Electronic Sensor Technology, Inc
Form 10QSB/A
September 26, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-QSB/A

[X] AMENDMENT NO. 1 TO QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____________ to ___________

Commission file number 333-87224

ELECTRONIC SENSOR TECHNOLOGY, INC.
(Exact Name of Small Business Issuer as Specified in Its Charter)

NEVADA	98-0372780
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1077 Business Center Drive
Newbury Park, California 91320
(Address of Principal Executive Offices)

(805) 480-1994
(Issuer's Telephone Number, Including Area Code)

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

(*) We were not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act during the past 12 months because (i) our registered common stock was registered under the Securities Act during such period and was not registered under the Exchange Act, (ii) we did not have any registration statement that became effective during such period and (iii) we had less than 300 shareholders of record throughout such period. Although we were not required to do so, we voluntarily filed such reports with the Securities and Exchange Commission during such period. On March 24, 2006 we filed a registration statement on Form 10-SB to register our common stock pursuant to the Exchange Act, which we subsequently withdrew pursuant to the request of the Securities and Exchange Commission until our registration statement on Form SB-2, for which an amendment was last filed on May 1, 2006, is declared effective. Once our registration statement on Form SB-2 is declared effective, we plan to file another registration statement on Form 10-SB to register our common stock pursuant to the Exchange Act. Once our registration statement on Form 10-SB is effective, we will be subject to the filing requirements of the Securities Exchange Act.

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date. 54,173,745 shares of common stock as of September 7, 2006

Transitional Small Business Disclosure Format Yes [ ] No [X]

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EXPLANATORY NOTE

We are filing this amended quarterly report on Form 10-QSB/A for the three months ended June 30, 2006 to restate our unaudited consolidated balance sheet at June 30, 2006 and the consolidated statement of operations and the consolidated statement of cash flows for the period ended June 30, 2005 in order to properly reflect the carry forward impact of certain restatements to our financial statements for the interim periods ending March 31, 2005, June 30, 2005, September 30, 2005 and March 31, 2006 and the fiscal year ended December 31, 2005.

The following Items of this amended quarterly report on Form 10-QSB/A for the period ended June 30, 2006 are amended and restated herein:

Part I Financial Information:

- Item 1. Financial Statements--Consolidated Balance Sheet as of June 30, 2006 (unaudited), Consolidated Statements of Operations for the Six Months Ended June 30, 2005 (unaudited), Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2005 (unaudited) and Notes to Consolidated Financial Statements as of June 30, 2006 (unaudited); and

- Item 2. Management Discussion and Analysis of Operations or Plan of Operations.

Part II Other Information:

- Item 6. Exhibits--Exhibits 31.1, 31.2, 32.1 and 32.2--currently-dated certifications from our President and Chief Executive Officer and Treasurer and Vice President of Finance and Administration, as required by Section 302 and 906 of the Sarbanes-Oxley Act of 2002.

The remaining Items are unaffected by the correction in classification, have not been updated from the disclosure originally contained in our quarterly report on Form 10-QSB for the period ended June 30, 2006 filed with the Securities and Exchange Commission on August 16, 2006 and are not reproduced in this Form 10-QSB/A. This amended quarterly report on Form 10-QSB/A for the period ended June 30, 2006 does not reflect events occurring after the filing of the quarterly report on Form 10-QSB filed with the Commission on August 16, 2006, nor does it modify or update the disclosures contained in the quarterly report on Form 10-QSB filed with the Commission on August 16, 2006, other than as described above and to correct typographical errors contained therein.

PART I.
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED BALANCE SHEET
JUNE 30, 2006
(Restated)
(Unaudited)

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents	$ 3,735,141
Certificate of deposit-restricted	250,000
Accounts receivable, net of allowance for doubtful accounts of $17,700	280,149
Prepaid expenses	36,721
Inventories	1,164,020
TOTAL CURRENT ASSETS	5,466,031
DEFERRED FINANCING COSTS, net of amortization of $121,079	607,282
PROPERTY AND EQUIPMENT, net of accumulated depreciation of $935,874	162,950
SECURITY DEPOSITS	12,817
	$ 6,249,079

LIABILITIES AND STOCKHOLDERS' DEFICIT

CURRENT LIABILITIES:	
Accounts payable and accrued expenses	$ 454,726
Credit line borrowings	370,000
Deferred revenues	116,667
Derivative liabilities	4,087,959
TOTAL CURRENT LIABILITIES	5,029,352
CONVERTIBLE DEBENTURES, net of unmortized discount of $5,638,889	1,361,111
TOTAL LIABILITIES	6,390,463
STOCKHOLDERS' DEFICIT:	
Preferred stock, $.001 par value 50,000,000 shares authorized, none issued and outstanding	-
Common stock, $.001 par value, 200,000,000 shares authorized, 54,173,745 issued and outstanding	54,174
Additional paid-in capital	8,516,354
Accumulated deficit	(8,711,912)
TOTAL STOCKHOLDERS' DEFICIT	(141,384)
	$ 6,249,079

