AMERICAN SCIENCE & ENGINEERING INC
Form 10-Q
November 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

o 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 1-6549

American Science and Engineering, Inc.

(Exact name of Registrant as specified in its charter)

Massachusetts (State or other jurisdiction of incorporation or organization)	**04-2240991** (I.R.S. Employer Identification No.)
829 Middlesex Turnpike **Billerica, Massachusetts** (Address of principal executive offices)	**01821** (Zip Code)

(978) 262-8700

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

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 (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes o 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 of Common Stock	**Outstanding at November 6, 2006**
$.66⅔ par value	9,152,312

American Science and Engineering, Inc. and Subsidiary

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

American Science and Engineering, Inc. and Subsidiary
Condensed Consolidated Balance Sheets
(Unaudited)

Dollars in thousands	**September 30, 2006**	**March 31, 2006**
Assets		
Current assets:		
Cash and cash equivalents	$ 28,543	$ 50,655
Restricted cash and investments	14,127	98
Short-term investments	72,272	43,117
Accounts receivable, net of allowances of $404 and $345 at September 30, 2006 and March 31, 2006, respectively	27,843	25,868
Unbilled costs and fees, net of allowances of $36 and $36 at September 30, 2006 and March 31, 2006, respectively	3,391	4,057
Inventories	18,438	16,886
Prepaid expense and other current assets	3,789	9,862
Deferred income taxes	3,984	3,381
Total current assets	172,387	153,924
Building, equipment and leasehold improvements, net	19,967	18,717
Deferred income taxes	1,160	748
Other assets, net	429	
Total assets	$ 193,943	$ 173,389
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,024	$ 6,659
Accrued salaries and benefits	2,550	6,554
Accrued warranty costs	2,832	3,606
Accrued income taxes	782	
Deferred revenue	3,977	3,331
Customer deposits	13,887	6,103
Current portion of lease financing liability	802	787
Warrant liability	565	
Other current liabilities	2,345	1,853
Total current liabilities	32,764	28,893
Lease financing liability, net of current portion	9,232	9,630
Warrant liability		4,038
Other long term liabilities	3,825	630
Total liabilities	45,821	43,191
Stockholders equity:		
Preferred stock, no par value Authorized 100,000 shares; Issued - none		
Common stock, $0.66 2/3 par value Authorized 20,000,000 shares Issued and Outstanding 9,149,378 shares at September 30, 2006 and 9,070,679 shares at March 31, 2006	6,099	6,047
Capital in excess of par value	99,332	94,061
Accumulated other comprehensive income	64	(16)
Unearned compensation		(1,773)
Retained earnings	42,627	31,879
Total stockholders equity	148,122	130,198
Total liabilities and stockholders equity	$ 193,943	$ 173,389

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

American Science and Engineering, Inc. and Subsidiary
Condensed Consolidated Statements of Operations
(Unaudited)

Dollars and shares in thousands, except per share amounts	Three Months Ended Sept. 30, 2006	Three Months Ended Sept. 30, 2005	Six Months Ended Sept. 30, 2006	Six Months Ended Sept. 30, 2005
Revenues:				
Net product sales and contract revenues	$ 17,038	$ 41,979	$ 36,151	$ 71,492
Net service revenues	12,550	7,162	23,319	12,811
Total net revenues	29,588	49,141	59,470	84,303
Cost of sales and contracts:				
Cost of product sales and contracts	9,235	19,781	19,976	36,808
Cost of service revenues	6,824	4,584	12,468	8,127
Total cost of sales and contracts	16,059	24,365	32,444	44,935
Gross profit	13,529	24,776	27,026	39,368
Expenses:				
Selling, general and administrative expenses	5,931	4,699	11,626	8,837
Research and development	1,531	2,470	3,780	4,892
Total expenses	7,462	7,169	15,406	13,729
Operating income	6,067	17,607	11,620	25,639
Other income (expense):				
Interest and investment income	1,375	511	2,491	872
Interest expense	(90)		(189)	
Other, net	80	11	93	25
Change in warrant valuation	207	(3,450)	2,339	(2,917)
Total other income (expense)	1,572	(2,928)	4,734	(2,020)
Income before income taxes	7,639	14,679	16,354	23,619
Provision for income taxes	2,886	6,283	5,606	8,226
Net income	$ 4,753	$ 8,396	$ 10,748	$ 15,393
Income per share Basic	$ 0.52	$ 0.99	$ 1.18	$ 1.83
Diluted	$ 0.49	$ 0.93	$ 0.90	$ 1.72
Weighted average shares Basic	9,094	8,475	9,083	8,425
Diluted	9,316	9,003	9,338	8,931

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

American Science and Engineering, Inc. and Subsidiary
Condensed Consolidated Statements of Cash Flows
(Unaudited)

