained earnings  | 201,283    | 193,046  |
| Accumulated other comprehensive loss   | (490)      | (2,070)  |
|  | -----      | -----    |
| Total shareholders' equity   | 440,465    | 427,656  |
| Less treasury stock, at cost: 3,158,366 and 3,166,026 common shares, respectively  | (51,098)   | (51,222) |
|  | -----      | -----    |
| Total shareholders' equity   | 389,367    | 376,434  |
|  | -----      | -----    |
| Total liabilities and shareholders' equity   | \$ 529,007 | 488,694  |
|  | =====      | =====    |

See accompanying notes to consolidated financial statements.

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

|                                       | Six Months Ended<br>March 31,<br>----- |       |
|---------------------------------------|--|-------|
|                                       | 2007                                   | 2006  |
|                                       | ----                                   | ----  |
| Cash flows from operating activities: |  |       |
| Net earnings                          | \$ 8,237                               | 9,548 |

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|   |           |           |
|---|-----------|-----------|
| Adjustments to reconcile net earnings to net cash provided by operating activities: |           |           |
| Depreciation and amortization   | 10,571    | 7,219     |
| Stock compensation expense  | 2,932     | 2,643     |
| Changes in operating working capital  | (10,097)  | 7,624     |
| Effect of deferred taxes  | (267)     | (1,563)   |
| Change in deferred revenue and costs, net   | 2,982     | 915       |
| Other   | (25)      | (197)     |
|   | -----     | -----     |
| Net cash provided by operating activities   | 14,333    | 26,189    |
| Cash flows from investing activities:   |           |           |
| Acquisition of businesses, less cash acquired                                       | (1,250)   | (90,862)  |
| Capital expenditures  | (7,180)   | (4,296)   |
| Additions to capitalized software   | (15,320)  | (18,095)  |
|   | -----     | -----     |
| Net cash used by investing activities   | (23,750)  | (113,253) |
| Cash flows from financing activities:   |           |           |
| Borrowings from long-term debt  | -         | 47,000    |
| Principal payments on long-term debt  | -         | (47,000)  |
| Excess tax benefit from stock options exercised                                     | 73        | 880       |
| Proceeds from exercise of stock options   | 706       | 1,526     |
| Other   | (136)     | 1,117     |
|   | -----     | -----     |
| Net cash provided by financing activities   | 643       | 3,523     |
|   | ---       | -----     |
| Net decrease in cash and cash equivalents   | (8,774)   | (83,541)  |
| Cash and cash equivalents, beginning of period                                      | 36,819    | 104,484   |
|   | -----     | -----     |
| Cash and cash equivalents, end of period  | \$ 28,045 | 20,943    |
|   | =====     | =====     |

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

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

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, 2006. Certain 2006 amounts have been reclassified to conform with the 2007 presentation.

The Company's business is typically not impacted by seasonality, however, the results for the three and six-month periods ended March 31, 2007 are not necessarily indicative of the results for the entire 2007 fiscal year.

### 2. 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<br>March 31,<br>----- |                 | Six Months Ended<br>March 31,<br>----- |                 |
|--|--|-----------------|--|-----------------|
|  | 2007<br>----                             | 2006<br>----    | 2007<br>----                           | 2006<br>----    |
| Weighted Average Shares<br>Outstanding - Basic | 25,895                                   | 25,659          | 25,885                                 | 25,620          |
| Dilutive Options and<br>Restricted Shares      | 596<br>---                               | 789<br>---      | 592<br>---                             | 782<br>---      |
| Adjusted Shares- Diluted                       | 26,491<br>=====                          | 26,448<br>===== | 26,477<br>=====                        | 26,402<br>===== |

Options to purchase 582,322 shares of common stock at prices ranging from \$42.10 - \$54.88 and options to purchase 282,069 shares of common stock at prices ranging from \$42.99 - \$50.26 were outstanding during the three month periods ended March 31, 2007 and 2006, 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 26,000 and 19,000 restricted shares were excluded from the computation of diluted EPS based upon the application of the treasury stock method for the three-month period ended March 31, 2007 and 2006, respectively.

### 3. SHARE-BASED COMPENSATION

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's stock option awards are generally subject to graded vesting over a three year service period. 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

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

issuance, expiring in various periods through 2013. Beginning in fiscal 2004, the options granted have a five-year contractual life from date of issuance. 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.

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 March 31, 2007 and 2006, respectively: expected dividend yield of 0% in both periods; expected volatility of 28.0% in both periods; risk-free interest rate of 4.9% and 4.5%; and expected term of 3.5 years in both periods. Pre-tax compensation expense related to the stock option awards was \$0.7 million and \$1.5 million for the three and six-month periods ended March 31, 2007, respectively, and \$0.6 million and \$1.1 million for the respective prior year periods.