See notes to consolidated financial statements

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Six Months Ended June 30,		Three Month June 3
	2006	2005	2006
		(Restated)	
REVENUES	$ 1,154,224	$ 651,652	$ 621,407
COST OF SALES	592,714	375,086	291,122
GROSS PROFIT	561,510	276,566	330,285
OPERATING EXPENSES:			
Research and development	416,144	331,285	204,345
Selling, general and administrative	1,436,961	1,103,030	656,651
TOTAL OPERATING EXPENSES	1,853,105	1,434,315	860,996
LOSS FROM OPERATIONS	(1,291,595)	(1,157,749)	(530,711)
OTHER INCOME AND EXPENSE:			
Other income - derivative	1,683,119	4,263,950	462,922
Other expense - derivative	-	(2,205,642)	-
Gain (loss) on sale of property and equipment	-	9,287	-
Interest expense	(1,416,279)	(34,271)	(685,887)
TOTAL OTHER INCOME AND EXPENSE	266,840	2,033,324	(222,965)
NET INCOME (LOSS)	$ (1,024,755)	$ 875,576	$ (753,676)
Earnings (loss) per share, basic	$ (0.02)	$ 0.02	$ (0.01)
Weighted average number of shares, basic	54,159,945	53,304,475	54,173,745
Earnings (loss) per share, diluted	$ (0.02)	$ (0.02)	$ (0.01)
Weighted average number of shares, diluted	54,159,945	53,304,475	54,173,745

See notes to consolidated financial statements

ELECTRONIC SENSOR TECHNOLOGY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005 (Restated)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (1,024,755)	$ 875,576
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	18,865	5,605
Issuance of shares for services	21,000	-
Amortization of debt discount	1,166,667	-
Amortization of deferred financing costs	103,782	-
Recognition of derivative liabilities	-	2,205,642
Decrease in fair value of derivative liability	(1,683,119)	(4,263,950)
Changes in assets and liabilities:		
Accounts receivable	185,625	(98,020)
Inventories	(224,400)	(12,502)
Prepaid expenses	33,214	(9,361)
Security deposits	-	140
Accounts payable and accrued expenses	(26,072)	46,842
Deferred revenues	(25,000)	(25,000)
Due to related party	-	(60,000)
Interest payable	-	(26,961)
Other current liabilities	-	(2,626)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	(1,454,193)	(1,364,616)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Decrease (increase) in restricted security deposit	668,678	-
Proceeds from sale of property and equipment	-	30,280
Purchase of property and equipment	(69,265)	(77,780)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(559,413)	(47,500)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase (decrease in line of credit	370,000	(200,000)
Repayment of partners' loans payable	-	(110,000)
Proceeds from issuance of common stock	-	3,811,708
NET CASH PROVIDED BY FINANCING ACTIVITIES	370,000	3,501,708
NET INCREASE (DECREASE) IN CASH	(484,780)	2,089,592
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	4,219,921	26,430
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 3,735,141	$ 2,116,022
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for:		
Interest	$ 282,236	$ 40,870
NON-CASH FINANCING ACTIVITIES		
Fair value of derivative liabilities issued in connection with issuance of shares of common stock	$ -	$ -

See notes to consolidated financial statements.

ELECTRONIC SENSOR TECHNOLOGY, INC.
Notes to Financial Statements
(Unaudited)
June 30, 2006

1) BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions to Form 10-QSB and Article 10 of Regulation S-B. Accordingly, they do not include all the information and disclosures required for annual financial statements. These financial statements should be read in conjunction with the consolidated financial statements and related footnotes for the year ended December 31, 2005, included in the Annual Report filed on Form 10-KSB/A for the year then ended.

In the opinion of the management of Electronic Sensor Technology, Inc. (the "Company"), all adjustments (consisting of normal recurring accruals) necessary to present fairly the Company's financial position as of June 30, 2006, and the results of operations and cash flows for the six-month period ending June 30, 2006 have been included. The results of operations for the six-month period ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report filed on Form 10-KSB/A as filed with the Securities and Exchange Commission for the year ended December 31, 2005.

2) BASIS OF CONSOLIDATION

The accompanying financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

3) NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) NATURE OF BUSINESS

The Company develops and manufactures electronic devices used for vapor analysis. It markets its products through distribution channels in over 20 countries.

b) CASH AND CASH EQUIVALENTS

The Company considers highly liquid financial instruments with maturities of three months or less at the time of purchase to be cash equivalents. The Company did not have any cash equivalents at June 30, 2006.

c) LINE OF CREDIT

The Company has a revolving line of credit agreement for borrowings up to $500,000. The line of credit is secured and collateralized with a certificate of deposit in the amount of $250,000. The line of credit had borrowings of $370,000 against it at June 30, 2006. The line of credit expires on March 31, 2007.

d) REVENUE RECOGNITION

The Company records revenue from direct sales of products to end-users when the products are shipped, collection of the purchase price is probable and the Company has no significant further obligations to the customer. Costs of remaining insignificant Company obligations, if any, are

accrued as costs of revenue at the time of revenue recognition. Cash payments received in advance of product shipment or service revenue are recorded as deferred revenue.

e) SHIPPING AND HANDLING

The Company accounts for shipping and handling costs as a component of "Cost of Sales".

f) INVENTORIES

Inventories are comprised of raw materials, work in process, and finished goods. Inventories are stated at the lower of cost or market and are determined using the first-in, first-out method.

g) DEFERRED FINANCING COSTS

Deferred financing costs consist of direct costs incurred by the Company in connection with the issuance of its convertible debentures. The direct costs include cash payments and fair value of warrants issued to the placement agent, which secured the financing. Deferred financing costs are amortized over 48 months using the effective interest rate method.

h) PROPERTY AND EQUIPMENT

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of five years.

i) RESEARCH AND DEVELOPMENT

Research and development costs are charged to operations as incurred and consists primarily of salaries and related benefits, raw materials and supplies.

j) USE OF ESTIMATES

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the recorded amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

k) FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of certain financial instruments, including accounts receivable, accounts payable and accrued liabilities, approximate their carrying values due to the short maturity of these instruments.

l) LONG-LIVED ASSETS

The Company reviews long-lived assets, such as property and equipment, to be held and used or disposed of, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the sum of the expected cash flows, undiscounted and without interest, is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value. At June 30, 2006 no assets were impaired.