Dollars in thousands	For the Six Months Ended September 30, 2006	September 30, 2005
Cash flows from operating activities:		
Net income	$ 10,748	$ 15,393
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,084	405
Provisions for contract, inventory and accounts receivable reserves	152	2,168
Amortization of bond discount	(755)	(173)
Deferred income taxes	(1,110)	2,284
Reversal of deferred tax asset valuation allowance relating to net operating losses		(1,593)
Stock based compensation expense	4,665	157
Change in value of warrants	(2,339)	2,917
Changes in assets and liabilities:		
Accounts receivable	(2,034)	(16,034)
Unbilled costs and fees	666	(110)
Inventories	(1,645)	7,848
Prepaid expenses and other assets	3,643	319
Accounts payable	(1,635)	(2,024)
Accrued income taxes	782	3,058
Customer deposits	7,784	(4,460)
Deferred revenue	3,850	(1,357)
Accrued expenses and other current liabilities	(3,934)	2,724
Non-current liabilities	(9)	(37)
Total adjustments	9,165	(3,908)
Net cash provided by operating activities	19,913	11,485
Cash flows from investing activities:		
Purchases of short-term investments	(65,435)	(25,444)
Maturity of short-term investments	37,095	23,915
Purchases of property and equipment	(2,334)	(3,522)
Net cash used for investing activities	(30,674)	(5,051)
Cash flows from financing activities:		
Decrease (increase) in restricted cash	(14,029)	193
Proceeds from exercise of warrants	834	1,263
Proceeds from exercise of stock options	85	3,154
Proceeds from financing of leasehold improvement	2,095	1,500
Repayment of lease financing	(383)	
Reduction of income taxes paid due to the tax benefit from employee stock option expense	27	2,277
Net cash provided by (used for) financing activities	(11,371)	8,387
Foreign currency translation effect on cash	20	1
Net increase (decrease) in cash and cash equivalents	(22,112)	14,822
Cash and cash equivalents at beginning of period	50,655	15,418
Cash and cash equivalents at end of period	$ 28,543	$ 30,240

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

American Science and Engineering, Inc. and Subsidiary
Notes to Unaudited Condensed Consolidated Financial Statements

1. General

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All significant intercompany transactions and balances have been eliminated.

The unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes included in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2006.

The unaudited condensed consolidated financial statements, in the opinion of management, include all adjustments necessary, consisting solely of normal recurring adjustments, to present fairly the Company s financial position, results of operations and cash flows. These quarterly results are not necessarily indicative of the results to be expected for the entire year.

Nature of Operations

The Company is engaged in the development and manufacture of sophisticated X-ray inspection systems for critical detection and security screening solutions for sale primarily to U.S. and foreign government agencies. The Company has only one reporting segment, X-ray screening products.

Significant Accounting Policies

Revenues on cost reimbursable and long-term fixed price contracts are generally recorded as costs are incurred using the percentage of completion method. For systems that are produced in a standard manufacturing operation and have shorter order to delivery cycles, the Company recognizes sales at the time of shipment of the system to the customer and when other revenue recognition criteria (such as transfer of risk) are met.

The Company s Export and Security Agreement with Silicon Valley Bank East requires certain cash balances to be restricted as collateral against outstanding standby letters of credit; these are separately presented as restricted cash. (See Note 5)

The other significant accounting policies followed by the Company and its subsidiary in preparing its consolidated financial statements are set forth in Note 1 to the consolidated financial statements included in its Form 10-K for the year ended March 31, 2006. The Company has made no changes to these policies during the current year.

Certain amounts in the prior period financial statements have been reclassified to conform to the current period presentation.

Comprehensive Income

Comprehensive income is comprised of the following:

	Three months ended		**Six months ended**	
(In thousands)	**Sept. 30, 2006**	**Sept. 30, 2005**	**Sept. 30, 2006**	**Sept. 30, 2005**
Net income	$4,753	$8,396	$10,748	$15,393
Foreign currency translation adjustments, net of tax	2	12	22	1
Unrealized gains and losses from marketable securities, net of tax	41	(22)	58	(18)
Comprehensive income	$4,796	$8,386	$10,828	$15,376

2. Accounting for Stock-Based Compensation

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R) (SFAS 123(R)) Accounting for Stock-Based Compensation , which requires the measurement and recognition of all compensation costs for all stock based awards made to employees and the Board of Directors based upon fair value over the requisite service period for awards expected to vest. Prior to adoption, the Company accounted for stock options under the intrinsic value method set in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, and provided the required pro forma disclosures prescribed by SFAS No. 123, Accounting for Share-based Compensation , as amended.

SFAS 123(R) requires the Company to estimate the fair value of share-based awards on the date of grant using an option pricing model. The Company adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting April 1, 2006, the first day of the Company s fiscal year 2007. Prior period information will not be restated to reflect the fair value method of expensing share-based awards.

Stock- based compensation costs recognized for the three and six month periods ended September 30, 2006, included compensation costs for awards granted prior to, but not yet vested as of April 1, 2006 (adoption date), as well as any new grants issued after April 1, 2006. Total costs recognized during the three and six month periods ended September 30, 2006 amounted to $2,465,000 and $4,665,000, respectively. The Company recognized $2,153,000 and $3,944,000 of the share-based compensation costs in the consolidated statements of income for the three and six months ended September 30, 2006, respectively. In the three and six months ended September 30, 2006, a total $312,000 and $721,000 of compensation costs were capitalized to inventory as such costs qualified for capitalization. These costs are recognized in the income statement when the inventory is disposed of or consumed. The income tax benefit related to such compensation for the three and six months ended September 30, 2006 was approximately $313,000 and $618,000, respectively.

