Electronic
Sensor
Technology

ANNUAL REPORT

2007

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DESCRIPTION OF BUSINESS

In this annual report, references to the "company," "we," "our," or "us" refers to Electronic Sensor Technology, Inc., a Nevada corporation.

We are engaged in the development, manufacture, and sale of a patented product we call zNose®, a device designed to detect and analyze chemical odors and vapors, or, in another words, an electronic "nose". We believe the zNose® is superior to other electronic "noses" because of its speed, specificity and sensitivity. The zNose® identifies the chemical makeup of any fragrance, vapor or odor. The zNose® does this by creating a visual image of the fragrance, vapor or odor that it detects, so that the user of the zNose® may easily identify the fragrance, vapor or odor.

We believe that our products have broad applications in the homeland security, analytical instrumentation/quality control, and environmental monitoring and detection markets. We are involved in ongoing product research and development efforts in that regard. We have also concentrated our efforts on further product development, testing and proving, and continuing to expand our sales and support organization.

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

HISTORY AND BACKGROUND

Electronic Sensor Technology, Inc. was originally incorporated under the laws of the state of Nevada as Bluestone Ventures Inc. on July 12, 2000. From the date of its incorporation until February 1, 2005, Bluestone Ventures was in the business of acquiring and exploring potential mineral properties in Ontario, Canada. The company's name was changed to "Electronic Sensor Technology, Inc." on January 26, 2005 in connection with the acquisition of two corporations that had together owned Electronic Sensor Technology, L.P. Since the acquisition of Electronic Sensor Technology, L.P., our business has been the development, manufacture and sale of instruments that detect and analyze vapors and odors. The company has abandoned its mining exploration business.

Overview of Past Operations of Electronic Sensor Technology, L.P.

Electronic Sensor Technology, L.P. was formed in 1995 to develop and manufacture, the zNose®, an advanced technology in chemical vapor detection and analysis. In 1999, Electronic Sensor Technology, L.P. completed beta testing of its products and commenced commercial sales to the analytical instrumentation/quality control market as well as the homeland security market.

Electronic Sensor Technology, L.P. Acquisition

On February 1, 2005, pursuant to the terms of an Agreement and Plan of Merger by and among Electronic Sensor Technology, Inc., Amerasia Technology, Inc., holder of approximately 55% of the partnership interests of Electronic Sensor Technology, L.P., L&G Sensor Technology, Inc., holder of approximately 45% of the partnership interests of Electronic Sensor Technology, L.P., Amerasia Acquisition, a wholly-owned subsidiary of Electronic Sensor Technology, Inc., and L&G Acquisition, a wholly-owned subsidiary of Electronic Sensor Technology, Inc., Electronic Sensor Technology, Inc., acquired 100% of the outstanding equity partnership interest of Electronic Sensor Technology, L.P. Under the Agreement and Plan of Merger:

(i) Amerasia Technology merged with and into Amerasia Acquisition such that Amerasia Technology became a wholly-owned subsidiary of Electronic Sensor Technology, Inc.;

(ii) L&G Sensor Technology merged with and into L&G Acquisition such that L&G Sensor Technology became a wholly-owned subsidiary of Electronic Sensor Technology, Inc.;

(iii) as a result of the mergers of (i) and (ii), Electronic Sensor Technology, Inc. indirectly acquired the partnership interests of Electronic Sensor Technology, L.P.; and

(iv) Electronic Sensor Technology, Inc. issued 20,000,000 shares of its common stock to the shareholders of Amerasia Technology and L&G Sensor Technology.

In November 2004, Electronic Sensor Technology, L.P. sold $200,000 in limited partnership interests to certain bridge investors. Concurrent with the mergers, these limited partnership interests were directly exchanged into 200,000 shares of common stock of Electronic Sensor Technology, Inc. and warrants to purchase 200,000 shares of common stock of Electronic Sensor Technology, Inc. at $1.00 per share.

In connection with the mergers, Electronic Sensor Technology, Inc. entered into Subscription Agreements with certain investors on January 31, 2005. Under these Subscription Agreements, Electronic Sensor Technology issued and sold in a private placement 3,985,000 shares of its common stock and warrants to purchase 3,985,000 shares of common stock at $1.00 per share to certain investors for gross proceeds of $3,985,000, which were received on February 1, 2005. Electronic Sensor Technology received net proceeds of approximately $3,821,000 less fees, including counsel fees for the investors and Electronic Sensor Technology, L.P. of approximately $164,000.

Immediately following the mergers and the private placement, on February 1, 2005 there were 53,968,471 shares of Electronic Sensor Technology common stock outstanding, of which (i) shareholders of Bluestone Ventures prior to the mergers and the private placement held 26,988,279 shares (approximately 50.0% of our common stock), (ii) the shareholders of Amerasia Technology and L&G Sensor Technology prior to the mergers and the private placement held 22,783,471 shares (approximately 42.2% of our common stock) and (iii) investors in the private placement occurring on February 1, 2005 and the bridge investors as a group held 4,185,000 shares (approximately 7.8% of our common stock). The total outstanding interests of Electronic Sensor Technology, L.P. were exchanged for 20,000,000 shares of Electronic Sensor Technology, Inc. In addition, 2,783,279 shares of Electronic Sensor Technology, Inc. were distributed to pre-merger shareholders of Amerasia Technology and L&G Sensor Technology in exchange for the cancellation of debt owed to such shareholders, at a conversion rate of $1.00 per share. The conversion rate of $1.00 per share was established immediately preceding the merger through the private placement of 3,985,000 shares of common stock at $1.00 per share and the conversion of a $200,000 equity advance to Electronic Sensor Technology, L.P. for 200,000 shares of Electronic Sensor Technology common stock. The transaction price of $1.00 per share was established by arms length negotiation between the former management of Bluestone Ventures and Electronic Sensor Technology, L.P. (now management of Electronic Sensor Technology, Inc.) in December 2004. As a condition to the merger transactions, Bluestone Ventures agreed to raise not less than $3,000,000 of new equity capital in a private placement offering. In determining to proceed with the merger transactions, management of Electronic Sensor Technology, L.P. (now management of Electronic Sensor Technology, Inc.) weighed the expected cash balance of Bluestone Ventures after giving effect to the private placement offering discussed above and the mergers against the overall equity ownership of Electronic Sensor Technology, Inc. post-merger that would be held by the former owners of Electronic Sensor Technology, L.P. (i.e., the former owners of Electronic Sensor Technology, L.P. were willing to give up 57.8% of Electronic Sensor Technology, L.P. for not less than $3,000,000 in cash). While management of Electronic Sensor Technology, L.P. (now management of Electronic Sensor Technology, Inc.) was not privy to the valuation methodology used by management of Bluestone Ventures in establishing a transaction price of $1.00 per share, management of Electronic Sensor Technology, L.P. (now management of Electronic Sensor Technology, Inc.) assumes that management of Bluestone Ventures and its advisors used one or more traditional valuation methodologies.

Following the mergers we assumed as our principal operations the operations of Electronic Sensor Technology, L.P. and the prior operations of Bluestone Ventures were terminated.

INDUSTRY OVERVIEW

Although there are a vast number of applications for the zNose® product, we believe that the most significant demands for our product will be in three general market categories - homeland security, analytical instrumentation/quality control and environmental monitoring and detection.

Homeland Security. According to published sources, the homeland security market is a multi-billion dollar market and is projected to remain as such in the foreseeable future. We believe that detection and analysis of chemical compounds will aid greatly in various homeland security efforts including:

- Cargo Containers. Over 22.5 million cargo containers arrive in the U.S. every year and only a fraction of them are being inspected by the U.S. Customs Department. We believe cargo container security will become a top priority with the U.S. government.

- Airports. Our zNose® products may be used to complement existing x-ray and bomb detection technologies.

- Drug Interdiction. The zNose® has been used to detect contraband, including illicit controlled substances along U.S. borders.

- Building Security. zNose® technology can be applied for continuous and real-time chemical detection and to monitor the air in buildings and in confined spaces. Detecting hazardous gases and poisonous chemical agents such as sarin, VX explosives, and contrabands for security and environmental safety purposes are the main concerns for various government and commercial buildings, as well as military facilities.

Analytical Instrumentation/Quality Control. The zNose® has been serving the chemical vapor analysis needs in various manufacturing industries. We estimate that the market for products such as zNose® will exceed $50 million during the next few years. The zNose® has been used for a host of applications relating to analysis and quality control such as:

- screening incoming raw materials;

- checking ingredients in processed food and pharmaceutical products;

- inspecting packaging materials and finished goods; and

- detecting hazardous gas leaks in chemical plants.

Environmental Monitoring and Detection. The zNose® has been serving rapid on-location needs in detection and monitoring of toxic chemicals in the water for environmental protection purposes. The zNose® was used by the China Environmental Protection Agency (China EPA) to detect and monitor toxic flows in a river caused by a chemical spill after a chemical plant explosion in northeastern China. This industrial accident contaminated the major water sources located near the plant. The zNose® is also used by the China Environmental Protection Agency (EPA) to determine the safety of drinkable water on a near real-time basis.

CONVENTIONAL ELECTRONIC NOSE TECHNOLOGY

Conventional electronic noses are unable to meet the needs of the market because of their fundamental construction. They are not able to identify fragrances, vapors and odors with an acceptable degree of specificity and preciseness. In addition, conventional electronic noses require sophisticated computer software in order for its chemical analyses to be recognized. This type of electronic nose is therefore not acceptable for use in scientific measurement.