Information regarding stock options awarded under the option plans is as follows:

|                                | Shares    | Weighted<br>Avg.<br>Price | Aggregate<br>Intrinsic<br>Value<br>(in<br>millions) | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life |
|--------------------------------|-----------|---------------------------|---|--|
| Outstanding at October 1, 2006 | 1,387,348 | \$26.60                   |   |  |
| Granted                        | 289,280   | \$45.75                   |   |  |
| Exercised                      | (33,790)  | \$22.67                   | \$ 0.8  |  |
| Cancelled                      | (10,670)  | \$35.79                   |   |  |
|                                | -----     | -----                     |   |  |
| Outstanding at March 31, 2007  | 1,632,168 | \$30.02                   | \$ 24.9   | 3.5 years  |
|                                | -----     | -----                     |   |  |
| Exercisable at March 31, 2007  | 978,391   | \$21.35                   | \$ 23.0   |  |
|                                | =====     | =====                     |   |  |

The weighted-average grant-date fair value of options granted during the six-month period ended March 31, 2007 and 2006 was \$12.25 and \$11.73, respectively.

### Performance-accelerated Restricted Share Awards

The performance-accelerated restricted shares (restricted shares) vest over

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

five years with accelerated vesting 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 \$0.5 million and \$1.0 million for the three and six-month periods ended March 31, 2007, respectively and \$0.6 million and \$1.1 million for the respective prior year periods.

The following summary presents information regarding outstanding restricted share awards as of March 31, 2007 and changes during the six-month period then ended:

|                              | Shares<br>----- | Weighted<br>Avg. Price<br>----- |
|------------------------------|-----------------|---------------------------------|
| Nonvested at October 1, 2006 | 155,730         | \$ 34.33                        |
| Granted                      | 62,030          | \$ 45.69                        |
| Vested                       | (51,200)        | \$ 24.60                        |
|                              | -----           | -----                           |
| Nonvested at March 31, 2007  | 166,560         | \$ 41.55                        |
|                              | =====           | =====                           |

### Non-Employee Directors Plan

Pursuant to the non-employee directors compensation plan, each non-employee director receives a retainer of 800 common shares per quarter. Pre-tax compensation expense related to the non-employee director grants was \$0.2 million and \$0.4 million for the three and six-month periods ended March 31, 2007, 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 \$1.4 million and \$2.9 million for the three and six-month periods ended March 31, 2007, respectively, and \$1.4 million and \$2.6 million for the three and six-months periods ended March 31, 2006. The total income tax benefit recognized in results of operations for share-based compensation arrangements was \$0.4 million and \$0.7 million for the three and six-month periods ended March 31, 2007 respectively, and \$0.3 million and \$0.7 million for the three and six-month periods ended March 31, 2006. As of March 31, 2007, there was \$11.7 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 3.4 years.

#### 4. INVENTORIES

Inventories consist of the following (in thousands):

|           |               |
|-----------|---------------|
| March 31, | September 30, |
| 2007      | 2006          |



Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|  |           |        |
|--|-----------|--------|
|  | ----      | ----   |
| Finished goods                                 | \$ 16,395 | 12,834 |
| Work in process, including long-term contracts | 15,818    | 13,211 |
| Raw materials                                  | 27,057    | 24,939 |
|  | -----     | -----  |
| Total inventories                              | \$ 59,270 | 50,984 |
|  | =====     | =====  |

5. COMPREHENSIVE INCOME

Comprehensive income for the three-month periods ended March 31, 2007 and 2006 was \$10.2 million and \$8.4 million, respectively. Comprehensive income for the six-month periods ended March 31, 2007 and 2006 was \$9.8 million and \$9.9 million, respectively. For the three and six-month periods ended March 31, 2007, the Company's comprehensive income was positively impacted by foreign currency translation adjustments of \$0.6 million and \$1.6 million, respectively. For the three and six-month periods ended March 31, 2006, the Company's comprehensive income was positively impacted by foreign currency translation adjustments of \$1.1 million and \$0.3 million, respectively.