The following table summarizes share-based compensation costs included in the Company s consolidated statement of income:

	Three Months Ended September 30, 2006	**Six Months Ended September 30, 2006**
Cost of revenues	$ 832	$ 1,514
Selling, general and administrative	1,321	2,430
Total share-based compensation expense before tax	$ 2,153	$ 3,944

The Company had previously adopted the provisions of SFAS No. 123, Accounting for Share-based Compensation, as amended by SFAS No. 148, Accounting for Share-based Compensation Transition and Disclosure, through disclosure only. The following table illustrates the effect on net income and earnings per share for the three and six months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to share-based employee awards.

(In thousands except per share amounts)	**Three months ended Sept. 30, 2005**	**Six months ended Sept. 30, 2005**
Net income		
As reported	$ 8,396	$ 15,393
Add: Stock based compensation included in net income as reported	106	157
Less: Stock based compensation using fair value method for all awards	(879)	(4,904)
Pro forma net income	7,623	$ 10,646
Income per share Basic:		
As reported	$ 0.99	$ 1.83
Pro forma	$ 0.90	$ 1.26
Income per share Diluted:		
As reported	$ 0.93	$ 1.72
Pro forma	$ 0.85	$ 1.20

Upon adoption of SFAS 123(R), in accordance with Staff Accounting Bulletin No. 107, the Company selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for the stock awards. The Black-Scholes method of valuation requires several assumptions: (1) the expected term of the stock award, (2) the expected future stock volatility over the expected term and (3) risk-free interest rate. The expected term represents the expected period of time the Company believes the options will be outstanding based on historical information. Estimates of expected future stock price volatility are based on the historic volatility of the Company s common stock and the risk free interest rate is based on the U.S. Zero-Bond rate. The fair value of options at date of grant was estimated with the following assumptions:

	Six Months Ended September 30, 2006	**September 30, 2005**
Assumptions:		
Option life	3 years	3-5 years

Risk-free interest rate	4.77	%	3.40	%
Stock volatility	56	%	62	%
Dividend yield	0	%	0	%

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Stock Option and Other Compensation Plans:

Effective April 1, 2006, the Company adopted SFAS 123(R) using the modified prospective method to account for share-based payments to employees and the Company s Board of Directors. The primary types of share-based payments currently utilized by the Company are stock options, restricted stock and restricted stock units.

The Company has various stock option and other compensation plans for directors, officers, and employees. The Company had the following stock option plans outstanding as of September 30, 2006: the 1995 Combination Plan, the 1996 Plan for Non-Employee Directors, the 1997 Non-Qualified Option Plan, the 1998 Non-Qualified Option Plan, the 1999 Combination Plan, the 2000 Combination Plan, the 2002 Combination Plan, the 2003 Stock Plan for Non-Employee Directors and the 2005 Equity and Incentive Plan. There are 3,780,000 shares authorized under these plans. Vesting periods are at the discretion of the Board of Directors and typically range between one and three years. Options under these plans are granted at fair market value and have a term of five or ten years from the date of grant.

Stock options

The following tables summarize stock option activity during the first six months of fiscal year 2007:

	Options Outstanding			
	Number of Shares	**Weighted Average Exercise Price**	**Weighted Average Contractual Life**	**Aggregate Intrinsic Value**
Outstanding at March 31, 2006	878,470	$ 36.79		
Grants	60,670			
Exercises	(3,400)			$ 100,000
Cancellations	(13,037)			
Outstanding at September 30, 2006	922,703	$ 37.38	7.99	
Exercisable at September 30, 2006	384,212	$ 25.15		$ 13,007,000

Information related to the stock options outstanding as of September 30, 2006 is as follows:

Range of Exercise Prices	**Number of Shares**	**Weighted-Average Remaining Contractual Life (years)**	**Weighted-Average Exercise Price**	**Exercisable Number of Shares**	**Exercisable Weighted-Average Exercise Price**
$6.50 - $20.00	258,470	6.27	$ 11.77	203,670	$ 11.43
$20.01 - $30.00	114,150	7.89	27.21	105,100	27.77
$30.01 - $40.00	73,041	8.19	38.95	7,375	37.96
$40.01 - $50.00	140,199	9.02	45.84	17,667	44.62
$50.01 - $60.00	240,443	8.79	53.63		
$60.01 - $83.02	96,400	9.11	64.04	50,400	66.45
$6.50 - $83.02	922,703	7.99	$ 37.38	384,212	$ 25.15

The weighted average fair value of options granted in the six months ended September 30, 2006 was $20.09. As of September 30, 2006, there was $5,751,000 of total unrecognized compensation cost related to nonvested stock options granted and outstanding; that cost is expected to be recognized over a 3 year period. Nonvested common stock options are subject to the risk of forfeiture until the fulfillment of specified conditions.