6

m) DERIVATIVE LIABILITIES

In June 2005, the Financial Accounting Standard Board issued EITF 05-04. EITF 05-04 addresses the question as to whether liquidated damages pursuant to a registration rights agreement should be combined as a unit with the underlying financial instruments and be evaluated as a single instrument. EITF 05-04 does not reach a consensus on this matter and allows for the treatment as a combined unit (Views A and B) as well as separate freestanding financial instruments (View C). On September 15, 2005, the FASB staff postponed further discussion of EITF 05-04. As of May 31, 2006, the FASB still has not rescheduled EITF 05-04 for further discussion.

In connection with the issuance of a convertible debentures and related warrants, we granted liquidated damages pursuant to a separate registration right agreement. The Company adopted View C of EITF 05-04. Accordingly, the liquidated damages pursuant to this registration right agreement were evaluated as a stand alone financial instrument. This treatment did not have a significant different effect than if the Company would have adopted View A or B, because the classification of the warrants and certain embedded features of the convertible debentures were classified as derivative liabilities. The Company believes that should the FASB staff reach a consensus on EITF 05-04 and select combined treatment (View A or B), the embedded conversion features and the warrants will have to be evaluated as a combined unit with the liquidated damages pursuant to the registration rights agreement, and accordingly, be evaluated as derivative liabilities. The Company does not believe that its measurement of the derivative liabilities under View A or View B would significantly differ from its measurement of the derivative liabilities under View C in these circumstances.

The Company accounts for liquidated damages granted pursuant to registration rights which are not included in a separate registration right agreement as a combined unit with the warrants which are contemporaneously issued with the registration rights pursuant to SFAS 133 "Accounting for Derivative and Hedging Activities" and EITF 00-19.

The Company accounts for its embedded conversion features and freestanding warrants pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", which requires a periodic valuation of their fair value and a corresponding recognition of liabilities associated with such derivatives. The recognition of derivative liabilities related to the issuance of shares of common stock is applied first to the proceeds of such issuance, at the date of issuance, and the excess of derivative liabilities over the proceeds is recognized as other expense in the accompanying consolidated financial statements. The recognition of derivative liabilities related to the issuance of convertible debt is applied first to the proceeds of such issuance as a debt discount, at the date of issuance, and the excess of derivative liabilities over the proceeds is recognized as other expense in the accompanying consolidated financial statements. Any subsequent increase or decrease in the fair value of the derivative liabilities, which are measured at the balance sheet date, are recognized as other expense or other income, respectively.

n) Basic and Diluted Earnings Per Share

Basic earnings per share are calculated by dividing income available to stockholders by the weighted-average number of common shares outstanding during each period. Diluted earnings per share are computed using the weighted average number of common and dilutive common share equivalents outstanding during the period. Dilutive common share equivalents consist of shares issuable upon the exercise of stock options and warrants embedded conversion features (calculated using the reverse treasury stock method). The outstanding options, warrants and shares equivalent issuable pursuant to embedded conversion features amounted to 66,982,944 and 5,576,871 at June 30, 2006 and 2005, respectively. The outstanding options, warrants and shares equivalent issuable pursuant to embedded conversion features and warrants at June 30, 2006 and 2005, respectively, are excluded from the loss per share computation for that period due to their antidilutive effect. The Company adjusted the numerator for any changes in income or loss that would result if the

contract had been recorded as an equity instrument for accounting purposes during the period. However, the Company did not adjust the numerator for interest charges during the period on the convertible debentures because it would have been anti-dilutive.

The following sets forth the computation of basic and diluted earnings per share at June 30:

	2006	2005 (Restated)
Numerator:		
Net income (loss)	$ (1,024,755)	$ 875,576
Net other income (expense) associated with derivative contracts	1,683,119	2,058,308
Net income (loss) for diluted earnings per share purposes	$ (2,707,874)	$ (1,182,732)
Denominator:		
Denominator for basic earnings per share- Weighted average shares outstanding	54,159,945	53,304,475
Effect of dilutive warrants, embedded conversion features and liquidated		

damages	-	-
Denominator for diluted earnings per share- Weighted average shares outstanding	54,159,945	53,304,475
Basic earnings (loss) per share	$ (0.02)	$ 0.02
Diluted earnings (loss) per share	$ (0.02)	$ (0.02)

4) CONVERTIBLE DEBENTURES

During December 2005, we issued in a private offering, $7,000,000 aggregate principal amount of convertible debentures due December 7, 2009. The convertible debentures are convertible at any time on or prior to the maturity date at the option of the debenture holder at a conversion price of $0.4544 and can be redeemed at the lesser of $0.4544 or 90% of the average of the volume weighted average price for the 20 consecutive trading days immediately prior to the conversion date. The Company received $7,000,000 in cash as consideration. The convertible debentures bear interest at 8%, payable in cash or stock, at the Company's option, and are required to be redeemed in 9 equal quarterly payments commencing January 1, 2008, in cash or stock, at the Company's option. If the Company chooses to pay interest on or redeem the debentures in shares of the Company's common stock, rather than in cash, the conversion rate for such stock payment is the lesser of $0.4544 and 90% of the average of the volume weighted average price for the 20 consecutive trading days immediately prior to the interest payment or redemption date, as applicable.