6. 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: Communications, Filtration/Fluid Flow 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 before interest and taxes.

| (\$ in thousands)     | Three Months ended<br>March 31,<br>----- |         | Six Months ended<br>March 31,<br>----- |         |
|-----------------------|--|---------|--|---------|
|                       | 2007                                     | 2006    | 2007                                   | 2006    |
|                       | -----                                    | -----   | -----                                  | -----   |
| NET SALES             |  |         |  |         |
| Communications        | \$ 49,226                                | 43,239  | \$ 79,260                              | 62,372  |
| PTI                   | 13,116                                   | 11,711  | 24,735                                 | 22,408  |
| VACCO                 | 8,460                                    | 8,325   | 15,141                                 | 16,379  |
| Filtertek             | 24,340                                   | 25,012  | 46,617                                 | 47,707  |
|                       | -----                                    | -----   | -----                                  | -----   |
| Filtration/Fluid Flow | 45,916                                   | 45,048  | 86,493                                 | 86,494  |
| Test                  | 33,926                                   | 34,597  | 62,128                                 | 64,604  |
|                       | -----                                    | -----   | -----                                  | -----   |
| Consolidated totals   | \$129,068                                | 122,884 | \$227,881                              | 213,470 |
|                       | =====                                    | =====   | =====                                  | =====   |
| EBIT                  |  |         |  |         |
| Communications        | 6,109                                    | 9,728   | 3,327                                  | 8,844   |

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|                                 |           |         |          |         |
|---------------------------------|-----------|---------|----------|---------|
| PTI                             | 2,608     | 1,583   | 3,711    | 2,782   |
| VACCO                           | 2,254     | 1,441   | 2,592    | 3,332   |
| Filtertek                       | 1,492     | 1,699   | 1,868    | 2,696   |
|                                 | -----     | -----   | -----    | -----   |
| Filtration/Fluid<br>Flow        | 6,354     | 4,723   | 8,171    | 8,810   |
| Test                            | 4,061     | 4,338   | 6,204    | 7,254   |
| Corporate                       | (4,725)   | (3,110) | (9,442)  | (6,251) |
|                                 | -----     | -----   | -----    | -----   |
| Consolidated EBIT               | 11,799    | 15,679  | 8,260    | 18,657  |
| Add: Interest<br>income         | 217       | 100     | 555      | 817     |
|                                 | ---       | ---     | ---      | ---     |
| Earnings before<br>income taxes | \$ 12,016 | 15,779  | \$ 8,815 | 19,474  |
|                                 | =====     | =====   | =====    | =====   |

7. 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 six-month periods ended March 31, 2007 and 2006 are shown in the following tables. Net periodic benefit cost for each period presented is comprised of the following:

| (Dollars in thousands)       | Three Months Ended<br>March 31, |       | Six Months Ended<br>March 31, |         |
|------------------------------|---------------------------------|-------|-------------------------------|---------|
|                              | 2007                            | 2006  | 2007                          | 2006    |
|                              | -----                           | ----- | -----                         | -----   |
| Defined benefit plans        |                                 |       |                               |         |
| Interest cost                | \$ 688                          | 650   | \$ 1,375                      | 1,300   |
| Expected return on<br>assets | (700)                           | (675) | (1,400)                       | (1,350) |
| Amortization of:             |                                 |       |                               |         |
| Prior service cost           | 2                               | -     | 5                             | -       |
| Actuarial loss               | 73                              | 125   | 170                           | 250     |
|                              | ---                             | ---   | ---                           | ---     |
| Net periodic benefit cost    | \$ 63                           | 100   | \$ 150                        | 200     |
|                              | =====                           | ====  | =====                         | ====    |

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

| (Dollars in thousands) | Three Months Ended<br>March 31, |      | Six Months Ended<br>March 31, |      |
|------------------------|---------------------------------|------|-------------------------------|------|
|                        | 2007                            | 2006 | 2007                          | 2006 |
| Service cost           | \$ 10                           | 9    | \$ 20                         | 18   |
| Interest cost          | 12                              | 10   | 25                            | 20   |

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

|  |       |     |       |     |
|--|-------|-----|-------|-----|
| Prior service cost                       | (1)   | (2) | (3)   | (2) |
| Amortization of actuarial gain (2)       | --    | 2   | (13)  | (7) |
|  | --    | -   | ---   | --  |
| Net periodic postretirement benefit cost | \$ 19 | 19  | \$ 29 | 29  |
|  | ====  | ==  | ====  | ==  |

### 8. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. SFAS No. 159 is effective for the company beginning in the first quarter of fiscal year 2009, although earlier adoption is permitted. The adoption of SFAS 159 is not expected to have a material impact to the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). The purpose of SFAS No. 157 is to define fair value, establish a framework for measuring fair value, and enhance disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The measurement and disclosure requirements are effective for the Company in the first quarter of fiscal year 2009. The adoption of SFAS 157 is not expected to have a material impact to the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS 158), which amends SFAS 87 and SFAS 106 to require recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS 158, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects. The measurement date - the date at which the benefit obligation and plan assets are measured - is required to be the Company's fiscal year-end, which is the date the Company currently uses. SFAS 158 is effective for publicly-held companies for fiscal years ending after December 15, 2006. The adoption of SFAS 158 is not expected to have a material impact to the Company's financial position or results of operations.

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 the Company 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.