Restricted Stock and Restricted Stock Units

During fiscal 2006, the Company instituted a long term incentive plan for certain key employees. The plan calls for the issuance of restricted stock and options which vest upon the achievement of certain performance based goals as well as service time incurred. Restricted stock and restricted stock units granted to other employees have vesting periods that range from one to three years. Annually on January 10th, the Board of Directors is granted restricted stock. The stock vests pro-rata based on service time incurred in the upcoming calendar year. The fair values of these restricted stock awards are equal to the market price per share of the Company s common stock on the date of grant.

Nonvested restricted stock and stock unit awards are subject to the risk of forfeiture until the fulfillment of specified conditions. As of September 30, 2006, there was $2,321,000 of total unrecognized compensation cost related to nonvested restricted stock and stock unit awards granted under the Company s stock plans. This cost is expected to be recognized over a 3 year period.

The following table summarizes the status of the Company s nonvested restricted stock and stock unit awards since March 31, 2006:

	Nonvested Restricted Stock and Stock Unit Awards	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at March 31, 2006	23,125	$ 54.92
Granted	36,494	
Vested	(1,707)	
Forfeited		
Outstanding at September 30, 2006	57,912	$ 53.25

3. Inventories

(Dollars in thousands)	**Sept 30, 2006**	**March 31, 2006**
Inventories consisted of:		
Raw materials, completed sub-assemblies, and spare parts	$ 8,052	$ 6,856
Work-in-process	6,196	6,325
Finished goods	4,190	3,705
Total	$ 18,438	$ 16,886

4. Income per Common and Common Equivalent Share

Basic earnings per common share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share include the dilutive impact of options and warrants using the average share price of the Company s common stock for the period. For the quarters ended September 30, 2006 and September 30, 2005, common stock equivalents of 392,000 and 177,000 respectively, are excluded from diluted earnings per share, as their effect is anti-dilutive. For the six months ended September 30, 2006 and September 30, 2005, common stock equivalents of 96,000 and 179,000 respectively, are excluded from diluted earnings per share, as their effect is anti-dilutive.

	Three Months Ended		**Six Months ended**	
(In thousands except per share amounts)	**Sept. 30, 2006**	**Sept. 30, 2005**	**Sept. 30, 2006**	**Sept. 30, 2005**
Income Per Share				
Basic:				
Net income	$ 4,753	$ 8,396	$ 10,748	$ 15,393
Weighted average number of common shares outstanding basic	9,094	8,475	9,083	8,425
Net income per share basic	$ 0.52	$ 0.99	$ 1.18	$ 1.83
Diluted:				
Net income	$ 4,753	$ 8,396	$ 10,748	$ 15,393
Adjustment to net income for change in warrant valuation	(207)		(2,339)	
Adjusted net income	$ 4,546	$ 8,396	$ 8,409	$ 15,393
Weighted average number of common shares outstanding	9,094	8,475	9,083	8,425
Assumed exercise of stock options and warrants, using the treasury stock method	222	528	255	506
Weighted average number of common and potential common shares outstanding diluted	9,316	9,003	9,338	8,931
Net income per share diluted	$ 0.49	$ 0.93	$ 0.90	$ 1.72

5. Borrowings

On November 30, 2004, the Company modified its two credit agreements with Silicon Valley Bank East. The modifications extended the credit facilities which expired on November 30, 2004 through November 29, 2006 and reduced the export loan and security facility, guaranteed by the Export-Import Bank of the United States, from $20.0 million to $10.0 million. The domestic facility is a

$5.0 million domestic loan and security agreement to support the Company s routine working capital needs. Maximum borrowings for this facility are set at the lower of (a) the sum of 80% of eligible domestic accounts receivable plus 10% of finished goods inventory up to $750,000, or (b) $5.0 million. The Company is currently finalizing a new agreement with Silicon Valley Bank which will commence at the expiration of the current facility.

The credit facilities bear an interest rate of the greater of 4.0% or the Silicon Valley Bank prime rate (8.25% at September 30, 2006). The credit agreements are collateralized by certain assets of the Company and contain certain restrictions, including limitations on the amount of distributions that can be made to stockholders, and the disposition or encumbrances of assets, and require the maintenance of certain financial covenants.

At September 30, 2006, there were no borrowings outstanding against these credit facilities. The Company had outstanding $2,160,000 in stand-by letters of credit against the domestic facility and no stand-by letters of credit against the export facility. Of the outstanding letters of credit, $1,250,000 relates to a performance bond on an ongoing international project, $300,000 relates to the Company s building lease and the remainder is guaranteeing performance on certain international projects. No amounts have been drawn against these letters of credit. In addition, at September 30, 2006, the Company had a restricted cash balance of $14,127,000. Of the restricted cash, $12,500,000 related to an advance payment guarantee associated with an ongoing international project and the remainder related to certain bank required deposits related to outstanding letters of credits, bid bonds, and other bank-related fees.

6. Warrant Liability

On May 28, 2002, the Company closed on a private placement offering of common stock and warrants. A total of 1,115,000 shares were sold to accredited investors at a price of $17.64 per share. In addition, warrants to purchase an additional 295,475 shares of common stock at an exercise price of $23.52 per share were issued. The warrants were immediately vested and have a five-year life expiring in May of 2007.