In connection with the issuance of the convertible debentures, the Company issued five-year warrants to purchase 12,130,314 shares of common stock at an exercise price of $0.4761 per share. Furthermore, the Company granted liquidated damages pursuant to a registration rights agreement.

The convertible debentures and related agreements provide, among other things, for:

1) Liquidated damages amounting to 2% per month of the outstanding principal amount, payable in cash or stock, to the debenture holders in the event that a registration statement covering the shares underlying the convertible debentures is not declared effective within 150 days of the date the debentures were issued (although a registration statement covering the shares underlying the convertible debentures has not been declared effective as of June 30, 2006, no claims for liquidated damages have been received from the debenture holders). The liquidated damages are payable in cash monthly or if unpaid, bear interest at 18% per annum. If unpaid by January 1,

2008 and thereafter, they may be converted in shares of common stock at the same prevailing rate as the remaining principal amount of the convertible debentures;

2) Default interest rate of 18% and a default premium of 30% of the principal amount of the debentures, payable in cash or stock. Events of default include, among other things, if a payment, whether cash or stock is not paid on time and cured within three days, if the Company's common stock is not quoted for trading for

at least five trading days, if a registration is not effective within 180 days after December 7, 2005 (although a registration statement covering the shares underlying the convertible debentures has not been declared effective as of June 30, 2006, no claims for liquidated damages have been received from the debenture holders). The default interest rate and the default premium may be converted in shares of common stock at the same prevailing rate as the remaining principal amount of the convertible debentures;

3) A reset feature of the conversion price in the event of a subsequent equity or convertible financing with an effective price lower than the debenture conversion price, whereby the aforementioned variable conversion price of the convertible debentures is adjusted to the new lower effective price of the subsequent equity or convertible financing;

4) A prepayment premium amounting to 30% of the principal balance of the convertible debentures in the event that the Company, at its sole option, prepays the convertible debentures before its due date. The prepayment is payable in cash only; and

5) The warrants require that the Company reimburse any holder of a warrant in respect of any trading loss resulting from the failure of the Company to timely deliver shares issued pursuant to the exercise of warrants. This compensation may be paid in shares of common stock or cash. The exercise price of the warrants, which is $0.4761 per share at the date of the agreement, may be reduced to $0.001 per share, at a monthly rate $0.03 per share if the registration statement we are required to file at the request of the warrant holders with respect to the common stock underlying the warrants is not declared effective within six months of the date of issuance of the warrants.

In connection with the issuance of the convertible debentures, we issued 485,213 warrants to a company in partial consideration for financial advisory services. The warrants have the same terms as those granted to the debenture holders. The fair value of the warrants (at the time of their issuance) and related professional fees pertaining to the issuance of the convertible debentures have been recorded as deferred financing costs. The deferred financing costs are amortized over the term of the convertible debentures. See Note 5 - Derivative Liabilities for further information on the accounting and measurement of the derivative liabilities associated with the issuance of the convertible debentures and related agreements.

5) DERIVATIVE LIABILITIES

FEBRUARY 2005 TRANSACTION

During February 2005, we recognized derivative liabilities of approximately $6.0 million pursuant to the issuance of 3,985,000 freestanding warrants and granting certain registration rights which provided for liquidated damages in the event of failure to timely register the shares in connection with the issuance of shares of common stock and the related warrants.

There are no liquidated damages provided for untimely effectiveness of the registration of shares pursuant to piggy-back registration rights. The Company intends to register all shares and warrants pursuant to the subscriber piggy-back registration rights.

The agreement pursuant to which the warrants were issued and the registration rights were granted provided for liquidated damages pursuant to demand registration rights in the event of a failure to timely register the shares after demand is made by the holders of a majority of the warrants and shares of common stock issued

pursuant to such agreement. The demand registration rights of these investors are such that if the Company fails to register the investors shares, including the shares underlying the warrants, the Company will pay a cash penalty amounting to 1% of the amount invested per month, $39,850, if the registration statement is not filed within 60 days of demand or is not declared effective within 150 days from the date of initial filing. The maximum liability associated with the liquidated damages amounts to 49% of the gross proceeds associated with the issuance of shares of common stock, which amounts to $1,952,650. The percentage of liquidated damages amounts to the difference between 60 months, which is the inherent time limitation under which the underlying shares would be free-trading (three year term and two year holding period) and 11 months, which is the grace period for registering the shares (no demand permitted for four months, two-month period to file and five-month period to become effective), times the penalty percentage, which is 1%. The Company believes that the likelihood that it will incur any liabilities resulting from the liquidated damages pursuant to the demand registration rights is remote considering that it will register the shares and the shares underlying the warrants pursuant to piggy-back registration rights, which do not contain liquidated damages.

Because the registration rights were not granted under a separate registration rights agreement, we considered those features in evaluating whether the associated warrants should be classified as derivative liabilities. Considering that the amount of the maximum penalty is 49%, the Company cannot conclude that that this discount represents a reasonable approximation of the difference between registered and unregistered shares under paragraph 16 of EITF 00-19. Accordingly, the warrants issued in connection with the February 2005 transaction are considered derivative liabilities.