In June 2006, the FASB issued EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

in the Income Statement (That Is, Gross versus Net Presentation)". This EITF Issue is effective for periods beginning after December 15, 2006 and requires disclosure of the accounting policy for any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction on a gross (include in revenues and costs) or net (excluded from revenues) basis. The Company's accounting policy is to record taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction on a net basis.

### 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 second quarters of 2007 and 2006 represent the fiscal quarters ended March 31, 2007 and 2006, respectively.

#### NET SALES

Net sales increased \$6.2 million, or 5.0%, to \$129.1 million for the second quarter of 2007 from \$122.9 million for the second quarter of 2006 due to the 2006 acquisitions of Hexagram and Nexus. Net sales increased \$14.4 million, or 6.7% to \$227.9 million for the first six months of fiscal 2007 from \$213.5 million for the first six months of fiscal 2006 due to the 2006 acquisitions of Hexagram and Nexus. Favorable foreign currency values resulted in approximately \$1.3 million and \$2.4 million of the sales increase in the second quarter of 2007 and in the first six months of fiscal 2007, respectively.

#### -Communications

Net sales increased \$6.0 million, or 13.9% to \$49.2 million for the second quarter of 2007 from \$43.2 million for the second quarter of 2006. Net sales increased \$16.9 million, or 27.1% to \$79.3 million for the first six months of fiscal 2007 from \$62.4 million in the prior year period. The sales increase in the second quarter of 2007 as compared to the prior year quarter was due to: an increase in sales of \$8.1 million from Hexagram including advanced metering projects in Kansas City, and at PG & E; an increase in sales of \$0.9 million from Nexus; and a \$3.0 million decrease in sales of DCSI's automatic meter reading (AMR) products due to lower sales to TXU Electric Delivery Company (TXU) and Puerto Rico Power Authority (PREPA) partially offset by additional sales to Duke Energy and Florida Power & Light (FPL).

The sales increase in the first six months of fiscal 2007 as compared to the prior year period was due to: an increase in sales of \$15.7 million from Hexagram (full six months of sales compared to two months included in the prior year period) in addition to the items mentioned above; an increase in sales of \$3.3 million from Nexus (full six months of sales compared to four months included in the prior year period); partially offset by a \$2.2 million decrease in sales of DCSI's AMR products.

The decrease in sales of DCSI's AMR products of \$2.2 million in the first six months of 2007 as compared to the prior year period was mainly due to: a decrease in sales to TXU of \$9.6 million and a decrease in sales to PREPA of \$1.7 million, partially offset by an increase in sales to other investor-owned utilities (IOUs), such as Duke Energy and FPL, of \$6.2 million and an increase in sales to COOP customers of \$3.4 million. In the first six months of 2007, DCSI's sales to COOP and public power (Municipal) customers were \$35.4 million compared to \$32.0 million in the prior year period.

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

Sales of Comtrak's SecurVision products were \$0.4 million each for the second quarters of 2007 and 2006 and \$3.0 million for the first six months of 2007 as compared to \$2.9 million in the prior year six-month period.

### -Filtration/Fluid Flow

Net sales increased \$0.9 million, or 2.0%, to \$45.9 million for the second quarter of 2007 from \$45.0 million for the second quarter of 2006. Net sales decreased \$0.1 million to \$86.4 million for the first six months of 2007 from \$86.5 million for the first six months of 2006. The sales increase during the fiscal quarter ended March 31, 2007 as compared to the prior year quarter was mainly due to: a \$1.4 million increase in commercial aerospace shipments at PTI of \$1.4 million and a sales increase of \$0.2 million at VACCO; partially offset by a net sales decrease at Filtertek of \$0.7 million driven by lower automotive shipments. Sales in the first six months of 2007 were consistent with the prior year period mainly due to: a \$2.3 million increase in commercial aerospace shipments at PTI; a decrease in defense spares and T-700 shipments at VACCO of \$1.2 million; and a net sales decrease at Filtertek of \$1.1 million driven by lower automotive shipments.

### -Test

For the second quarter of 2007, net sales of \$34.0 million were \$0.6 million, or 1.7% lower than the \$34.6 million of net sales recorded in the second quarter of 2006. Net sales decreased \$2.4 million, or 3.7%, to \$62.2 million for the first six months of 2007 from \$64.6 million for the first six months of 2006. The sales decrease in the second quarter of 2007 as compared to the prior year quarter was mainly due to: a \$2.5 million decrease in net sales from the Company's U.S. operations driven by the timing of sales of test chambers and components; partially offset by a \$1.7 million increase in net sales from the Company's Asian operations due to several chamber projects in Japan. The sales decrease for the first six months of 2007 compared to the prior year period was due to: a \$3.5 million decrease in net sales from the Company's U.S. operations driven by the timing of sales of test chambers and components; a \$1.3 million decrease in net sales from the Company's European operations due to the timing of test chamber sales; partially offset by a \$2.4 million increase in net sales from the Company's Asian operations due to several chamber projects in Japan.