At September 30, 2006, 21,625 warrants remain outstanding. Due to certain conversion features of these warrants that provide that the holder may opt for a cash settlement in certain instances, including a merger, a sale of all or substantially all of the Company s assets, or a tender offer or exchange offer of shares of the Company s stock, a liability equal to the fair value of the warrants at the deal closing date was recorded on the Company s balance sheet. This liability is remeasured each quarter and marked to market. The mark to market change in the warrants valuation of $207,000 and $(3,450,000) was recorded as other income (expense) for the three months ended September 30, 2006 and September 30, 2005, respectively. The mark to market change in the warrants valuation of $2,339,000 and $(2,917,000) was recorded as other income(expense) for the six months ended September 30, 2006 and September 30, 2005, respectively. The liability of $565,000 and $4,038,000 representing the fair market value of outstanding warrants at period end is recorded as a current liability at September 30, 2006 and as a non-current liability as of March 31, 2006, respectively. The fair market value of the warrants was determined using the Black-Scholes pricing model with an assumed volatility of 65% and 49% at September 30, 2006 and March 31, 2006, respectively, an interest rate of 4.98% and 4.60% at September 30, 2006 and March 31, 2006, respectively and a life equal to the remaining term of the warrants at each period end.

7. Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Accordingly, the Company recognizes deferred income taxes based on the expected future tax consequences of differences between the financial statement basis and the tax basis of assets and liabilities, calculated using enacted tax rates in effect for the year in which the differences are expected to be reflected in the tax return. The Company evaluates the need for a valuation allowance against its net deferred tax assets at year end based upon its three year cumulative income and its projections of future income, and records a valuation allowance against any net deferred tax assets if it is more likely than not that they will not be realized.

On November 10, 2005, the Financial Accounting Standards board (FASB) issued FASB Staff Position No. FAS 123(R) Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards that allows for a simplified or Long-Haul Method to establish the beginning balance of the additional paid-in-capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoptions of SFAS 123(R). The Company has elected to use the Long-Haul Method of calculating the APIC pool.

8. Guarantees

Certain of the Company s products carry a one-year warranty, the costs of which are accrued for at time of shipment or delivery. Accrual rates are based upon historical experience over the preceding twelve months and management s judgment of future exposure. Warranty experience for the three and six months ended September 30, 2006 and September 30, 2005 is as follows:

	Three Months Ended		Six Months Ended	
(In thousands)	**Sept. 30, 2006**	**Sept. 30, 2005**	**Sept. 30, 2006**	**Sept. 30, 2005**
Warranty accrual - beginning of period	$ 3,210	$ 2,768	$ 3,606	$ 2,322
Accruals for warranties issued during the period	465	1,412	1,054	2,499
Adjustment of preexisting accrual estimates	(451)	(85)	(981)	(358)
Warranty costs incurred during the period	(392)	(344)	(847)	(712)
Warranty accrual end of period	$ 2,832	$ 3,751	$ 2,832	$ 3,751

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In conjunction with the sale of certain assets and contracts of the Company s High Energy Systems Division in January of 2005, the lease for the California operations of the High Energy Systems Division was assigned to Accuray, Inc. The Company remains secondarily liable for the remaining lease payments in the event of default by Accuray, Inc. during the lease term which expires in February 2011. Total remaining lease payments at September 30, 2006 totaled $1,647,000. No accrual for this contingent liability has been recorded at September 30, 2006 as payment of this liability is considered remote.

9. Lease Commitments

In March 2005, the Company renewed its lease agreement for its corporate headquarters and manufacturing facilities in Billerica, Massachusetts. As part of the lease agreement, the Company s landlord agreed to certain renovations to the Billerica facility including the construction of additional high bay manufacturing space. The Company was responsible for a portion of the construction costs and was deemed to be the owner of the building during the construction period under EITF 97-10, The Effect of Lessee Involvement in Asset Construction . During the year ended March 31, 2006, the Company capitalized $5,153,000 to record the facility on its books with an offsetting credit to the lease financing liability. In addition, amounts paid for construction were recorded as construction in progress and the landlord construction allowances of $5,642,000 (of which $208,000 was a receivable at September 30, 2006) were recorded as additional lease financing liability.

At the completion of the construction in February 2006, the lease was reviewed for potential sale-leaseback treatment in accordance with SFAS No. 98. Based on this review, it was determined that the lease did not qualify for sale-leaseback treatment. As a result, building and tenant improvements and associated lease financing liabilities remain on the Company s books. The lease financing liability is being amortized over the lease term based on the payments designated in the agreement and the building and tenant improvement assets are being depreciated on a straight line basis over their useful lives.

Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Net revenues for the quarter ended September 30, 2006 decreased by $19,553,000 to $29,588,000 compared to the corresponding period a year ago. This decrease is attributable primarily to a decrease of $24,941,000 in product sales, $16,869,000 which relates to decreased shipments of Z Backscatter systems. In addition, there was a $4,066,000 decrease in sales of aftermarket parts from the prior year due to a one-time large order fulfilled last year, a decrease of $2,771,000 in CargoSearch system revenues due primarily to the completion of two large CargoSearch projects which were ongoing last fiscal year and a decrease of $1,176,000 in ParcelSearch system revenues attributable to lower unit sales in the current year. Service revenues increased by $5,388,000 to $12,550,000 compared to the second quarter of fiscal 2006 due primarily to an increase in the number of systems under service contracts as the warranties on systems sold in prior years expired and were replaced with service contracts and additional extended warranties sold with international systems.