THE ZNOSE® SOLUTION

Speed, precision and versatility are the key characteristics of the zNose® product. The zNose® has been developed to replace the conventional electronic nose. The zNose® operates as quickly as a conventional electronic nose while delivering the precision and accuracy of a much more expensive instrument. The zNose® has advanced chemical analysis technology by performing vapor analysis within 10 seconds. Early models of the zNose® have been tested by the U.S. Environmental Protection Agency under Environmental Technology Verification program and by the Office of National Drug Control Policy for drug interdiction. Tests have also been performed at the Midwest Research Institute's Surety Laboratory in Kansas City and at the U.S. Army Dugway Proving Ground in Utah with respect to the effectiveness of the zNose® in detecting chemical agents such as sarin gases. The zNose® is currently approved for purchase through the General Services Administration pre-approved procurement program.

Our VaporPrint® imaging ability is another major advantage of the zNose® product. VaporPrint® allows the user of the zNose® to see a visual image of the makeup of a particular fragrance, vapor or odor within 10 seconds. In addition, VaporPrint®

can produce high-resolution visual images of odor intensity. VaporPrint® images are displayed on a laptop computer screen and are recorded on the hard drive of the laptop computer.

OUR PRODUCTS

zNose®

The zNose® is essentially a vapor detector that uses a sensor based on Surface Acoustic Wave technology. Basically, the zNose® "inhales" a particular fragrance, vapor or odor. The fragrance, vapor or odor is carried up through a column and the chemicals making up the fragrance, vapor or odor condense on the crystal surface of the sensor in the zNose®. This condensation on the sensor causes a change in what is called the "fundamental acoustic frequency" of the crystal surface. It is this change in fundamental acoustic frequency that allows the zNose® to determine the chemical makeup of the fragrance, vapor or odor. This change is measured by a microprocessor that calculates the change in frequency which is related to the amount of fragrance, vapor or odor sampled by the zNose®. The microprocessor also measures the arrival time (called the retention time) of the change in the fundamental frequency. Different chemicals arrive at different times and so, once the microprocessor has determined the retention time of the unidentified fragrance, vapor or odor, it compares it to retention times that are stored in a computer library. This allows the zNose® to identify the particular fragrance, vapor or odor.

The zNose® analyzes and identifies vapor specimens in a two-step process. In the first step, typically lasting 10 seconds, the instrument collects a small sample of the vapor to be analyzed. The sample is then injected in to the gas chromatography column where the individual chemicals present are separated and measured. The chemical analysis requires as little as 10 seconds to produce the vapor's chemical signature, or chromatogram. The vapor's chemical signature can also be visually displayed in a graphic form called a "VaporPrint". This chemical signature is then compared against the reference database of chemical odor profiles. If the chemical compound of the specimen is not in the reference database, it will not be identified by name; however, the makeup of the unidentified specimen can be stored in the reference database for future identification. The reference database of chemical odor profiles that is stored on the hard drive of the laptop computer is composed of standards of various chemicals that are available through the National Institute of Standards and Technology (NIST). The database can be updated when standards of new chemicals are encountered and input by way of simple software selection, or by way of sampling unknown chemical compounds and storing the measurements of such chemical compounds in the database. If the zNose® samples a non-specimen vapor, such as clear ambient air, no signal is generated on the laptop computer screen and no VaporPrint® is created. If the zNose® samples a complex mixture of chemical compounds, each compound and the concentration of such compound is measured independently of the other compounds contained in the mixture. Due to the independent measurement of each compound in a complex mixture, each measurement is free from the influence of the other compounds, and the accuracy of the zNose® is therefore not affected by complex mixtures.

We currently manufacture and sell three zNose® models designated as Model 4200 (Handheld Unit), Model 4300 (Portable Unit) and Model 7100 (Bench Top Unit). Model 4200 is designed for portability and for applications requiring quick and accurate vapor screening in the field. Model 4300 is also designed for portability and can operate outdoors with the same capabilities of Model 4200 without the need for an external power source. Model 7100 is designed for laboratory testing and is ideal for testing water and product quality control samples. Both Model 4200 and Model 7100 weigh approximately 27 pounds, not including a laptop computer that must be used with each zNose®. Model 4300 weighs approximately 24 pounds, not including the laptop computer, but also includes a battery charger that weighs approximately 8 pounds. The Model 4200 has two housings (the case and the detector head) and a laptop computer. The case of the Model 4200 is 10" x 12" x 6" and weighs 20 pounds and the detector head of the Model 4200 is 4.25" x 12" x 7" and weighs 7 pounds. The components and dimensions of the Model 4300 are similar to the Model 4200, but the battery charger of the Model 4300 is 5.5" x 13.5" x 5.5. The Model 7100 is packaged in a single housing and also requires a laptop computer. The dimensions of the Model 7100 packaging are 14.3" x 14.3" x 7.5". Both the Model 4200 and Model 7100 are powered by a standard AC electrical outlet, and both models adapt to standard outlets in North America, Asia and Europe (i.e., the zNose® may be operated by a 110 volt or 220 volt power source). All three models can be produced in one of two basic vapor sensing configurations: volatile and semi-volatile. The volatile configuration can detect volatile organic compounds, such as benzene. The semi-volatile configuration can detect heavier vapors such as those found in explosives and drugs.

During 2007, we developed Models 8100 and 7300. Model 8100 is designed as a fixed installation unit for indoor ambient air monitoring. It can also be used for building security monitoring applications. It is designed to be operated remotely from a central control station via a Bluetooth control link. Model 7300 is a bench top unit similar in configuration to the Model 7100 minus the internal helium container. Operation of the Model 7300 requires an external helium source.

We have designs to produce a hand-held zNose® that is smaller than the Model 4300 for the commercial market. This model is designed to meet the needs of law enforcement, manufacturing process monitoring, and environmental monitoring. We plan to develop a separate version of the mini-zNose® to be used as a personal nerve agent detector for the military and security markets.

Accessories

We offer several lines of accessory products such as calibration devices, sample desorbers, MicroSense Software©, and GPS receivers. An example is our Model 3100 which provides a calibrated vapor source as well as a tool for extracting vapors from solid and liquid samples.

SALES AND DISTRIBUTION

We sell our zNose® product through distribution channels including equipment distributors and sales representatives both in the U.S. and in over 20 foreign countries, e-commerce, customer referrals, and GSA contracted suppliers. We entered into an agreement with eScreen Sensor Solutions to be a distributor in Israel, the Caribbean, the State of Florida, and Central and South America on October 16, 2003. As part of the agreement, eScreen paid us an up-front fee of $250,000 in 2004. We entered into an agreement with TechMondial, Ltd. to be a distributor in the countries of the European Community, Romania, Bulgaria, Turkey, Croatia and Switzerland on October 21, 2005. In 2005, we selected Beijing R&D Technology Co., Ltd. to be our exclusive distributor in China. We entered into an agreement with Macrochem JSC to be a distributor in the countries of Germany, Russia, and Ukraine on March 27, 2006. We entered into an agreement with Analytical Solutions and Product B.V. to be a distributor in the Benelux countries on January 15, 2007. Also, on December 3, 2007, we entered into an agreement with Breckbuhler, AG to be a distributor in the countries of Switzerland, France, Austria, and Italy.

All sales representatives and distributors are required to attend a three-day training course conducted at our headquarters in Newbury Park, California. We advertise in selected industry trade journals and trade conventions. We are working to build a dedicated marketing and sales team. We historically generated sales from both domestic and international customers, each of which accounted for approximately 50% of our sales in the past. However, for the fiscal years ending December 31, 2006 and December 31, 2007, international customers accounted for approximately two-thirds of our total sales. We expect a similar split among domestic and international sales to continue. All of our customers pay us in U.S. dollars. Major domestic customers include the U.S. Armed Forces, Proctor & Gamble, United States Department of Agriculture, and S.C. Johnson. Major international customers include Beijing R&D Technology Company Ltd. in China, Kosmo Scientific Co. in Korea, and Macrochem Corp. in Ukraine.

COMPETITION

We are unaware of any direct competitor to the zNose® product on the market today. In the homeland security markets, we face competition from manufacturers of x-ray machines, ion-mobility spectrometers and chemical coated sensors. X-ray machines have been widely used for security purposes in detecting metal objects but not for chemical compounds. Ion-mobility spectrometer equipment is a vapor detector and is designed to detect certain compounds but is blind to other compounds. Hence, it can only see a small dot in a space but cannot see the total picture. It employs a different sample collection technique by wiping the surfaces of the object placed for screening. The ion-mobility spectrometer also uses materials in its construction which may be offensive to users in certain countries.

Chemical coated sensors are the conventional electronic noses. They use an array of chemical sensors each reacting to certain specific compounds. As mentioned earlier, electronic noses cannot be calibrated with chemical standards and therefore cannot be used effectively for scientific measurement.

We have another set of competitors manufacturing portable vapor and odor analysis products for the instrumentation market from major corporations such as Agilent Technologies, Inc. (NYSE: A), Perkin-Elmer, Inc. (NYSE: PKI) and Varian, Inc. (NASDAQ: VARI). We believe that our zNose® product is competitive with these companies' products based on speed and cost.

Many of our current and potential competitors, including the aforementioned competitors, have larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do and may enter into strategic or commercial relationships with larger, more established companies. Some of our competitors may be able to secure alliances with customers and affiliates on more favorable terms, devote greater resources to marketing, advertising and promotional campaigns and devote substantially more resources to research and development than we do. In addition, new technologies and the expansion of existing technologies may increase the competitive pressures on us.