The fair value of the warrants issued in connection with the February 2005 transaction at the date of issuance of the warrants and the granting of registration rights and at June 30, 2006 is as follows:

	At issuance	At June 30, 2006
Freestanding warrants	$6,017,350	$ 0

The Company used the following assumptions, using the Black Scholes Model to measure the identified derivatives as follows:

Freestanding warrants

	At issuance	At June, 30, 2006
Market price:	$2.40	$0.19
Exercise price:	$1.00	$1.00
Term:	3 years	1.58 years
Volatility:	39%	39%
Risk-free interest rate:	2.78%	5.13%
Number of warrants:	3,985,000	3,985,000

December 2005 Transaction

During December 2005, in connection with the issuance of the convertible debentures, the Company determined that the conversion feature of the convertible debentures represents an embedded derivative since the debentures are convertible into a variable number of shares upon conversion. Because there is no explicit number of shares that are to be delivered upon satisfaction of the convertible debentures and that there is no cap on the number of shares to be delivered upon expiration of the contract to a fixed number, the Company is unable to assert that it had sufficient authorized and unissued shares to settle its obligations under the convertible debentures and therefore, net-share settlement is not within the control of the Company. Accordingly, the convertible debentures are not considered to be conventional debt under EITF

00-19 and the embedded conversion feature must be bifurcated from the debt host and accounted for as a derivative liability.

The embedded conversion features are as follows:

Default Interest Rate and Premium: The default interest rate is 18% while the stated rate of the convertible debentures is 8%. Additionally, the Company is liable to pay for a premium amounting to 30% of the principal amount of the convertible debentures in the event of default. This embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with similar credit quality. Furthermore, the default interest rate may be triggered by certain events of defaults which are not related to credit-risk-related covenants or the Company's creditworthiness (e.g., if a registration statement is not effective within 180 days after December 7, 2005). The default provisions are effective, at the holders' option, upon an event of default. Although a registration statement covering the shares underlying the convertible debentures has not been declared effective as of June 30, 2006, the debenture holders have not notified the Company of an election to accelerate the debentures, nor have any claims for liquidated damages been received.

Reset Feature Following Subsequent Financing: The debenture provides for a reset feature of the conversion price in the event of a subsequent equity or convertible financing with an effective price lower than the debenture conversion price, whereby the aforementioned variable conversion price of the convertible debentures is adjusted to the new lower effective price of the subsequent equity or convertible financing , which amounts to 10% of the shares issuable pursuant to the convertible debentures, which is the effective discount to market value we would offer in the event we provide for a subsequent private placement financing. This reset does not constitute a standard anti-dilution provision and is indexed to an underlying other than an interest rate or credit risk.

Conversion Rate: The convertible debentures are convertible at a variable conversion price, which is the lesser of $0.4544 or 90% of the average of the volume weighted average price for the 20 consecutive trading days immediately prior to the conversion date. The convertible debentures are convertible at any time on or prior to the maturity date at the option of the debenture holder. The implied conversion embedded feature amounts to a conversion discount of 10% to market.

The Company believes that the aforementioned embedded derivatives meet the criteria of SFAS 133, including Implementation issue No. B16 and EITF 00-19, when appropriate, and should be accounted for as derivatives with a corresponding value recorded as a liability.

In connection with the issuance of the convertible debentures, the Company issued warrants to the debenture holders. The related warrants require that the Company reimburse any holder of a warrant in respect of any trading loss resulting from the failure of the Company to timely deliver shares issued pursuant to the exercise of warrants. This compensation may be paid in shares of common stock or cash. Accordingly, we have accounted for such warrants as derivatives.

In connection with the issuance of the convertible debentures, the Company granted liquidated damages pursuant to a registration rights agreement. The liquidated damages amount to 2% per month of the outstanding principal amount, payable in cash or stock, to the debenture holders in the event that a registration statement covering the shares underlying the convertible debentures is not declared effective within 150 days of the date the debentures were issued (although a registration statement covering the shares underlying the convertible debentures has not been declared effective as of June 30, 2006, no claims for liquidated damages have been received from the debenture holders). The liquidated damages are payable in cash monthly or if unpaid, bear interest at 18% per annum. If unpaid by January 1, 2008 and thereafter, they may be converted in shares of common stock at the same prevailing rate as the remaining principal amount of the convertible debentures. Pursuant to View C of EITF 05-04 the liquidated damages are accounted for as a separate derivative. While the liquidated damages may be settled in stock if unpaid

11

by January 1, 2008, the Company determined that it was more likely that they would be paid in cash shortly after their occurrence and has used such assumption in measuring the fair value of the derivative liability associated with the liquidated damages. The maximum liability associated with the liquidated damages amount to 38% of the gross proceeds associated with the issuance of the convertible debentures, which amounts to $2,660,000.

Additionally, because there is no explicit number of shares that are to be delivered upon satisfaction of the convertible debentures, the Company is unable to assert that it had sufficient amount of authorized and unissued shares to settle its obligations under the convertible debentures. Accordingly, all of the Company's previously issued and outstanding instruments, such as warrants, as well as those issued in the future, would be classified as liabilities as well, effective with the issuance of the convertible debentures and until the Company is able to assert that it has a sufficient amount of authorized and unissued shares to settle its obligations under all outstanding instruments. At the date of the issuance of the convertible debentures, the Company had 1,941,871 warrants outstanding which were classified as derivatives.