### ORDERS AND BACKLOG

Backlog was \$307.7 million at March 31, 2007 compared with \$253.4 million at September 30, 2006. The Company received new orders totaling \$135.8 million in the second quarter of 2007 compared to \$128.7 million in the prior year quarter (including \$6.0 million of Hexagram acquired backlog). New orders of \$44.4 million were received in the second quarter of 2007 related to Communications products, \$54.7 million related to Filtration/Fluid Flow products, and \$36.7 million related to Test products. Hexagram received a \$13.5 million order for a water AMR project in Kansas City, Missouri, during the second quarter of 2007.

The Company received new orders totaling \$282.1 million in the first six months of 2007 compared to \$254.8 million in the prior year period (including \$15.0 million of Hexagram and Nexus acquired backlog). New orders of \$106.2 million were received in the first six months of 2007 related to Communications products, \$100.0 million related to Filtration/Fluid Flow products, and \$75.9 million related to Test products. New orders of \$114.6 million were received in the first six months of 2006 related to Communications products (including \$15.0 million of Hexagram and Nexus acquired backlog), \$84.4 million related to Filtration/Fluid Flow products and \$55.8 million related to Test products.

In November 2005, DCSI signed an agreement with PG&E with an anticipated contract value of up to approximately \$310 million covering up to five million electric endpoints over a five year deployment period beginning in fiscal 2007.

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

Also, in November 2005, Hexagram entered into an agreement to provide equipment, software and services to PG&E in support of the gas utility portion of PG&E's Advanced Metering Infrastructure (AMI) project. The total anticipated contract revenue from commencement through the five-year full deployment for this Hexagram contract is expected to be up to approximately \$225 million. The Company received orders totaling \$2.8 million and \$18.3 million from PG&E under these agreements during the second quarter and first six months of fiscal 2007, respectively.

### AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets was \$2.9 million and \$5.0 million for the three and six-month periods ended March 31, 2007, respectively, compared to \$1.5 million and \$2.0 million for the respective prior year periods. Amortization of intangible assets for the three and six-month periods ended March 31, 2007 included \$0.6 million and \$1.2 million, respectively, of amortization of acquired intangible assets related to the Nexus and Hexagram acquisitions compared to \$0.8 million and \$0.9 million for the respective prior year periods. The amortization of acquired intangible assets related to Nexus and Hexagram are included in Corporate's operating results, see "EBIT - Corporate". The remaining amortization expenses consist of other identifiable intangible assets (primarily software, patents and licenses). During the three and six-month periods ended March 31, 2007, the Company recorded \$1.8 million and \$2.7 million, respectively, of amortization related to DCSI's TNG capitalized software compared to \$0.3 million for each of the respective prior year periods.

### SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative (SG&A) expenses for the second quarter of 2007 were \$31.4 million (24.3% of net sales), compared with \$26.7 million (21.7% of net sales) for the prior year quarter. For the first six months of 2007, SG&A expenses were \$60.8 million (26.7% of net sales) compared with \$50.2 million (23.5% of net sales) for the prior year period. The increase in SG&A spending in the fiscal quarter ended March 31, 2007 as compared to the prior year quarter was primarily due to: an increase of \$1.7 million of SG&A related to Hexagram (due to a full quarter of SG&A expenses compared to two months included in the prior year quarter); an increase of \$0.8 million in SG&A expenses at DCSI due to an increase in headcount; an increase of \$0.5 million in SG&A expenses at Nexus; and an increase of \$0.8 million of sales and marketing expenses incurred in the Test segment to support growth opportunities, primarily in Asia.

The increase in SG&A spending in the first six months of 2007 as compared to the prior year period was primarily due to: an increase of \$4.4 million of SG&A related to Hexagram (due to a full six months of SG&A expenses compared to two months included in the prior year period); an increase of \$2.4 million in SG&A expenses at Nexus (due to a full six months of SG&A expenses compared to four months included in the prior year period); an increase of \$1.5 million related to the Test segment including expenses to further expand its Asian presence; an increase of \$0.9 million in SG&A expenses at DCSI due to an increase in headcount; and a \$0.6 million increase at Corporate due to an increase in professional fees incurred to support a research tax credit project.

### OTHER (INCOME) AND EXPENSES, NET

Other income, net, was \$0.1 million for the second quarter of 2007 compared to \$1.5 million for the prior year quarter. Other income, net, was \$0.6 million for the first six months of 2007 compared to \$1.9 million for the prior year period. The principal components of other income, net, for the first six months of 2007 included \$1.0 million of royalty income.