Net revenues for the six months ended September 30, 2006 decreased by $24,833,000 to $59,470,000 compared to the corresponding period a year ago. This decrease is attributable primarily to a decrease of $35,341,000 in product sales, $22,494,000 which relates to decreased shipments of Z Backscatter systems. In addition, there was a $4,249,000 decrease in sales of aftermarket parts from the prior year due primarily to a large order fulfilled last year, a decrease of $4,946,000 in CargoSearch system revenues due primarily to the completion of two large CargoSearch projects which were ongoing last fiscal year and a decrease of $3,116,000 in ParcelSearch system revenues attributable to lower unit sales in the current year. Service revenues increased by $10,508,000 to $23,319,000 compared to the first six months of fiscal 2006 due primarily to an increase in the number of systems under service contracts as the warranties on systems sold in prior years expired and were replaced with service contracts and additional extended warranties sold with international systems.

Total cost of sales and contracts for the quarter ended September 30, 2006 decreased by $8,306,000 to $16,059,000 as compared to the corresponding period a year ago. Cost of sales and contracts related to product revenues decreased by $10,546,000 to $9,235,000 as compared to the corresponding period a year ago. Cost of product sales and contract revenues represented 54% of revenues versus 47% of revenue, for the corresponding period last year. This decrease in gross margin is due primarily to $832,000 of stock-based compensation recorded as a result of adopting SFAS 123(R) and a decrease in the volume of shipments of higher margin Z Backscatter systems. The cost of service revenues for the quarter ended September 30, 2006 increased by $2,240,000 to $6,824,000 as

compared to the corresponding period a year ago. Cost of service revenues represented 54% of revenues versus 64% for the corresponding period last year. This margin improvement is due primarily to the revenue increases noted above and increased margins on extended warranty related contracts.

Total cost of sales and contracts for the six months ended September 30, 2006 decreased by $12,491,000 to $32,444,000 as compared to the corresponding period a year ago. Cost of sales and contracts related to product revenues decreased by $16,832,000 to $19,976,000 as compared to the corresponding period a year ago. Cost of product sales and contract revenues represented 55% of revenues versus 51% of revenue, for the corresponding period last year. This decrease in gross margin is due primarily to $1,514,000 of stock-based compensation recorded as a result of adopting SFAS 123(R) and a decrease in the volume of shipments of higher margin Z Backscatter systems in the period. The cost of service revenues for the six months ended September 30, 2006 increased by $4,341,000 to $12,468,000 as compared to the corresponding period a year ago. Cost of service revenues represented 53% of revenues versus 63% for the corresponding period last year. This margin improvement is due primarily to the revenue increases noted above and increased margins on extended warranty related contracts.

Selling, general and administrative expenses for the quarter ended September 30, 2006 of $5,931,000 were $1,232,000 higher than the corresponding period a year ago. Selling, general and administrative expenses represented 20% of revenues in the current period as compared to 10% for the corresponding period last year. The increase in costs was primarily the result of $1,321,000 of stock-based compensation expense recorded in accordance with SFAS 123(R) and a $278,000 increase in bid and proposal related costs.

Selling, general and administrative expenses for the six months ended September 30, 2006 of $11,626,000 were $2,789,000 higher than the corresponding period a year ago. Selling, general and administrative expenses represented 20% of revenues in the current period as compared to 10% for the corresponding period last year. The increase in costs was primarily the result of $2,430,000 of stock-based compensation expense recorded in accordance with SFAS 123(R) and a $576,000 increase in bid and proposal related costs.

Company funded research and development expenses of $1,531,000 for the quarter ended September 30, 2006 decreased by $939,000 compared to the corresponding period last year. Research and development expenses represented 5% of revenues in both periods reported. These expenditures decreased as the Company s engineering efforts focused on revenue producing programs, bid and proposal activities and product maintenance during the quarter.

Company funded research and development expenses of $3,780,000 for the six months ended September 30, 2006 decreased by $1,112,000 compared to the corresponding period last year. Research and development expenses represented 6% of revenues in both periods reported. These expenditures decreased as the Company s engineering efforts focused on revenue producing programs, bid and proposal activities and product maintenance during the quarter.

Other income was $1,572,000 in income for the quarter ended September 30, 2006 as compared to $2,928,000 in expense for the corresponding period a year ago. Other income for the quarter ended September 30, 2006 and September 30, 2005 includes $207,000 and $(3,450,000), respectively of warrant income (expense) due to the changes in the warrant liability as a result of stock price volatility. In addition, in the quarter ended September 30, 2006, the Company earned $1,375,000 in income on investments held as compared to $511,000 in the quarter ended September 30, 2005 due to increases in the Company s cash and investments balances, and a 30% increase in the average interest rate when compared to the prior year.