The fair value of the derivative liabilities at the date of issuance of the convertible debentures and at June 30, 2006 are as follows:

	At Issuance	At June 30, 2006
Freestanding warrants	$ 3,532,348	$ 504,621
Embedded conversion features	3,463,542	3,390,838
Liquidated damages	192,500	192,500
Other outstanding warrants	143,268	0

The Company used the following methodology to value the embedded conversion features and liquidated damages:

It estimated the discounted cash flows payable by the Company, using probabilities and likely scenarios, for event of defaults triggering the 30% penalty premium and 18% interest accrual, subsequent financing reset, and liquidated damages, such as the untimely effectiveness of a registration statement. If the additional cash consideration was payable in cash or stock, it determined the amount of additional shares that would be issuable pursuant to its assumptions. The Company will revisit the weight of probabilities and the likelihood of scenarios at each of the measurement dates of the derivative liabilities, which are the balance sheet dates.

The Company used the following assumptions to measure the identified derivatives, using the Lattice valuation model, as follows:

Embedded conversion features

	At issuance	At June 30, 2006
Market price:	$ 0.4880	$ 0.19
Conversion price:	$ 0.4544	$ 0.17
Term:	4 years	3.42 years
Volatility:	39%	39%
Risk-free interest rate:	4.39%	5.13%

Freestanding warrants

The derivative liability amounts to the fair value of the warrants issuable upon exercise, assuming that the underlying shares will not be timely registered. We computed the fair value of this embedded derivative using the Black Scholes valuation model with the following assumptions:

	At issuance	At June 30, 2006
Market price:	$ 0.488	$ 0.19
Exercise price:	$ 0.4761	$ 0.34
Term:	5 years	4.42 years
Volatility:	39%	39%
Risk-free interest rate:	4.39%	5.13%

We adjusted the effective exercise price to reflect the contractual adjustment assuming that the warrants will most likely be registered during the fourth quarter of 2006.

Liquidated damages

The liquidated damages, payable in cash, are valued using the weighting probabilities and likely scenarios to estimate the amount of liquidated damages and were valued at approximately $192,500 at the date of the grant of the registration rights and at June 30, 2006.

The aggregate fair value of the derivative liabilities associated with the warrants, embedded conversion features, and liquidated damages in connection with the issuance of the convertible debentures and related agreements amounted to approximately $7.05 million at the date of issuance which exceeded the principal amount of the convertible debentures by approximately $50,000. The Company recognized $7,000,000 as debt discount and the excess amount has been recorded as other expenses. Additionally, approximately $136,000 of the fair value of the warrants was recorded as deferred financing costs.

The aggregate fair value of all derivative liabilities upon issuance of the various debt and equity instruments amounted to $13.3 million, of which $10.7 million was allocated to the net proceeds of the issuance of common stock and convertible debentures, $2.4 million was allocated to other expenses and approximately $136,000 was allocated to deferred financing costs.

The decrease in fair value of the derivative liabilities between measurement dates, which are the date of issuance of the various debt and equity instruments and the balance sheet date, which is June 30, 2006 amounted to approximately $8.7 million and has been recorded as other income.

6) RESTATEMENT OF INTERIM FINANCIAL STATEMENTS

After amending our financial statements for the interim periods ended March 31, 2005, June 30, 2005, September 30, 2005 and March 31, 2006; and for the year ended December 31, 2005 to properly account for certain liquidated damages associated with the $3.985 million private placement of warrants and shares of our common stock, and the $7,000,000 private offering of convertible debentures and warrants, management determined that the carry forward impact of some of the restatements were not properly reflected in the financial statements for the interim period ended June 30, 2006. Proper carry forward of the restated amounts would affect following figures in our quarterly financial statements:

Balance sheet: decrease in deferred financing costs ($101,894), accumulated deficit ($10,568,028); and an increase in additional paid-in capital ($10,466,134).

Statement of income for the six-month period ended June 30, 2005: decrease in other expense-derivatives ($92,860), earnings per share-diluted ($0.03); and an increase in net income ($92,860), earnings per share-basic ($0.01).

Statement of cash flows for the six-month period ended June 30, 2005: decrease in recognition of derivative liabilities ($92,860); and an increase in net income ($92,860).

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

You should read the following discussion and analysis of our financial condition and results of operations together with our interim financial statements and the related notes appearing at the beginning of this report. The interim financial statements and this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 2005 and the related Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are contained in our Annual Report on Form 10-KSB/A filed with the Securities and Exchange Commission.

The following discussion and other parts of this Form 10-QSB contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as "anticipates," "expects," "believes," "plans," and similar terms. Our actual results could differ materially from any future performance suggested in this report as a result of factors, including the risk factors discussed in Exhibit 99.1 hereto, which is incorporated herein by reference, and factors discussed elsewhere in this report and in our Annual Report on Form 10-KSB/A for the fiscal year ended December 31, 2005. All forward-looking statements are based on information currently available to the Company and we assume no obligation to update such forward-looking statements, except as required by law. Service marks, trademarks and trade names referred to in this Form 10-QSB are the property of their respective owners.

OVERVIEW

The Company is engaged in the development, manufacturing, and sales of a patented product called zNose(R); a device designed to detect and analyze chemical odors and vapors, or, in other words, an electronic "nose." We believe the zNose(R) is superior to other electronic "noses" because of its speed, specificity and sensitivity. The zNose(R) is capable of measuring and quantifying the chemistry of any compound, fragrance, vapor or odor with parts per trillion sensitivity in 10 seconds. We also believe the zNose(R) has the unique ability to quantify and speciate the subject chemical vapor by creating visual olfactory images. This enables the measured odor or vapor to be easily identified by the user.

We believe that our products will have broad applications in the homeland security, environmental and laboratory instrumentation markets. The Company is involved in ongoing product research and development efforts in that regard. The Company has also concentrated its efforts on further product development, testing and proving and assembling a sales and support organization.