We cannot assure you that we will be able to compete successfully against current or future competitors, and competitive pressures faced by us could harm our business, operating results and financial condition. We do not currently represent a significant competitive presence in the homeland security or analytic instrumentation markets.

MANUFACTURING AND RAW MATERIALS

We design, prototype and manufacture our products at our headquarters. Our manufacturing facilities adhere to ISO9001 manufacturing methods (quality standards developed by the International Organization for Standardization, which have been adopted by many countries around the world). We contract out the manufacturing and assembling of certain components to subcontractors. Our current annual manufacturing capacity is approximately 300 zNose® units. The principal components to our products are computer chips, circuit boards, transformers and sensory devices. The prices for these components are subject to market forces largely beyond our control, including energy costs, market demand, and freight costs. The prices for these components have varied significantly in the past and may vary significantly in the future. Our principal suppliers of components and raw materials include: Sigma Aldrich Co. of Bellefonte, Pennsylvania, American Precision of Chatsworth, California, Machine Works LLC of Santa Paula California, Clayton Controls of Costa Mesa, California, and Syncor Industries, Inc. of Ventura, California.

CUSTOMERS

In 2007, we had approximately 41 customers. Our largest customer in 2007, Beijing R&D Technology Company Ltd. (which is our exclusive distributor in China), purchased 36 of the total 66 zNose® units sold by us in 2007, constituting approximately 55% of the zNose® units sold in 2007. Our largest customers are (1) Beijing R&D Technology Company Ltd. of China, (2) United States Armed Forces and (3) Proctor and Gamble Co.

PATENTS, TRADEMARKS AND OTHER PROPRIETARY RIGHTS

We regard our patents, trademarks, trade names and similar intellectual property as critical to our success. We rely on patent and trademark laws, trade secret protection and confidentiality agreements with employees, distributors, customers, partners and others to protect our proprietary rights.

We own four United States patents covering our zNose® product, including:

- No. 5,289,715, "Vapor Detection Apparatus and Method Using an Acoustic Interferometer" issued March 1, 1994;
- No. 5,970,803, "Method and Apparatus for Identifying and Analyzing Vapor Elements", issued October 26, 1999;
- No. 6,212,938, "Method of Detecting Smell of a Vapor and Producing a Unique Visual Representation thereof," issued April 10, 2001;
- No. 6,354,160, "Method and Apparatus for Identifying and Analyzing Vapor Elements," issued December 3, 2002.

We may not be able to obtain patent protection for any derivative uses of zNose®, or for any other products we may later acquire or develop. We also cannot assure you that we will be able to obtain other foreign patents to protect our products.

We have copyrighted our MicroSense Windows software and Xilinx gate array firmware, which controls the operation of the zNose® and produces visual images. These images, trademarked as VaporPrint® images, make it possible to display vapor analysis data from any vapor analysis system, as unique visual images and facilitate pattern recognition of complex odors and fragrances.

We currently hold registered trademarks for zNose® and VaporPrint®. We intend to evaluate the possible application for new patents and trademarks as needed to cover current and future applications of our technology and product developments. We intend to undertake all steps necessary to preserve and protect our patents, trademarks and intellectual property generally.

We are not aware that our products, trademarks or other proprietary rights infringe the rights of third parties, nor are we aware of any infringements of our proprietary rights. We continually evaluate potential infringements of our proprietary rights and intend to take such legal and other actions as may be necessary to protect those rights. However, there can be no assurance that third parties will not assert infringement claims against us in the future with respect to current or future products or that any such assertion may not require us to enter into royalty arrangements or result in costly litigation.

GOVERNMENT REGULATION

Government agencies, in particular, the Department of Defense, are principal customers for our products. As a result, we are required to comply with the Federal Acquisition Regulations, a comprehensive set of regulations governing how vendors do business with the U.S. federal government, to the extent we contract with departments or agencies of the U.S. government, as well as similar regulations to the extent we contract with state or local governments. Sales to or grants from foreign governments or organizations generally have their own regulatory framework, which may or may not be similar to present U.S. standards or requirements.

RESEARCH AND DEVELOPMENT

Our research and development program consists of developing technologies related to enhancing our electronic nose product and making it more portable. Fees related to research and development include consulting fees, technical fees, and research, development and testing of our zNose® product. We spent approximately $834,000 in 2006 and $745,000 in 2007 on research and development activities, none of which was borne directly by customers.

EMPLOYEES

As of December 31, 2007 we had a total of 19 full-time employees and 1 consultant. In addition to management, we employ sales people, administrative staff, and development and technical personnel. From time to time, we may employ independent consultants or contractors to support our research and development, marketing, sales and support, and administrative organizations. No collective bargaining units represent our employees and Electronic Sensor Technology is not party to any labor contracts.

CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2007. The figures in the table are derived from our audited financial statements and should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this annual report. All information below excludes any securities issued subsequent to December 31, 2007.

	December 31, 2007
Long-term debt	$ 2,527,777
Stockholders' deficit:	
Common stock; $0.001 par value; 200,000,000 Shares authorized; 56,756,098 shares issued and outstanding	$ 56,756
Additional paid-in capital	$ 8,939,562
Accumulated deficit	$ (14,873,789)
Total Stockholders' deficit	$ (5,877,471)
Total capitalization	$ (3,349,694)

DIRECTORS AND EXECUTIVE OFFICERS

Name	Principal Occupation (arranged by title, company and industry)
Teong C. Lim, Executive Officer and Director	President and Chief Executive Officer Electronic Sensor Technology
	Former President and Chief Executive Officer and former Vice President of Corporate Development Electronic Sensor Technology
	Chairman of the Board of Directors Electronic Sensor Technology technology
Philip Yee, Executive Officer	Secretary, Treasurer and Chief Financial Officer Electronic Sensor Technology technology
Gary Watson, Executive Officer	Vice President of Engineering and interim Chief Scientist Electronic Sensor Technology technology
Rita Benoy Bushon, Director	Executive Director Land & General Berhad property development and management, education
Lewis Larson, Director	President The Lion Group consulting and system engineering

Name	Principal Occupation (arranged by title, company and industry)
Maggie Tham, Director	Co-Founder eXS, Inc. telecommunications
	Co-Founder, Chief Executive Officer and Executive Director eXS Network Technologies Sdn. Bhd. telecommunications
James Wilburn, Director	Dean Pepperdine University School of Public Policy education
William Wittmeyer, Director	Chief Executive Officer and Co-Founder eXS, Inc. telecommunications
	Co-Founder eXS Network Technologies Sdn. Bhd. telecommunications

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET FOR COMMON EQUITY

Our common stock is quoted on the Over-the-Counter Bulletin Board under the symbol "ESNR.OB". There is currently no broadly followed, established public trading market for our common stock. The quarterly range of high and low Over-the-Counter Bulletin Board quotation information for our common stock for the first two quarters of 2008 and the last two fiscal years is set forth below. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

QUARTERLY COMMON STOCK PRICE RANGES

QUARTER ENDED	2008	
	HIGH	LOW
March 31	$.09	.04
June 30	.06	.02

QUARTER ENDED	2007	
	HIGH	LOW
December 31	$ .19	$ .04
September 30	.22	.06

June 30	.26	.18
March 31	.29	.13

QUARTER ENDED	2006	
	HIGH	LOW
December 31	$ .48	$ .21
September 30	.40	.20
June 30	.29	.17
March 31	.41	.19

Source: Yahoo! Finance.

There were 45 record holders of our common stock as of August 7, 2008. This number does not include an indeterminate number of shareholders whose shares are held by brokers in street name.

We have not paid dividends on our common stock since our inception. The decision to pay dividends on common stock is within the discretion of our Board of Directors. It is our current policy to retain any future earnings to finance the operations and growth of our business. Accordingly, we do not anticipate paying any dividends on common stock in the foreseeable future.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

The following table illustrates, as of December 31, 2007, information relating to all of our equity compensation plans:

EQUITY COMPENSATION PLAN INFORMATION

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under the equity compensation plan
Equity compensation plans approved by security holders	0	N/A	0
Equity compensation plans not approved by security holders	3,437,950	$.41	1,562,050 (1)
Total	3,437,950	$.41	1,562,050

(1) This amount represents the remainder of the 5,000,000 shares of our common stock authorized for issuance under the Electronic Sensor Technology, Inc. 2005 Stock Incentive Plan, less 3,437,950, the number of shares of common stock underlying outstanding options granted pursuant to the Stock Incentive Plan as of December 31, 2007.

ELECTRONIC SENSOR TECHNOLOGY, INC. 2005 STOCK INCENTIVE PLAN

A description of the Electronic Sensor Technology, Inc. 2005 Stock Incentive Plan is set forth in Note 7 to the company's consolidated financial statements for the period ended December 31, 2007 under the heading "Options" included in this annual report and is incorporated herein by reference.

RECENT SALES OF UNREGISTERED SECURITIES

We did not repurchase any of our equity securities during the three months ended December 31, 2007 or the three months ended March 31, 2008. All sales of unregistered equity securities during the three months ended December 31, 2007 have previously been included on our current report on Form 8-K filed January 16, 2008. All sales of unregistered equity securities during the three months ended March 31, 2008 have previously been included on our current report on Form 8-K filed on February 27, 2008 and April 3, 2008.

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations together with the financial statements and the related notes appearing in this annual report.