Other income was $4,734,000 in income for the six months ended September 30, 2006 as compared to $2,020,000 in expense for the corresponding period a year ago. Other income for the six months ended September 30, 2006 and September 30, 2005 include $2,339,000 and $(2,917,000), respectively of warrant income (expense) due to the changes in the warrant liability as a result of stock price volatility. In addition, in the six months ended September 30, 2006, the Company earned $2,491,000 in income on investments held as compared to $872,000 in the six months ended September 30, 2005 due to increases in the Company s cash and investments balances, and an increase in the average interest rate when compared to the prior year.

As a result of the above, the Company reported pre-tax income of $7,639,000 in the quarter ended September 30, 2006 as compared to pre-tax income of $14,679,000 in the corresponding period a year ago. The Company reported pre-tax income of $16,354,000 in the six months ended September 30, 2006 as compared to pre-tax income of $23,619,000 in the corresponding period a year ago.

The Company s projected effective tax rate, excluding the income tax effect of the warrants which is a permanent item, for fiscal year 2007 increased to 40.0% from 30.8% for the year ended March 31, 2006. This increase is due to the Company recognition of tax carryforward benefits during fiscal 2006 which reduced taxable income as well as changes in other permanent tax items.

The Company had net income of $4,753,000 during the quarter ended September 30, 2006 as compared to net income of $8,396,000 in the second quarter of fiscal 2006. For the six months ended September 30, 2006, the Company had net income of $10,748,000 as compared to $15,393,000 for the six months ended September 30, 2005. The significant factors contributing to these results are noted in the above sections.

Liquidity and Capital Resources

Cash and cash equivalents decreased by $22,112,000 to $28,543,000 at September 30, 2006 compared to $50,655,000 at March 31, 2006. This decrease in cash and cash equivalents is due primarily to $28,340,000 of net purchases of short term investments, a $14,029,000 increase in restricted cash related primarily to one large international contract and $2,334,000 in capital expenditures related primarily to the Company s ongoing ERP system implementation and other leasehold improvements. These decreases are offset by $19,913,000 in cash provided by operating activities comprised mainly of $10,748,000 of net income earned during the period adjusted for non-cash related items related to stock compensation and warrants, and increases in customer deposits ($7,784,000) and deferred revenue ($3,850,000).

On November 30, 2004, the Company modified its two credit agreements with Silicon Valley Bank East. The modifications extended the credit facilities which expired on November 30, 2004 through November 29, 2006 and reduced the export loan and security facility, guaranteed by the Export-Import Bank of the United States, from $20.0 million to $10.0 million. The domestic facility is a $5.0 million domestic loan and security agreement to support the Company s routine working capital needs. Maximum borrowings for this facility are set at the lower of (a) the sum of 80% of eligible domestic accounts receivable plus 10% of finished goods inventory up to $750,000, or (b) $5 million. The Company is currently finalizing a new agreement with Silicon Valley Bank which will commence at the expiration of the current facility.

The credit facilities bear an interest rate of the greater of 4.0% or the Silicon Valley Bank prime rate (8.25% at September 30, 2006). The credit agreements are collateralized by certain assets of the Company and contain certain restrictions, including limitations on the amount of distributions that can be made to stockholders, and the disposition or encumbrances of assets, and require the maintenance of certain financial covenants.

At September 30, 2006, there were no borrowings outstanding against these credit facilities. The Company had outstanding $2,160,000 in stand-by letters of credit against the domestic facility and no stand-by letters of credit against the export facility. Of the outstanding letters of credit, $1,250,000 relates to a performance bond on an ongoing international project, $300,000 relates to the Company s building lease and the remainder is guaranteeing performance on certain international projects. No amounts have been drawn against these letters of credit. In addition, at September 30, 2006, the Company had a restricted cash balance of $14,127,000. Of the restricted cash, $12,500,000 related to an advance payment guarantee associated with an ongoing international project and the remainder related to certain bank required deposits related to outstanding letters of credits, bid bonds, and other bank-related fees.

New Accounting Pronouncements:

In December 2004, the FASB issued a FASB Staff Position (FSP) 109-1 Application of FASB 109 to the Tax Deduction on Qualified Production Activities provided by the American Jobs Creation Act of 2004. The new act provides for a special tax deduction on qualified production activities income that effectively reduces the Company s tax rate. The FASB has decided that these amounts should be recorded as a special deduction, and recorded in the year earned. The Company does not believe that the adoption of this FSP statement will have a material impact on the Company s consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN48). FIN 48 is an interpretation of FASB Statement No. 109. Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes and is required to be adopted for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact, if any, that FIN 48 will have on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 Fair Value Measurements , (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements regarding fair value measurement. FAS 157 is effective for the Company beginning April 1, 2008. The Company is currently reviewing the Statement to determine the impact and materiality of its adoption to the Company.

Item 3 - Quantitative and Qualitative Disclosures about Market Risk

The cash accounts for the Company s operations in Singapore, Hong Kong, England, and Abu Dhabi are maintained in Singapore dollars, Hong Kong dollars, pounds sterling and dirham, respectively. Foreign currency accounts are marked to market at current rates that resulted in immaterial translation adjustments to stockholders equity. The gains and losses from foreign currency transactions are included in the statements of operations for the period and were also immaterial. A hypothetical 10% change in foreign currency rates would not have a material impact on the Company s results of operations or financial position.