The Company was originally incorporated under the laws of the state of Nevada as "Bluestone Ventures, Inc." on July 12, 2000. From inception until February 1, 2005, we engaged in the business of acquiring, exploring and developing certain mining properties in Ontario, Canada. Upon acquisition of Electronic Sensor Technology, L.P. ("ELP"), we abandoned our mining business and adopted ELP's business of developing, manufacturing and selling the vapor analysis device. Prior to the closing of the mergers, as discussed in the footnotes to the financial statements, on January 26, 2005, we changed our name to "Electronic Sensor Technology, Inc."

Our executive offices are located at 1077 Business Center Circle, Newbury Park, California 91320 and our telephone number is (805) 480-1994.

CRITICAL ACCOUNTING POLICIES

The Company records revenue from direct sales of products to end-users when the products are shipped, collection of the purchase price is probable and the Company has no significant further obligations to the customer. Costs of remaining insignificant Company obligations, if any, are accrued as costs of revenue at the time of revenue recognition. Cash payments received in advance of product or service revenue are recorded as deferred revenue.

15

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the recorded amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company reviews long-lived assets, such as property and equipment, to be held and used or disposed of, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the sum of the expected cash flows, undiscounted and without interest, is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value. At June 30, 2006 no assets were impaired.

We account for liquidated damages pursuant to Emerging Issue Task Force ("EITF") 05-04, View C, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument", subject to EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". Pursuant to EITF 05-04, View C, liquidated damages payable in cash or stock are accounted for as a separate derivative, which requires a periodical valuation of its fair value and a corresponding recognition of liabilities associated with such derivative. We also account for our embedded conversion features and freestanding warrants pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", which requires a periodic valuation of their fair value and a corresponding recognition of liabilities associated with such derivatives. The recognition of derivative liabilities related to the issuance of shares of common stock is applied first to the proceeds of such issuance, at the date of issuance, and the excess of derivative liabilities over the proceeds is recognized as other expense in the accompanying consolidated financial statements. The recognition of derivative liabilities related to the issuance of convertible debt is applied first to the proceeds of such issuance as a debt discount, at the date of issuance, and the excess of derivative liabilities over the proceeds is recognized as other expense in the accompanying consolidated financial statements. Any subsequent increase or decrease in the fair value of the derivative liabilities is recognized as other expense or other income, respectively. The valuation of such derivatives requires significant judgment. We exercise our judgment in determining the maximum liabilities associated with such derivatives as well as the expected volatility related to their fair value. We base our estimate of the maximum liabilities on our interpretation of the agreements related the derivatives.

PLAN OF OPERATIONS

Over the course of the next 12 months, we intend to execute our business plan and focus our business development efforts in the following key areas:

- By diversifying our product offerings to enhance the usefulness of our solutions for customers who will have already adopted one or more products;

- By enhancing our product lines and developing new products to attract new customers; and

- By developing partnering relationships with wide-ranging sales and distribution channel leaders already serving our vertical market space in a way that assists them in developing new revenue streams and opportunities through improved technical and sales support and customer services.

RESULTS OF OPERATIONS

The following tables sets forth, in $ and as a percentage of revenues, certain items included in our Income Statements (see Financial Statements and Notes) for the periods indicated:

	SIX MONTHS ENDED JUNE 30	
	2006	2005
		(Restated)
STATEMENTS OF OPERATIONS DATA:		
Revenues	100%	100%
Cost of Sales	51%	58%
Gross Profit	49%	42%
Operating Expenses	161%	220%
(Loss) From Operations	(112%)	(178%)
Other Income	23%	312%
Net Income (loss)	(89%)	134%

SIX MONTHS ENDED JUNE 30, 2006 COMPARED TO SIX MONTHS ENDED JUNE 30, 2005

Revenues are derived from product sales and product support services. For the six months ended June 30, 2006 revenues were $1,154,224, compared to $651,652 in 2005. The 77% increase in revenues results mainly from an increase in the number of zNose(R) units shipped from 19 units in 2005 to 32 units in 2006 for the six-month period. Also contributing to the increase in revenues was a slight increase in sales from product support services.

Cost of Sales consist of product costs and expenses associated with product support services. For the six-month period, cost of sales was $592,714 for 2006 as compared to $375,086 in 2005. The increase in cost of sales was due to a greater volume of products shipped in the current year as compared to last year. The improvement in cost of sales as a percent of revenues, from 58% of 2005 revenues to 51% of 2006 revenues, is attributed to production efficiencies and production economies of scales resulting in overhead being spread over a greater volume of production - all of which contributed to a lower manufacture cost per unit.

Gross profit was $561,510 for the six months ending June 30, 2006, compared to $276,566 for the same period in 2005. The increase in gross profit was due to greater sales volume, and an increase in high-margin support services revenues over 2005. The improvement in 2006 gross profit from 42% in 2005 to 49% of revenues is attributed to greater labor utilization, which improved labor productivity and lowered the direct labor cost per manufactured unit.

Research and Development costs for the first six months of 2006 were $416,144 versus $331,285 for 2005. The increase of $84,859 in current year expenditures over 2005 were mainly for greater personnel related expenses incurred for enhancement of existing products and development of the Model 4300, the company's newest zNose(R) product that was introduced to market in June 2006.