Principal components of other income, net, for the first six months of 2006 included the following items: \$1.8 million non-cash gain representing the

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

release of reserve related to an indemnification obligation with respect to a previously divested subsidiary; \$1.1 million of royalty income; partially offset by a \$0.2 million write-off of assets related to a terminated subcontract manufacturer.

### EBIT

The Company evaluates the performance of its operating segments based on EBIT, defined below. EBIT was \$11.8 million (9.1 % of net sales) for the second quarter of 2007 and \$15.7 million (12.8% of net sales) for the second quarter of 2006. For the first six months of fiscal 2007, EBIT was \$8.3 million (3.6% of net sales) and \$18.7 million (8.7% of net sales) for the first six months of 2006. The decrease in EBIT for the second quarter of 2007 and first six months of 2007 as compared to the prior year periods 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 presents a reconciliation of EBIT to net earnings.

| (\$ in thousands)    | Three Months ended<br>March 31,<br>----- |              | Six Months ended<br>March 31,<br>----- |              |
|----------------------|--|--------------|--|--------------|
|                      | 2007<br>----                             | 2006<br>---- | 2007<br>----                           | 2006<br>---- |
| Consolidated EBIT    | \$11,799                                 | 15,679       | \$ 8,260                               | 18,657       |
| Add: Interest income | 217                                      | 100          | 555                                    | 817          |
| Less: Income taxes   | 2,398                                    | 8,436        | 578                                    | 9,926        |
|                      | -----                                    | -----        | ---                                    | -----        |
| Net earnings         | \$ 9,618                                 | 7,343        | \$ 8,237                               | 9,548        |
|                      | =====                                    | =====        | =====                                  | =====        |

### -Communications

EBIT in the second quarter of 2007 was \$6.1 million (12.4% of net sales) compared to \$9.7 million (22.5% of net sales) in the prior year quarter. For the first six months of 2007, EBIT was \$3.3 million (4.2% of net sales) compared to \$8.8 million (14.1% of net sales) in the prior year period. The decrease in EBIT in the second quarter of 2007 was due to: a \$4.6 million decrease in EBIT at DCSI resulting from lower sales mentioned above, the amortization expenses of its TNG software and PG&E related program support costs; partially offset by an \$0.8 million increase at Hexagram resulting from increased sales; and a \$0.2 million increase at Nexus. The decrease in EBIT for the first six months of 2007 compared to the prior year period was due to: a \$6.4 million decrease in EBIT at DCSI resulting lower sales mentioned above, an increase of \$2.4 million in amortization expenses of its TNG software and PG&E related program support costs; partially offset by a \$0.6 million increase at Hexagram resulting from increased sales; and a \$0.3 million increase at Comtrak due to lower SG&A spending.

During the second quarter of 2007, Hexagram entered into a contract with a new supplier for its manufactured products. The new supplier offers a broader range

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

of capabilities as well as an opportunity for cost reductions.

### -Filtration/Fluid Flow

EBIT was \$6.4 million (13.9% of net sales) and \$4.7 million (10.4% of net sales) in the second quarters of 2007 and 2006, respectively, and \$8.2 million (9.4% of net sales) and \$8.8 million (10.2% of net sales) in the first six months of 2007 and 2006, respectively. For the second quarter of 2007 as compared to the prior year quarter, EBIT increased \$1.7 million due to: a \$1.0 million increase at PTI due to higher commercial aerospace shipments; an \$0.8 million increase at VACCO resulting from an improved sales mix resulting in more favorable overhead absorption; partially offset by a \$0.2 million decrease at Filtertek due to lower automotive sales volumes. For the first six months of 2007 as compared to the prior year period, EBIT decreased \$0.6 million due to: an \$0.8 million decrease at Filtertek due to lower sales volumes and higher raw material costs; a \$0.7 million decrease at VACCO due to lower defense spares shipments and additional engineering costs on new Space programs; partially offset by a \$0.9 million increase at PTI due to higher commercial aerospace shipments.

### -Test

EBIT in the second quarter of 2007 was \$4.1 million (12.1% of net sales) as compared to \$4.3 million (12.4% of net sales) in the prior year quarter. For the first six months of 2007, EBIT was \$6.2 million (10.0% of net sales) as compared to \$7.3 million (11.2% of net sales) in the prior year period. EBIT decreased \$0.2 million and \$1.1 million over the prior year quarter and six month period, respectively, due to the timing of sales, and additional sales and marketing costs to support near-term sales growth opportunities, primarily in Asia.