CRITICAL ACCOUNTING POLICIES

Fiscal Year Ended December 31, 2007 and Six Months Ended June 30, 2008

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.

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 December 31, 2007 and the three months ended June 30, 2008 no assets were impaired.

The company accounts for its 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". In December 2006, FASB issued FASB Staff Position No. EITF 00-19-2 "Accounting for Registration Payment Arrangements" ("FSP 00-19-2"), which superseded EITF 05-04. FSP 00-19-2 provides that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, should be separately recognized and measured in accordance with FASB Statement No.5, "Accounting for Contingencies". The registration statement payment arrangement should be recognized and measured as a separate unit of account from the financial instrument(s) subject to that arrangement. If the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, such contingent liability is included in the allocation of proceeds from the related financing instrument. Pursuant to EITF 05-04, View C, the liquidated damages paid 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. FSP00-19-2 did not have an impact on the company's accounting of the liquidated damages.

The company had registered, as of June 30, 2008, all shares underlying the 8% convertible debentures as well as all shares underlying the warrants related to the convertible debentures.

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.

Fiscal Year Ended December 31, 2007

Accounts receivable are reported at net realizable value. We have established an allowance for doubtful accounts based upon factors pertaining to the credit risk of specific customers, historical trends, and other information. Delinquent accounts are written-off when it is determined that the amounts are uncollectible.

Inventories are stated at the lower of cost or market, cost determined by the first-in, first-out (FIFO) method. The company writes down its inventory for estimated obsolescence or unmarketable inventory using the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions.

We are required to estimate our income taxes in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. SFAS No. 109, "Accounting for Income Taxes", requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is not more likely than not that some portion or all of the deferred tax assets will be realized. Management reviews deferred tax assets periodically for recoverability and makes estimates and judgments regarding the expected geographic sources of taxable income, gains from investments, as well as tax planning strategies in assessing the need for a valuation allowance. We determined that a valuation allowance of approximately $3,300,000 relating to net operating loss carryovers was necessary to reduce our deferred tax assets to the amount that will more likely than not be realized. As a result, at December 31, 2007 the company has no net deferred tax assets. If the estimates and assumptions used in our determination change in the future, we could be required to revise our estimates of the valuation allowances against our deferred tax assets and adjust our provisions for additional income taxes. In the ordinary course of global business, there are transactions for which the ultimate tax outcome is uncertain, thus judgment is required in determining the worldwide provision for income taxes. We provide for income taxes on transactions based on our estimate of the probable liability. We adjust our provision as appropriate for changes that impact our underlying judgments. Changes that impact provision estimates include such items as jurisdictional interpretations on tax filing positions based on the results of tax audits and general tax authority rulings.

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

Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007

The following table sets forth, as a percentage of revenues, certain items included in the company's Income Statements (see Financial Statements and Notes) for the periods indicated:

	Six Months Ended June 30	
Statement of Operations Data:	**2008**	**2007**
Revenues	100%	100%
Cost of Sales	61%	50%
Gross Profit	39%	50%
Operating Expenses	196%	154%
(Loss) From Operations	(157%)	(104%)
Other Income (Expense)	105%	(83%)
Net (Loss)	(52%)	(187%)

Revenues are derived from product sales and product support services. For the six months ending June 30, 2008, revenues were $760,000 which was $408,000 less than for the same period in 2007. For the quarter, revenues were $325,000 below second quarter 2007. The decreases in revenues resulted from 9 and 15 fewer instruments shipped in the quarter and year to date, respectively. Performance continues to be severely impacted by a significant drop in business from our Chinese distributor whose year-to-date purchases are 70% below that of last year. The combined revenues from all other geographical markets, excluding China, are approximately even with last year with growth in the domestic market, offsetting a decrease in the European market.

Cost of Sales consist of product costs and expenses associated with product support services. For the three and six month periods ending June 30, 2008, cost of sales were $233,000 and $461,000, compared to $331,000 and $585,000 in 2007. For the same periods, cost of sales, as a percentage of revenues, were 64% and 61%, respectively, versus 48% and 50%, in 2007. Cost of sales continues to be negatively impacted by overhead spending and labor variances totaling $69,000 for the six month period, compared to $9,000 in 2007. The variances were caused by a slow down in production to reflect lower sales activities and to work-off on-hand inventory. Excluding the impact of the variances, cost of sales for the first six months of 2008 would be 52% of revenues or 3% worse than last year.

Gross profit was $299,000 or 39% of sales for the six months ending June 30, 2008, compared to $583,000 or 50% of sales for the same period in 2007. The decrease in gross margin over last year is attributed to lower sales volume and to the labor and overhead variances written off to cost of sales as noted above. Excluding the impact of the variances, gross margin is 3% worse than last year due to an unfavorable sales mix for ancillary items for our products.

Research and Development costs for the six months ending June 30, 2008 were $349,000 versus $411,000 for the same period in 2007. The $62,000 improvement is attributed to lower personnel expenses due to reduction of census ($51,000), and to non-recurring patent attorney expenses incurred in 2007.

Selling, General and Administrative expenses for the six months ending June 30, 2008 were $1,141,000, compared to $1,387,000 for the same period in 2007. The $246,000 decrease resulted from a reduction of personnel expenses due to reduction of census ($142,000), net reduction of outside services ($30,000), reduction of operating expenses ($53,000), and net difference between severance amounts paid in 2007 ($116,000) and in 2008 ($82,000), offset by an increase in promotional expenses ($13,000).

Interest expense for the six months ending June 30, 2008 was $786,000, as compared to $1,429,000 for the same period in 2007. The $643,000 reduction in interest expense is due to retirement of the $7.0 million 8% convertible debentures, and related debt discount, on March 31, 2008. Previously, interest expense included both interest accrued on the 8% convertible debentures as well as amortization of the related debt discount. During the second quarter, interest expense pertains mostly to the interest accrued on the $2.0 million convertible debenture, which was issued on March 28, 2008.

Other income-derivatives primarily consist of the decrease in the fair value of derivative liabilities between the measurement dates which are the balance sheet dates. On March 31, 2008, we satisfied our obligations under the 8% convertible debentures and as a result, the Company can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares. Accordingly, the Company reclassified all contracts, warrants, and other convertible instruments outstanding at March 31, 2008 from liability to equity (see Note 5).

Gain on extinguishment of debt is the gain realized from the early retirement of the 8% convertible debentures on March 31, 2008 (see Note 4 to the Notes to Consolidated Financial Statements (unaudited) June 30, 2008).

Fiscal Year Ended December 31, 2007 Compared to Fiscal Year Ended December 31, 2006

The following table sets forth certain items included in our Income Statements (see Financial Statements and Notes) for the periods indicated:

	Year Ended December 31,		Variation $ 2007 vs 2006	Variation % 2007 vs 2006
	2007	2006		
In $				
REVENUES	$ 2,198,204	$ 2,180,208	17,996	1.0%
COST OF SALES	1,356,719	1,085,056	(271,663)	(25.0%)
GROSS PROFIT	841,485	1,095,152	(253,667)	(23.2%)
OPERATING EXPENSES:				
Research and development	744,646	833,791	89,145	10.7%
Selling	664,838	822,954	158,116	19.2%
Compensation	787,114	655,045	(132,069)	(20.2%)
General and administrative	1,078,651	1,200,800	122,149	10.2%
TOTAL OPERATING EXPENSES	3,275,249	3,512,590	237,341	6.8%
LOSS FROM OPERATIONS	(2,433,764)	(2,417,438)	(16,326)	(1.0%)
OTHER INCOME AND EXPENSE:				
Other income – derivative liabilities	987,805	2,414,605	(1,426,800)	(59.1%)
Other income	1,854	2,140	(286)	(13.4%)
Gain (loss) on sale of property and equipment	(6,051)	(1,615)	(4,436)	(274.7%)
Interest expense	(2,924,486)	(2,809,682)	(114,804)	(4.1%)
TOTAL OTHER INCOME (EXPENSE)	(1,940,878)	(394,552)	(1,546,326)	(391.1%)
NET INCOME (LOSS)	$ (4,374,642)	$ (2,811,990)	(1,562,652)	(55.6%)

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

	Year Ended December 31,	
	2007	2006
As a % of revenues		
REVENUES	100%	100%
COST OF SALES	62%	49%
GROSS PROFIT	38%	51%
OPERATING EXPENSES	149%	161%
LOSS FROM OPERATIONS	(111%)	(110%)
OTHER INCOME AND EXPENSE	(88%)	(18%)
NET INCOME (LOSS)	(199%)	(128%)

Revenues primarily consist of the sale of our zNose products. Revenues in 2007 were flat compared to 2006. Product revenues increased approximately 4.4% over 2006 as a result of a greater number of zNose units shipped, 66 units versus 58 units. The increase in product revenues was offset by a 45% decrease in product support revenues. The decline in product support sales was due primarily to a decrease in training and after-sales support. A majority of our sales were to overseas customers whose training and after-sales support needs are performed by the respective sales representative or distributor servicing their accounts. Training and after-sales support functions for domestic customers are performed by the company.

Cost of Sales primarily consist of manufacturing costs and licensing fees. The increase in cost of sales for the year ended December 31, 2007, compared to the respective period in 2006 was due primarily to $193,000 in labor and overhead spending variances which resulted from an extended slow down of production to work-off on-hand inventories. Cost of sales was also negatively impacted by an unfavorable sales mix as shipments of our lowest margin instrument more than doubled that shipped in 2006, and an increase in inventory write-offs related to materials identified as excess or obsolete.