Selling, General and Administrative expenses for the six months ending June 30, 2006 were $1,436,961, compared to $1,103,030 for 2005. The $333,931 increase was due to increased staffing required to support the growth of the company, incurrence of necessary expenses associated with being a public company, expansion of marketing activities including increased personnel staffing and participation in a greater number of industry trade shows and conferences.

Interest expense for the first six months of 2006 was $1,416,279, as compared to $34,271 in 2005. The increase in interest expense is primarily due to the amortization of debt discount and stated interest associated with our $7,000,000 convertible debentures, which were issued in December 2005.

Other income-derivatives primarily consist of the decrease in the fair value of derivative liabilities between the measurement dates. The increase in other income during the six-month period ending June 30, 2006 when compared to prior period is primarily attributable to a decrease in the quoted price of our common stock. Please refer to Note 5

of our accompanying financial statements for further explanation of the origin and nature of such income. We are unable to determine whether we will record further decreases in the fair value of derivative liabilities in the foreseeable future, which would be recorded as other income-derivatives. Such decreases would be generally triggered by a decrease in the fair value of our stock price, upon satisfaction of liquidated damages pursuant to registration rights, or, possibly, upon satisfaction of our convertible debentures.

Other expense-derivatives primarily consist of the recognition of derivative liabilities we issued during the three-month period ended March 31, 2005. No derivatives were issued during the three-month period ended June 30, 2005 nor were any derivatives issued in 2006. Please refer to Notes 5 of our accompanying financial statements for further explanation of the origin and nature of such expenses.

LIQUIDITY AND CAPITAL RESOURCES

For the six-month period, net cash used by the company for operating activities were $1,454,193 and $1,364,616 for 2006 and 2005 respectively. Cash used in the first six months of 2006 was comprised of the net loss for the period of $1,024,755, less net non-cash items (including depreciation and amortization expenses of $18,865, issuance of common shares for services of $21,000, amortization of debt discount of $1,166,667, amortization of deferred financing costs of $103,782, less decrease in fair value of derivative liability of $1,683,119) of $372,805 minus the net change in operating assets and liabilities of $56,633. Cash used in operations during the same six months of 2005 was comprised of the net income for the period of $875,576, less net non-cash expenses of $2,052,703 (including depreciation and amortization expenses of $5,605, recognition of derivative liabilities of $2,205,642, less decrease in fair value of derivative liability of $4,263,950), less the net change in operating assets and liabilities of $187,488.

Investing activities provided cash of $599,413 in the first six months of 2006 and used $47,500 during the same period in 2005. Cash of $69,265 in 2006 and $77,780 in 2005 were used to purchase of capital equipment. In 2005, $30,280 was received from the sales of property and equipment. Whereas in 2006, $668,678 was provided due to a reduction in the amount of collateral required for the company's line of credit.

Cash provided from financing activities for the first six months of 2006 consisted of $370,000 from an increase in the line of credit the company has in place with its bank. The funds from the credit line were used for operating expenses. In 2005, financing activities provided cash of $3,501,708 primarily from the issuance of common stock in February.

On June 30, 2006 the company's cash (including cash equivalents) was $3,735,141, compared to $1,209,424 on June 30, 2005. The company had a working capital on June 30, 2006 of $436,679. The working capital includes $4,087,959 for derivative liabilities - excluding this amount from current liabilities, the company's working capital would be $4,524,638. The company's working deficit at June 30, 2005 was $1,220,398 - excluding derivative liabilities of $1,753,400, working capital would be $533,011.

The company has a credit facility in place with East West Bank for $500,000. The line of credit had borrowings of $370,000 against it at June 30, 2006. The funds from the line of credit was used for operating expenses. The line of credit expires on March 31, 2007.

Although the company possesses a bank operating line of credit, there can be no assurance that these proceeds will be adequate for our future capital needs. There can be no assurance that any required or desired financing will be available through any other bank borrowings, debt, or equity offerings, or otherwise, on acceptable terms. If future financing requirements are satisfied through the issuance of equity securities, investors may experience significant dilution in the net book value per share of common stock and there is no guarantee that a market will exist for the sale of the company's shares.

The company's primary capital needs are to fund its growth strategy, which includes a sales and marketing staff to support the marketing, advertising and selling of the zNose(R) family of chemical detection products, increasing

distribution channels both in the domestic and foreign markets, introducing new products, improving existing product lines and development of a strong corporate infrastructure.

SEASONALITY AND QUARTERLY RESULTS

We do not foresee any seasonality to our revenues or our results of operations.

INFLATION

Although we currently use a limited number of sources for most of the supplies and services that we use in the manufacturing of our vapor detection and analysis technology, our raw materials and finished products are sourced from cost-competitive industries. While prices for our raw materials may vary significantly based on market trends, we do not foresee any material inflationary trends for our product sources.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

PART II
OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibit No.	Description
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act.
31.2	Certification of Principal Financial and Accounting Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act.
32.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) or 15d-14(b) of the Exchange Act and 18 U.S.C. 1350.

32.2	Certification of Principal Financial and Accounting Officer Pursuant to Rule 13a-14(b) or 15d-14(b) of the Exchange Act and 18 U.S.C. 1350.
99.1	Risk Factors (previously filed).

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized.

ELECTRONIC SENSOR TECHNOLOGY, INC.

Dated September 26, 2006

By: /s/ Teong C. Lim

Name: Teong C. Lim
Title: President and Chief Executive Officer
(Principal Executive Officer)

Dated September 26, 2006

By: /s/ Francis Chang

Name: Francis Chang
Title: Secretary, Treasurer
and Vice President of
Finance and Administration
(Principal Accounting Officer)