### -Corporate

Corporate costs included in EBIT were \$4.7 million and \$9.4 million for the three and six-month periods ended March 31, 2007, respectively, compared to \$3.1 million and \$6.2 million for the respective prior year periods. The increase in Corporate costs in the second quarter of 2007 as compared to the prior year quarter was due to a \$1.8 million non-cash gain recorded in the second quarter of 2006 related to an indemnification obligation with respect to a previously divested subsidiary. The increase in Corporate costs in the first six months of 2007 as compared to the prior year period was due to: a \$1.8 million non-cash gain recorded in the second quarter of 2006 mentioned above; \$0.4 million of additional pre-tax amortization of acquired intangible assets related to Nexus and Hexagram; \$0.4 million of additional professional fees incurred to support a research tax credit project; and \$0.3 million of additional expense related to stock compensation. In the first six months of 2007, Corporate costs included \$2.9 million of pre-tax stock compensation expense and \$1.2 million of pre-tax amortization of acquired intangible assets related to Nexus and Hexagram.

### INTEREST INCOME, NET

Interest income, net, was \$0.2 million and \$0.6 million for the three and six-month periods ended March 31, 2007, respectively, compared to interest income, net, of \$0.1 million and \$0.8 million for the respective prior year periods. The decrease in interest income in the first six months of 2007 as compared to the prior year period was due to lower average cash balances on hand.

### INCOME TAX EXPENSE

The second quarter 2007 effective income tax rate was 20.0% compared to 53.5% in the second quarter of 2006. The effective income tax rate in the first six months of 2007 was 6.6% compared to 51.0% in the prior year period. The decrease in the effective income tax rate in the second quarter and first six months of



## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

2007 as compared to the prior year periods was due to the favorable impact of a research tax credit in 2007. The second quarter 2007 income tax expense was favorably impacted by a \$2.2 million research tax credit, reducing the 2007 second quarter effective income tax rate by 18.7%. The income tax expense in the first six months of 2007 was favorably impacted by a \$3.1 million research tax credit, reducing the rate for the first six months of 2007 by 35.6%. The effective income tax rate in the second quarter and first six months of 2006 was adversely impacted by the repatriation of \$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 which increased the fiscal 2006 second quarter effective income tax rate by 10.9% and the first six months of 2006 by 8.9%. Due to the tax research credits favorably impacting the tax rate in the first half of 2007, the Company estimates the fiscal 2007 tax rate to be approximately 35%.

In December 2006, the President signed into law the "Tax Relief and Health Care Act of 2006" (The Act). The Act extended the expiration date for the research tax credit from December 31, 2005 to December 31, 2007. During the second quarter of 2007, the Company completed its analysis of available research credits for fiscal years 2000 through 2006 and has recorded total research credit claims, net, of \$5.6 million. The Company expects the net research credits related to fiscal year 2007 to be approximately \$1.6 million.

### CAPITAL RESOURCES AND LIQUIDITY

Working capital (current assets less current liabilities) increased to \$144.3 million at March 31, 2007 from \$131.4 million at September 30, 2006. Accounts receivable increased by \$7.5 million in the first six months of 2007, of which \$7.0 million related to DCSI due to the timing and volume of sales. The \$8.3 million increase in inventories at March 31, 2007 is mainly due to a \$4.0 million increase within the Communications segment and a \$2.6 million increase within the Filtration/Fluid Flow segment to support near term sales growth. Accounts payable increased by \$7.9 million in the first six months of 2007, of which \$3.1 million related to DCSI due to timing of vendor invoicing.

Net cash provided by operating activities was \$14.3 million and \$26.2 million for the six-month periods ended March 31, 2007 and 2006, respectively. The decrease is due to an increase in operating working capital requirements.

Capital expenditures were \$7.2 million and \$4.3 million in the first six months of fiscal 2007 and 2006, respectively. Major expenditures in the current period included equipment used in the Filtration/Fluid Flow and Communications businesses.

At March 31, 2007, intangible assets, net, of \$67.4 million included \$54.7 million of capitalized software. Approximately \$48.1 million of the capitalized software balance represents software development costs on the TNG software within the Communications segment to further penetrate the IOU market. TNG is being deployed to efficiently handle the additional levels of communications dictated by the size of the utility service territories and the frequency of meter reads that are required under time-of-use or critical peak pricing scenarios to meet the requirements of large IOUs. At March 31, 2007, the Company had approximately \$9 million of commitments related to the development of TNG versions 2.0 and 3.0 which is expected to be spent over the next six months. Amortization of TNG expense is on a straight-line basis over seven years and began in March 2006. The Company recorded \$1.8 million and \$2.7 million in amortization expense related to TNG in the second quarter of 2007 and in the first six months of 2007, respectively.

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 March 31, 2007. The facility is being marketed for sale.