Research and development expenses primarily consist of salaries and related benefits, material and supplies associated with our efforts in developing and enhancing our products. In 2007, research and development expenses decreased 10.7% from 2006. The decrease is primarily attributable to a reduction of personnel expenses due to a reduction of census ($81,000), reduction of overhead expenses ($21,000), offset by an increase in patent attorney fees incurred to register the company's new technologies ($13,000).

Selling expenses primarily consist of salaries, commissions and related benefits associated with our selling and marketing efforts. The decrease in selling expenses during 2007 when compared to 2006 resulted from savings through reduction of consulting expenses ($148,000) , selective attendance at trade shows ($22,000), reduction of overhead expenses ($32,000), offset by an increase in commissions paid to outside sales representatives ($44,000).

Compensation expenses primarily consist of salaries and related benefits of our general and administrative personnel. The increase in compensation expenses during 2007 when compared to 2006 is primarily attributable to stock based compensation expenses ($114,000) and an increase in personnel to support our operations. There were no stock based compensation expenses in 2006.

General and administrative expenses for 2007 were approximately 10% less than 2006. The improvement of approximately $122,000 resulted primarily from reduction of legal and professional expenses ($198,000), offset by the cost to implement the ISO 9001 program, and the occurrence of additional Board of Directors meetings during the year.

Other income – derivative liabilities primarily consists of the decrease in the fair value of derivative liabilities between balance sheet dates. The decrease in other income-derivative liabilities during 2007 when compared to 2006 is primarily attributable to a decrease in the fair value of our stock between issuance of the derivative contracts and the measurement dates during 2005.

Interest expense primarily consists of debt discount amortization and interest on certain debt. The slight increase in interest expense during 2007 when compared to 2006 is primarily attributable to the lack of offsetting interest income from a certificate of deposit the company had in 2006 but liquidated in 2007 for funds used in operations.

LIQUIDITY AND CAPITAL RESOURCES

Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007

Liquidity and Capital Resources

For the six months ending June 30, net cash used by the Company for operating activities were $900,112 and $901,286 for 2008 and 2007 respectively. Cash used for the six months ending June 30, 2008 was comprised of the net loss for the period of $392,036, less net non-cash items (including depreciation and amortization expenses of $24,167, issuance of common shares for payment of interest of $280,000, amortization of debt discount of $586,269, amortization of deferred financing costs of $45,387, stock based compensation of $21,931, less decrease in fair value of derivative liability of $323,210, gain on early retirement of debt of $1,261,864) of $627,320 plus the net change in operating assets and liabilities of $119,244. Cash used in operations during the same six months of 2007 was comprised of the net loss for the period of $2,183,841, plus net non-cash expenses (including depreciation and amortization expenses of $26,184, stock based compensation of $72,357, amortization of debt discount of $1,166,667, amortization of deferred financing costs of $90,774, less decrease in fair value of derivative liability of $450,293, decrease in allowance for doubtful accounts of $4,784) of $900,905, and plus the net change in operating assets and liabilities of $381,650.

Investing activities provided cash of $7,495 in the first six months of 2008 and used cash of $84,675 during the same period in 2007. For the period, cash of $9,884 was provided from the sale of property and equipment and $2,389 was used to purchase capital equipment. In 2007, there was an increase in our certificate of deposit of $21,000 and $63,675 was used to purchase capital equipment.

Financing activities for the first six months of 2008 provided cash of $1,991,316 which included $2,000,000 received from the issuance of 9% convertible debentures to an investor, $3,500,000 from the issuance of equity to the same investor, less $3,500,000 used to retire the 8% convertible debentures and a decrease in capital lease obligation of $8,684. There were no financing activities for the first six months of 2007.

On June 30, 2008 the Company's cash (including cash equivalents) was $1,347,300, compared to $108,200 on June 30, 2007. The Company had a working capital on June 30, 2008 of $1,840,300. The Company's working deficit at June 30, 2007 was $2,606,000 – excluding derivative liabilities; working capital would be $300,200.

Fiscal Year Ended December 31, 2007 Compared to Fiscal Year Ended December 31, 2006

Our cash and cash equivalents amounted to approximately $249,000 at December 31, 2007.

During 2007, we used approximately $1.807 million in our operating activities which is the result of the following:

- A net loss of approximately $4.375 million adjusted for:
  - the amortization of debt discount of approximately $2.333 million, amortization of deferred financing costs of approximately $182,000, issuance of shares for payment of interest of $311,000, and stock based compensation of $115,000, and a decrease in the fair value of the derivative liabilities of approximately $980,000.

- A decrease in inventories of approximately $410,000 due to an extended slow down of production to work-off on-hand materials, and an increase in accounts payable and accrued expenses of approximately $117,000 due to better management of cash expenditures.

During 2007, investing activities provided approximately $22,000 from proceeds received from the sale of property and equipment.

During 2007, we generated approximately $940,000 from financing activities by liquidating a certificate of deposit that was used to satisfy collateral requirement of our line of credit which we cancelled.

A certificate of deposit in the amount of approximately $12,000 at December 31, 2007 is used to secure and collateralize the company's credit card liability.

During 2006, we used approximately $2.963 million in our operating activities which is the result of the following:

- A net loss of approximately $2.812 million adjusted for:
    - the amortization of debt discount of approximately $2.333 million, amortization of deferred financing costs of approximately $182,000 and a decrease in the fair value of the derivative liabilities of approximately $2.415 million.
- An increase in inventories of approximately $383,000 for materials required for the production of several new products introduced during the year. A decrease in accounts receivable and accounts payable and accrued expenses of approximately $165,000, and $77,000 respectively, due to better collection efforts and control over expenditures.

During 2006, we used approximately $129,000 in investing activities mostly for purchase of property and equipment.

During 2006, we used approximately $33,000 in financing activities for purchase of a certificate of deposit to satisfy collateral requirement of our line of credit.

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. There is no guarantee that a market will exist for the sale of our shares.

Our primary capital needs are to fund our growth strategy, which includes expanding our sales and marketing staff for the marketing, advertising and selling of the zNose® family of chemical detection products, increasing distribution channels both in the U.S. and foreign countries, introducing new products, improving existing product lines and development of a strong corporate infrastructure. We do not believe that we will have to incur significant capital expenditures in the near future in order to meet our growth strategy goals.

As of December 31, 2007, our cash balance and working deficit were $249,000 and $3,848,000, respectively. Excluding the impact of derivative liabilities, our working deficit is $1,471,000. The first principal payment of approximately $780,000 is due on the convertible debentures that we issued on December 7, 2005, which such payment is due on January 1, 2008. On December 27, 2007, the company entered into a First Amendment Agreement with the holders of the convertible debentures, which provides for certain amendments to the debentures issued to them on December 7, 2005 and under the related Securities Purchase Agreement, Registration Rights Agreement, and Forbearance and Amendment Agreement, the terms of which are described on our current report on Form 8-K filed on December 8, 2005 and September 8, 2006. Pursuant to the Agreement, the convertible debenture holders agreed to extend the initial principal payment date on the convertible debentures from January 1, 2008 to April 1, 2008.

On March 28, 2008, the company received $5.5 million from an investor, $3.5 million of which will be for the purchase of common stock of the company, and $2.0 million of which will be in exchange for a 9% convertible debenture to be issued by the company. The company issued to the investor common stock shares at a price of $0.0405 per share. The 9% convertible debenture will have a five (5)-year term, and the conversion rate of the debenture will be at $0.0486. The new investment required that the company use $3.5 million to extinguish the 8% convertible debentures held by the current holders.

Pursuant to a Conversion and Termination Agreement entered into with the current debentures holders on February 26, 2008, in exchange for $3.5 million, the current debenture holders converted $3.5 million of the principal amount of their 8% convertible debentures, together with interest thereon, at a conversion price of $0.35 per share of Common Stock. Upon receipt of the foregoing sum and the conversion shares of Common Stock, the current debenture holders cancelled the remainder of their 8% convertible debentures and 50% of the shares of Common Stock underlying warrants. The remaining 6,065,158 shares of Common Stock underlying the warrants continue in full force and effect in accordance with their terms.

Absent other transactions which would warrant the same accounting treatment, the company will discontinue the recognition of derivative liabilities once it can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares. As a result of the satisfaction of the company's obligations under its convertible debentures, the company can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which were settled in shares at March 31, 2008. Accordingly, the company reclassified all contracts, warrants, and other convertible instruments outstanding at March 31, 2008 from liability to equity.

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.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

FINANCIAL STATEMENTS

INDEX TO FINANCIAL STATEMENTS

Audited Financial Statements for the Fiscal Year Ended December 31, 2007

Unaudited Financial Statements for the Three and Six Months Ended June 30, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Electronic Sensor Technology, Inc.

We have audited the accompanying balance sheet of Electronic Sensor Technology, Inc. as of December 31, 2007 and the related consolidated statements of operations, changes in stockholders' deficit and cash flows for the years ended December 31, 2007 and 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, the consolidated financial position of Electronic Sensor Technology, Inc., as of December 31, 2007 and the consolidated results of its operations and its cash flows for the years ended December 31, 2007 and 2006 in conformity with accounting principles generally accepted in the United States of America.