As of September 30, 2006, the Company held short-term investments consisting of money market funds and U.S. government and government agency bonds. The Company s primary objective with its investment portfolio is to invest available cash while preserving principal and meeting liquidity needs. These investments had an average interest rate of approximately 5.03% and are subject to interest rate risk. As a result of the average maturity and conservative nature of the investment portfolio, a sudden change in interest rates would not have a material adverse effect on the value of these investments.

In fiscal 2003, the Company issued 295,475 warrants in connection with a private placement offering of common stock. As of September 30, 2006, 21,625 of these warrants remain outstanding. These warrants can be exchanged for cash under certain circumstances including a merger, sale or tender offer of the Company, and as such a liability equal to the fair value of the warrants is recorded on the balance sheet. Changes in the fair value of the warrants are recorded as other income (expense). The Black-Scholes value of these warrants can fluctuate significantly based on the current fair market value of the Company s common stock. A 10% change in the fair market value of the Company s common stock, holding other assumptions constant, would have approximately a $100,000 positive or negative impact on earnings.

Item 4 - Controls and Procedures

a) Evaluation of disclosure controls and procedures.

As of the end of the period covered by this report, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, the Company reviewed and evaluated the effectiveness of the Company s disclosure controls and procedures pursuant to Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 as amended (the Exchange Act). Based upon their evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in the reports filed and submitted by it under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission s rules and forms, and to provide reasonable assurance that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

b) Changes in internal controls

There have been no changes in our internal controls over financial reporting as such term is defined in Rule 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934 during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal controls over financial reporting.

PART II OTHER INFORMATION

Item 1- Legal Proceedings

Since February 2004, the Company and L-3 Communications, Inc. had been engaged in litigation in the United States District Court for the District of Massachusetts in Boston over two of the Company s patents United States Patent No. 6,292,533 and No. 5,903,623. In August 2006, the parties entered into a Settlement Agreement that resulted in the dismissal of the underlying suit. This settlement had no material effect on the Company, the value of its intellectual property or the development and sale of any of its products.

The Company is also subject to various legal proceedings and claims that arise in the ordinary course of business. At the present time, it is not possible to predict the outcome of these matters; however, the Company currently believes that resolving these matters will not have a material adverse impact o its financial condition, results of operations or cash flows.

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

At the annual meeting of Stockholders of the Company held on September 14, 2006, the stockholders of the Company (1) elected William E. Odom, Denis R. Brown, Roger P. Heinisch, Hamilton W. Helmer, Ernest J. Moniz, Carl W. Vogt and Anthony R. Fabiano as directors of the Company to hold office for a one-year term and no other nominations were made; and (2) ratified the appointment of Vitale, Caturano and Company, Ltd., independent registered public accountants, as our independent auditors for the fiscal year ending March 31, 2007. The votes were as follows:

	Votes For	Votes Withheld or Opposed	Abstentions
(1) Election of Directors:			
William E. Odom	7,836,383	309,969	

Denis R. Brown	7,821,344	325,008	
Roger P. Heinisch	6,899,076	1,247,276	
Hamilton W. Helmer	7,758,340	388,012	
Ernest J. Moniz	7,841,237	305,115	
Mark Thompson	7,845,117	301,235	
Carl W. Vogt	7,819,781	326,571	
Anthony R. Fabiano	7,749,517	396,835	
(2) Ratification of Vitale, Caturano and Company, Ltd. as independent auditors	8,072,792	39,931	33,629

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Item 6 - Exhibits

(a) **Exhibits**

31.1 Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

The information required by Exhibit Item 11 (Statement re: Computation of Income per Common and Common Equivalent Share) may be found in Footnote No. 4.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned hereunto duly authorized.

AMERICAN SCIENCE AND ENGINEERING, INC.

Date November 9, 2006

/s/ Kenneth J. Galaznik
Kenneth J. Galaznik
Chief Financial Officer and Treasurer

Safe Harbor Statement

The foregoing 10-Q contains statements concerning the Company s financial performance and business operations, which may be considered forward-looking under applicable securities laws.

The Company wishes to caution readers of this Form 10-Q that actual results might differ materially from those projected in any forward-looking statements.

Factors which might cause actual results to differ materially from those projected in the forward-looking statements contained herein include the following: significant reductions or delays in procurements of the Company s systems by the United States and other governments; disruption in the supply of any source component incorporated into AS&E s products; litigation seeking to restrict the use of intellectual property used by the Company; potential product liability claims against the Company; global political trends and events which affect public perception of the threat presented by drugs, explosives and other contraband; global economic developments and the ability of governments and private organizations to fund purchases of the Company s products to address such threats; and the potential insufficiency of Company resources, including human resources, capital, plant and equipment and management systems, to accommodate any future growth and any future delays in federal funding. These and certain other factors which might cause actual results to differ materially from those projected are more fully set forth in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2006 under Item 1A Risk Factors. Please also refer to our other filings with the Securities and Exchange Commission.