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

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 March 31, 2007, the Company had approximately \$99.2 million available to borrow under the credit facility in addition to \$28.0 million cash on hand. At March 31, 2007, the Company had no borrowings, and outstanding letters of credit of \$3.6 million (\$0.8 million outstanding under the credit facility). 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.

### Pacific Gas & Electric

In November 2005, DCSI 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 AMI project. PG&E's current AMI project plan calls for the purchase of TWACS communication equipment for up to 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 up to approximately \$310 million. PG&E also has the right to purchase additional equipment and services to support existing and new customers through the twenty 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. 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. Delivery of the final version for which DCSI has committed is currently anticipated in the fourth quarter of fiscal 2007. In accordance with U.S. generally accepted accounting standards, the Company will defer all revenue related to the DCSI arrangement until all software is delivered and acceptance criteria have been met. The contract provides for liquidated damages in the event that DCSI's late delivery of hardware or software causes a delay to PG&E's AMI master project plan or delays PG&E's realization of its business case benefits and also 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.

In November 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 up to approximately \$225 million. As with DCSI's contract with PG&E, 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. 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

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

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, 2006 at Exhibit 13.

### 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 February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. SFAS No. 159 is effective for the company beginning in the first quarter of fiscal year 2009, although earlier adoption is permitted. The adoption of SFAS 159 is not expected to have a material impact to the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). The purpose of SFAS No. 157 is to define fair value, establish a framework for measuring fair value, and enhance disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The measurement and disclosure requirements are effective for the Company in the first quarter of fiscal year 2009. The adoption of SFAS 157 is not expected to have a material impact to the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS 158), which amends SFAS 87 and SFAS 106 to require recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS 158, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects. The measurement date - the date at which the benefit obligation and plan assets are measured - is required to be the Company's fiscal year-end, which is the date the Company currently uses. SFAS 158 is effective for publicly-held companies for fiscal years ending after December 15, 2006. The adoption of SFAS 158 is not expected to have a material impact to the Company's financial position or results of operations.

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 the Company beginning October 1, 2007. This

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

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.

In June 2006, the FASB issued EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)". This EITF Issue is effective for periods beginning after December 15, 2006 and requires disclosure of the accounting policy for any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction on a gross (include in revenues and costs) or net (excluded from revenues) basis. The Company's accounting policy is to record taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction on a net basis.

### 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, but are not limited to, the risk factors described in Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006, those relating to the estimates or projections made in connection with the Company's accounting policies, SFAS 158, FASB Interpretation No. 48, annual effective tax rate, research tax credits, timing and amounts 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 future delivery and acceptance of the TNG software by PG&E, and timing of spending for TNG commitments. 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: actions by 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; 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 market risks since September 30, 2006. Refer to the Company's Annual Report on Form 10-K for the fiscal year ended September

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

30, 2006 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 2006, the Company's Board of Directors authorized an open market common stock repurchase program for up to 1.2 million shares, subject to market conditions and other factors, which covers the period through September 30, 2008. There were no stock repurchases during the three month period ended March 31, 2007.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of the Company's shareholders was held on Friday, February 2, 2007. The voting for directors was as follows:

|                   | For        | Withheld | Broker Non-Votes |
|-------------------|------------|----------|------------------|
| V. L. Richey, Jr. | 21,912,876 | 932,366  | 0                |
| J. M. Stolze      | 22,395,204 | 450,038  | 0                |

The terms of W.S. Antle III, J.M. McConnell, L.W. Solley, D.C. Trauscht, and J.D. Woods as directors continued after the meeting.

The voting to ratify the Company's selection of KPMG LLP as independent auditors for the fiscal year ending September 30, 2007 was as follows:

|  | For        | Against | Abstain | Broker Non-Votes |
|--|------------|---------|---------|------------------|
|  | 22,686,596 | 144,768 | 13,878  | 0                |

### ITEM 6. EXHIBITS

- a) Exhibits  
Exhibit

## Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

### 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 as of July 10, 2000.  | Incorporated by reference to Form 10-K for the fiscal year ended September 30, 2003, at Exhibit 3.4         |
| 3.5 | Amendment to Bylaws effective as of February 2, 2007.   | Incorporated by reference to Form 10-Q for the fiscal quarter ended December 31, 2006, at Exhibit 3.5       |
| 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 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 | Incorporated by reference 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 Form 10-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               |

Edgar Filing: ESCO TECHNOLOGIES INC - Form 10-Q

- 31.1 Certification of Chief Executive Officer relating to Form 10-Q for period ended March 31, 2007
- 31.2 Certification of Chief Financial Officer relating to Form 10-Q for period ended March 31, 2007
- 32 Certification of Chief Executive Officer and Chief Financial Officer relating to Form 10-Q for period ended March 31, 2007

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: May 9, 2007