/s/ Sherb & Co., LLP
Sherb & Co., LLP
Certified Public Accountants

New York, New York
March 31, 2008

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED BALANCE SHEET

DECEMBER 31, 2007

ASSETS

CURRENT ASSETS:		
Cash and cash equivalents	$	248,587
Certificate of deposit-restricted		12,384
Accounts receivable, net of allowance for doubtful accounts of $1,500		281,400
Prepaid expenses		80,761
Inventories		818,989
TOTAL CURRENT ASSETS		1,442,121
DEFERRED FINANCING COSTS, net of amortization of $380,393		347,967
PROPERTY AND EQUIPMENT, net of accumulated depreciation of $363,544		174,111
SECURITY DEPOSITS		12,817
	$	1,977,016

LIABILITIES AND STOCKHOLDERS' DEFICIT

CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$	520,685
Deferred revenues		41,667
Derivative liabilities		2,376,543
Convertible debentures – current portion		2,333,333
Obligation under capital lease due within one year		17,875
TOTAL CURRENT LIABILITIES		5,290,103
CONVERTIBLE DEBENTURES, long-term portion, net of unamortized discount of $2,138,890		2,527,777
LONG-TERM OBLIGATION UNDER CAPITAL LEASE		36,607
TOTAL LIABILITIES		7,854,487
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, 56,756,098 issued and outstanding		56,756
Additional paid-in capital		8,939,562
Accumulated deficit		(14,873,789)
TOTAL STOCKHOLDERS' DEFICIT		(5,877,471)
	$	1,977,016

See notes to consolidated financial statements

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31, 2007	Year Ended December 31, 2006
REVENUES	$ 2,198,204	$ 2,180,208
COST OF SALES	1,356,719	1,085,056
GROSS PROFIT	841,485	1,095,152
OPERATING EXPENSES:		
Research and development	744,646	833,791
Selling	664,838	822,954
Compensation	787,114	655,045
General and administrative	1,078,651	1,200,800
TOTAL OPERATING EXPENSES	3,275,249	3,512,590
LOSS FROM OPERATIONS	(2,433,764)	(2,417,438)
OTHER INCOME AND EXPENSE:		
Other income – derivative liabilities	987,805	2,414,605
Other income	1,854	2,140
Gain (loss) on sale of property and equipment	(6,051)	(1,615)
Interest expense	(2,924,486)	(2,809,682)
TOTAL OTHER INCOME (EXPENSE)	(1,940,878)	(394,552)
NET INCOME (LOSS)	$ (4,374,642)	$ (2,811,990)
Earnings (loss) per share, basic	$ (0.08)	$ (0.05)
Weighted average number of shares, basic	54,884,012	54,166,872
Earnings (loss) per share, diluted	$ (0.10)	$ (0.10)
Weighted average number of shares, diluted	54,884,012	54,166,872

See notes to consolidated financial statements

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' DEFICIT

	Common Stock		Preferred Stock		Additional Paid-In	Accumulated	Total Stockholders'
	Shares	Amount	Shares	Amount	Capital	Deficit	Deficit
BALANCE – January 1, 2006	54,098,745	$ 54,099	-	$ -	$ 8,495,429	$ (7,687,157)	$ 862,371
Issuance of shares for services	75,000	75	-	-	20,925	-	21,000
Net (loss)	-	-	-	-	-	(2,811,990)	(2,811,990)
BALANCE – December 31, 2006	54,173,745	54,174	-	-	8,516,354	(10,499,147)	(1,928,619)
Issuance of shares for interest	2,582,353	2,582	-	-	308,529	-	311,111
Stock based compensation	-	-	-	-	114,679	-	114,679
Net (loss)	-	-	-	-	-	(4,374,642)	(4,374,642)
BALANCE – December 31, 2007	56,956,098	$ 56,756	-	-	$ 8,939,562	$ (14,873,789)	$ (5,877,471)

See notes to consolidated financial statements.

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2007	Year Ended December 31, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (4,374,642)	$ (2,811,990)
Adjustments to reconcile net income (loss) to net cash provided by (used in)operating activities:		
Depreciation and amortization	56,511	43,756
Decrease in allowance for doubtful accounts	(22,862)	-
Increase in reserve for obsolescence	56,320	36,483
Issuance of shares for services	-	21,000
Issuance of shares for payment of interest	311,112	-
Amortization of stock based compensation	114,679	-
Amortization of debt discount	2,333,334	2,333,333
Amortization of deferred financing costs	181,548	181,547
Decrease in fair value of derivative liability	(979,930)	(2,414,606)
Changes in assets and liabilities:		
Accounts receivable	41,875	165,363
Inventories	410,381	(382,551)
Prepaid expenses	(1,991)	(8,834)
Accounts payable and accrued expenses	116,765	(76,880)
Deferred revenues	(50,000)	(50,000)
Net cash provided by (used in) operating activities	(1,806,900)	(2,963,379)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of property and equipment	21,647	(128,997)
Net cash provided by (used in) investing activities	21,647	(128,997)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Decrease in certificate of deposit - restricted	939,698	(33,404)
Net cash provided by (used in) financing activities	939,698	(33,404)
NET DECREASE IN CASH	(845,555)	(3,125,780)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	1,094,141	4,219,921
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 248,587	$ 1,094,141
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for:		
Interest	$ 147,888	$ 578,280
NON-CASH INVESTING AND FINANCING ACTIVITIES		
Purchase of property and equipment under capital lease	$ 54,482	$ -

See notes to consolidated financial statements.

ELECTRONIC SENSOR TECHNOLOGY, INC.
Notes to Financial Statements
December 31, 2007

(1) Nature of Business and Summary of Significant Accounting Policies

Nature of Business

Electronic Sensor Technology, Inc. develops and manufactures electronic devices used for vapor analysis. It markets its products through distribution channels in over 20 countries.

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.

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 had cash and cash equivalents amounting to $248,587 at December 31, 2007.

Certificate of Deposit – Restricted

The Company credit card liability is secured and collateralized with a certificate of deposit in the amount of approximately $12,000 at December 31, 2007.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the Company's assessment of the collectibilty of customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than the Company's historical experience, the Company's estimates of the recoverability of amounts due it could be adversely affected. The Company regularly reviews the adequacy of the Company's allowance for doubtful accounts through identification of specific receivables where it is expected that payments will not be received. The Company also establishes an unallocated reserve that is applied to all amounts that are not specifically identified. In determining specific receivables where collections may not be received, the Company reviews past due receivables and gives consideration to prior collection history and changes in the customer's overall business condition. The allowance for doubtful accounts reflects the Company's best estimate as of the reporting dates. Changes may occur in the future, which may require the Company to reassess the collectibility of amounts and at which time the Company may need to provide additional allowances in excess of that currently provided.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, certificate of deposit, accounts receivables, accounts payable and accrued expenses approximate their fair value due to their short-term maturities. The fair value of the convertible debentures issued by the Company in December 2005 amounts to $7,000,000, based on the Company's incremental borrowing rate.

Concentration of Credit Risks

The Company is subject to concentrations of credit risk primarily from cash and cash equivalents and accounts receivable. The Company maintains accounts with financial institutions, which at times exceeds the insured limit of approximately $100,000. The Company minimizes its credit risks associated with cash by periodically evaluating the credit quality of its primary financial institutions. The Company's accounts receivables are due from distributors in all other countries in which it markets its products. The Company does not require collateral to secure its accounts receivables. The Company's two largest customers accounted for 96% of its net accounts receivable at December 31, 2007. No other customers accounted for more than 5% of its net accounts receivables.

Product Concentration Risk

Substantially all of the Company's revenues derive from the sale of electronic devices used for vapor analysis.

Customer Concentration Risk

One of the Company's customers accounted for 47% of its revenues during 2007. This same customer accounted for 42% of the Company's revenues in 2006. No other customers accounted for more than 10% of its revenues.

Inventories

Inventories are comprised of raw materials, work-in-process, and finished goods. Inventories are stated at the lower of cost or market, cost determined by the first-in, first-out (FIFO) method. The Company writes down its inventory for estimated obsolescence or unmarketable inventory using the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. The Company writes down inventory during the period in which such products are no longer marketable in any of their markets due to governmental regulations as well as inventory which matures within the next three months.

Property and Equipment

Property and equipment are recorded at cost and are depreciated on a straight-line basis over their estimated useful lives of five years. Maintenance and repairs are charged to expense as incurred. Significant renewals and betterments are capitalized.

Property and equipment consist of the following as of December 31, 2007:

Machinery and equipment	$ 352,500
Leasehold improvements	39,500
Office furniture and equipment	145,600
	537,600
Accumulated depreciation	(363,500)
	$ 174,100

Depreciation expense amounted to approximately $56,500 and $43,800 during 2007 and 2006, respectively.

Capital Lease

On June 28, 2007, the Company entered into a capital lease under which the present value of the minimum lease payments amounted to $59,200. The lease expires in September 2010. The present value of the minimum lease payments was calculated using a discount rate of 11.41%. The principal balance of the capital lease obligation amounted to $54,500 at December 31, 2007, of which $17,900 is included in the current portion of capital lease obligations in the accompanying consolidated balance sheet. As of December 31, 2007, the total future minimum lease payments on this lease is approximately $54,500 (if stated by year, the minimum lease payments are: 2008 – $17,900, 2009 – $20,000, and 2010 – $16,600).

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 the term of the related convertible debentures using the effective interest rate method.

Income Taxes

Income taxes are accounted for in accordance with SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 requires the recognition of deferred tax assets and liabilities to reflect the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of the Company's assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such assets. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some or the entire deferred tax asset will not be realized.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates made by management include, but are not limited to, the realization of receivables, recognition of stock based compensation and the valuation of the derivative liability. Actual results may differ from these estimates.

Basic and Diluted Earnings per Share

Basic earnings per share is calculated by dividing income available to stockholders by the weighted-average number of common shares outstanding during each period. Diluted earnings per share is 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 113,604,126 and 54,190,546 at December 31, 2007 and 2006, respectively. The outstanding options, warrants and shares equivalent issuable pursuant to embedded conversion features and warrants at December 31, 2007 and 2006, 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 reported 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 for the year ended December 31:

	2007	2006
Numerator:		
Net (loss) income	$ (4,374,642)	$ (2,811,990)
Net other income (expense) associated with derivative contracts	(987,805)	(2,414,605)
Net loss for diluted earnings per share purposes	$ (5,362,447)	$ (5,226,595)
Denominator:		
Denominator for basic earnings per share - Weighted average shares outstanding	54,884,012	54,166,872
Effect of dilutive warrants, embedded conversion features and liquidated damages	-	-
Denominator for diluted earnings per share - Weighted average shares outstanding	54,884,012	54,166,872
Basic earnings (loss) per share	$ (0.04)	$ (0.05)
Diluted earnings (loss) per share	$ (0.10)	$ (0.10)

Stock-Based Compensation

The Company adopted SFAS No. 123R, "Share Based Payments." SFAS No. 123R requires companies to expense the value of employee stock options and similar awards and applies to all outstanding and vested stock-based awards.

In computing the impact, the fair value of each option is estimated on the date of grant based on the Black-Scholes options-pricing model utilizing certain assumptions for a risk free interest rate; volatility; and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and the Company uses different assumptions, the Company's stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what we have recorded in the current period. The impact of applying SFAS No. 123R approximated $114,000 in additional compensation expense during the year ended December 31, 2007. Such amount is included in general and administrative expenses on the statement of operations.

Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses at December 31, 2007 consist primarily of vendor payables.

Deferred Revenues

Deferred revenues at December 31, 2007 amounted to $41,667. The deferred revenues consist of a one-time licensing fee received by the Company during 2004 and is recognized over the term of the agreement which is five years. The Company recognized revenues of $50,000 and $50,000 pursuant to this agreement during 2007 and 2006, respectively.

Derivative Liabilities

The Company accounts for its 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". In December 2006, FASB issued FASB Staff Position No. EITF 00-19-2 "Accounting for Registration Payment Arrangements" ("FSP 00-19-2"), which superseded EITF 05-04. FSP 00-19-2 provides that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, should be separately recognized and measured in accordance with FASB Statement No.5, "Accounting for Contingencies". The registration statement payment arrangement should be recognized and measured as a separate unit of account from the financial instrument(s) subject to that arrangement. If the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, such contingent liability is included in the allocation of proceeds from the related financing instrument. Pursuant to EITF 05-04, View C, the liquidated damages paid 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. FSP00-19-2 did not have an impact on the Company's accounting of the liquidated damages.

The Company has registered all shares underlying the convertible debentures as well as all shares underlying the warrants related to the convertible debentures.

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.

The reclassification of a contract is reassessed at each balance sheet date. If a contract is reclassified from permanent equity to an asset or a liability, the change in the fair value of the contract during the period the contract was classified as equity is accounted for as an adjustment to equity. If a contract is reclassified from an asset or liability to equity, gains or losses recorded to account for the contract at fair value during the period that contract was classified as an asset or a liability are not reversed and are accounted for as an adjustment to equity.

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.

Segment reporting

The Company operates in one segment, manufacturing of electronic devices used for vapor analysis. The Company's chief operating decision-maker evaluates the performance of the Company based upon revenues and expenses by functional areas as disclosed in the Company's statements of operations.

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 or service revenue are recorded as deferred revenue.

Shipping and Handling

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

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 December 31, 2007 no assets were impaired.

Recently Issued Accounting Pronouncements

<u>FASB Statement Number 157</u>

In September 2006, the FASB issued FASB Statement No. 157. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is a relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practices. This Statement is effective for financial statements for fiscal years beginning after November 15, 2007. Earlier application is permitted provided that the reporting entity has not yet issued financial statements for that fiscal year. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

<u>FASB Interpretation Number 48</u>

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, ("FIN 48"), entitled, "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109". Concurrently, FASB issued a FASB staff position (FSP) relating to income taxes, (FSP) No. FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction." FASB's summary of FIN 48 notes that differences between tax positions recognized in the financial statements and tax positions taken in the tax return (referred to commonly as "book" vs. "tax") will generally result in: (a) an increase in a liability for income taxes payable or a reduction of an income tax refund receivable, (b) a reduction in a deferred tax asset or an increase in a deferred tax liability, or (c) both of the above. FIN 48 requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. Further, if a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements. Additionally, FIN 48 establishes guidance for "derecognition" of previously recognized deferred tax items, and sets forth disclosure requirements. The effective date of FIN 48 is for fiscal years beginning after December 15, 2006. The Company does not believe that FIN 48, once adopted, will have a significant impact on its financial position, operating results, or cash flows.

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FAS 115 ("SFAS No. 159"). SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. The Company is currently evaluating the impact of adopting SFAS No. 159 on our consolidated financial position, results of operations and cash flows.

FASB Statement Number 141 (revised 2007)

In December 2007, the FASB issued FASB Statement No. 141 (revised 2007), Business Combinations. This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. This Statement's scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. By applying the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses, this Statement improves the comparability of the information about business combinations provided in financial reports.

This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces Statement 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values.

This Statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquirer), including those sometimes referred to as "true mergers" or "mergers of equals" and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This Statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: (a) The formation of a joint venture, (b) The acquisition of an asset or a group of assets that does not constitute a business, (c) A combination between entities or businesses under common control, (d) A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

FASB Statement Number 160

In December 2007, the FASB issued FASB Statement No. 160 - Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51. This Statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. Not-for-profit organizations should continue to apply the guidance in

Accounting Research Bulletin No. 51, Consolidated Financial Statements, before the amendments made by this Statement, and any other applicable standards, until the Board issues interpretative guidance.

This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Before this Statement was issued, limited guidance existed for reporting noncontrolling interests. As a result, considerable diversity in practice existed. So-called minority interests were reported in the consolidated statement of financial position as liabilities or in the mezzanine section between liabilities and equity. This Statement improves comparability by eliminating that diversity.

A noncontrolling interest, sometimes called a minority interest, is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. The objective of this Statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require: (a) The ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity, (b) The amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income, (c) Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. A parent's ownership interest in a subsidiary changes if the parent purchases additional ownership interests in its subsidiary or if the parent sells some of its ownership interests in its subsidiary. It also changes if the subsidiary reacquires some of its ownership interests or the subsidiary issues additional ownership interests. All of those transactions are economically similar, and this Statement requires that they be accounted for similarly, as equity transactions, (d) When a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value. The gain or loss on the deconsolidation of the subsidiary is measured using the fair value of any noncontrolling equity investment rather than the carrying amount of that retained investment, (e) Entities provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners.

This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall be applied retrospectively for all periods presented. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

(2) Inventory

Inventory at December 31, 2007 consist of the following:

Finished goods	$ 475,091
Work-in-process	360,671
Raw materials	76,030
Reserve for obsolescence	(92,803)
	$ 818,989

Inventories are stated at the lower of cost or market, cost determined by the first-in, first-out (FIFO) method. The Company writes down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. The Company writes down inventory during the period in which such products are no longer marketable in any of their markets due to governmental regulations as well as inventory which matures within the next three months of the measurement date.

(3) 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, which was subsequently reduced to $0.4000 as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the convertible debentures (see Note 5), and can be redeemed at the lesser of $0.4000 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 (which was subsequently postponed to April 1, 2008 as per a First Amendment Agreement (see Note 6) with the holders of the convertible debentures dated December 27, 2007), 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, which was subsequently reduced to $0.4000 as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the convertible debentures (see Note 5), or 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, which was subsequently reduced to $0.4300 per share as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the warrants (see Note 5). Furthermore, the Company granted liquidated damages pursuant to a registration rights agreement.

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

a. 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 (which was subsequently extended to February 28, 2007 as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the convertible debentures and warrants – see Note 5). The registration statement covering the shares underlying the convertible debentures was declared effective on November 21, 2006;

b. 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 (which was subsequently extended to February 28, 2007 as per a Forbearance and Amendment Agreement, dated September 7, 2006 with the holders of the convertible debentures and warrants (see Note 5) - the registration statements covering the shares underlying the convertible debentures and warrants were declared effective on November 21 and December 21, 2006, respectively). 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;

c. 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; and

d. 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 (and was subsequently reduced to $0.4300 per share as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the warrants - see Note 5), may be further reduced 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 (which was subsequently extended to February 28, 2007 as per a Forbearance and Amendment Agreement, dated September 7, 2006 with the holders of the warrants - see Note 5). The registration statement covering the shares underlying the warrants was declared effective on December 21, 2006.

In connection with the issuance of the convertible debentures, we issued 485,213 warrants to a company in partial consideration for financial advisory services, as well as paid $490,000 to this company. The warrants have the same terms as those granted to the debenture holders. The fair value of the warrants at the date of issuance amounted to approximately $136,000. We also incurred approximately $102,500 in additional professional fees relating to the issuance of the convertible debentures and warrants. The payments of professional fees and the fair value of the warrants, aggregating approximately

$729,000 have been recorded as deferred financing costs. The deferred financing costs are amortized over the term of the convertible debentures. The amortization of deferred financing costs approximated $181,500 and $181,500 for the years ending December 31, 2006 and 2007, respectively.

See Note 4 - 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.

We recognized a debt discount of $7,000,000 at the date of issuance of the convertible debentures and the excess amount has been recorded as liability and a corresponding increase to other expense. The debt discount is recognized over the term of the convertible debentures.

Amounts due on the convertible debentures within the next twelve months are classified as a current liability. The amount of convertible debentures payable within the next twelve months at December 31, 2007 is approximately $2,333,333.

On March 31, 2008 the Company satisfied its obligations under its convertible debentures. Reference Note 11, Subsequent events.

(4) 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 December 31, 2007 is as follows:

	At issuance	At December 31, 2007
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 December 31, 2007
Market price:	$2.40	$ 0.09
Exercise price:	$1.00	$ 1.00
Term:	3 years	.26 years
Volatility:	39%	36%
Risk-free interest rate:	2.78%	3.07%
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 a 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 timely filed). The default provisions are effective, at the holders' option, upon an event of default.

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, which was subsequently reduced to $0.4000 as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the convertible debentures (see Note 5), 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 results 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 (which was subsequently extended to February 28, 2007 as per a Forbearance and Amendment Agreement, dated September 7, 2006 with the holders of the convertible debentures – see Note 5). The registration statement covering the shares underlying the convertible debentures was declared effective on November 21, 2006.

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 December 31, 2007 are as follows:

	At Issuance	At December 31, 2007
Freestanding warrants	$ 3,532,348	$ 2,376,543
Embedded conversion features	3,463,542	0
Liquidated damages	192,500	0
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 revisits the weight of probabilities and the likelihood of scenarios at each measurement date 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 December 31, 2007
Market price:	$ 0.4880	$ 0.09
Conversion price:	$ 0.4544	$ 0.08
Term:	4 years	1.93 years
Volatility:	39%	36%
Risk-free interest rate:	4.39%	3.07%

Freestanding warrants

The derivative liability amounts to the fair value of the warrants issuable upon exercise. We computed the fair value of this embedded derivative using the Black Scholes valuation model with the following assumptions:

	At issuance	At December 31, 2007
Market price:	$ 0.488	$ 0.09
Exercise price:	$ 0.4761	$ 0.43
Term:	5 years	2.93 years
Volatility:	39%	36%
Risk-free interest rate:	4.39%	3.07%

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 and $0 at the date of the grant of the registration rights and at December 31, 2007, respectively.

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 was recorded as other expenses in December 2005. 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 their issuance in 2005 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 and charged to other expenses (in 2005), and approximately $136,000 was allocated to deferred financing costs (in 2005).

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 December 31, amounted to approximately $1.0 million and $2.4 million, and have been recorded as other income in 2007 and 2006, respectively.

(5) Forbearance and Amendment Agreement

On September 7, 2006, the Company entered into a Forbearance and Amendment Agreement with the holders of the convertible debentures and warrants that we issued in a private placement on December 7, 2005. The terms of the convertible debentures and warrants required that we register the shares of our common stock underlying such debentures and warrants within 180 days of the date of issuance of the debentures and warrants. The failure to do so is an event of default under the debentures, giving the holders the right to accelerate the debentures and receive a premium of approximately 30% of the outstanding amounts due under the debentures upon acceleration. The failure to do so also reduces the exercise price of the warrants by $0.03 per month until such shares are registered. In addition, the failure to register such shares within 150 days of the date of issuance of the debentures and warrants gives the holders the right to receive liquidated damages in the amount of 2% per month of the purchase price of the debentures and warrants, pursuant to a registration rights agreement, and the failure to pay such liquidated damages relating to the debentures is an event of default under the debentures.

Pursuant to the Forbearance and Amendment Agreement, the holders agreed, among other things, to abstain from exercising the aforementioned rights and remedies arising out of the existing defaults under the debentures and warrants unless we were unable to register the shares underlying the convertible debentures and the warrants by February 28, 2007. In exchange for such forbearance, the Company agreed to reduce the conversion price of the debentures issued on December 7, 2005 from $0.4544 per share to $0.4000 per share and to reduce the exercise price of the warrants issued to the holders of the convertible debentures on such date from $0.4761 per share to $0.4300 per share. The registration statements covering the shares underlying the convertible debentures and warrants were declared effective on November 21 and December 21, 2006, respectively.

The Forbearance and Amendment Agreement provides for revised probabilities and likely outcomes that the Company will use in its valuation of the embedded conversion features, the freestanding warrants and the liquidated damages associated with the issuance of the convertible debentures, as required by SFAS 133, paragraph 17. Such valuation is performed at each balance sheet date.

(6) First Amendment Agreement

On December 27, 2007, the Company entered into a First Amendment Agreement with the holders of the convertible debentures, which provides for certain amendments to the debentures issued to them on December 7, 2005 and under the related Securities Purchase Agreement, Registration Rights Agreement, and Forbearance and Amendment Agreement, the terms of which are described in the Registration Statement numbers 333-130900 and 333-138977, effective November 11, 2006 and December 21, 2006, respectively, as amended and supplemented. Pursuant to the Agreement, Midsummer and Islandia agreed to extend the initial principal payment date on the convertible debentures from January 1, 2008 to April 1, 2008.

The Company satisfied its obligations under its convertible debentures. Reference Note 11, Subsequent events. Absent other transactions which would warrant the same accounting treatment, the Company will discontinue the recognition of derivative liabilities once it can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares. As a result of the satisfaction of the Company's obligations under its convertible debentures, the Company can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares at March 31, 2008. Accordingly, the Company will reclassify all contracts, warrants, and other convertible instruments outstanding at March 31, 2008 from liability to equity.

(7) Stockholders' Deficit

Common Stock

Shares issued for payment of interest

During 2007, the Company elected to pay second and third quarter interest on the convertible debentures in shares of the Company's common stock, rather than in cash. The Company issued 2,582,353 shares of the Company's common stock to the holders of the convertible debentures.

Options

In 2005, the Board of Directors adopted the Electronic Sensor Technology, Inc. 2005 Stock Incentive Plan. The purpose of the Stock Incentive Plan is to attract and retain the services of experienced and knowledgeable individuals to serve as our employees, consultants and directors. On the date the Stock Incentive Plan was adopted, the total number of shares of common stock subject to it was 5,000,000. The Stock Incentive Plan is currently administered by the Board of Directors, and may be administered by any Committee authorized by the Board of Directors, so long as any such Committee is made up of Non-Employee Directors, as that term is defined in Rule 16(b)-3(b) of the Securities Exchange Act of 1934.

The Stock Incentive Plan is divided into two separate equity programs: the Discretionary Option Grant Program and the Stock Issuance Program. Under the Discretionary Option Grant Program, eligible persons may, at the discretion of the administrator, be granted options to purchase shares of common stock and stock appreciation rights. Under the Stock Issuance Program, eligible persons may, at the discretion of the administrator, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered for Electronic Sensor Technology (or a parent or subsidiary of Electronic Sensor Technology).

Pursuant to the terms of the Discretionary Option Grant Program, the exercise price per share is fixed by the administrator, but may not be less than 85% of the fair market value of the common stock on the date of grant, unless the recipient of a grant owns 10% or more of Electronic Sensor Technology's common stock, in which case the exercise price of the option must not be less than 110% of the fair market value. An option grant may be subject to vesting conditions. Options may be exercised in cash, with shares of the common stock of Electronic Sensor Technology already owned by the person or through a special sale and remittance procedure, provided that all applicable laws relating to the regulation and sale of securities have been complied with. This special sale and remittance procedure involves the optionee concurrently providing irrevocable written instructions to: (i) a designated brokerage firm to effect the immediate sale of the purchased shares and remit to Electronic Sensor Technology, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable federal, state and local income and employment taxes required to be withheld by Electronic Sensor Technology by reason of such exercise and (ii) Electronic Sensor Technology to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale. The term of an option granted pursuant to the Discretionary Option Grant Program may not be more than 10 years.

The Discretionary Option Grant Program also allows for the granting of Incentive Options to purchase common stock, which may only be granted to employees, and are subject to certain dollar limitations. Any options granted under the Discretionary Option Grant Program that are not Incentive Options are considered Non-Statutory Options and are governed by the aforementioned terms. The exercise price of an Incentive Option must be no less than 100% of the fair market value of the common stock on the date of grant, unless the recipient of an award owns 10% or more of Electronic Sensor Technology's common stock, in which case the exercise price of an incentive stock option must not be less than 110% of the fair market value. The term of an Incentive Option granted may not be more than five years if the option is granted to a recipient who owns 10% or more of Electronic Sensor Technology's common stock, or 10 years for all other recipients of Incentive Options. Incentive Options are otherwise governed by the general terms of the Discretionary Option Grant Program.

Pursuant to the terms of the Stock Issuance Program, the purchase price per share of common stock issued is fixed by the administrator, but may not be less than 85% of the fair market value of the common stock on the issuance date, unless the recipient of a such common stock owns 10% or more of Electronic Sensor Technology's common stock, in which case the purchase price must not be less than 100% of the fair market value. Common stock may be issued in exchange for cash or past services rendered to Electronic Sensor Technology (or any parent or subsidiary of Electronic Sensor Technology). Common stock issued may be fully and immediately vested upon issuance or may vest in one or more installments, at the discretion of the administrator.

Management used Black Scholes methodology to determine the fair value of the options on the date of issue based on the following assumptions. The expected volatility was based on the average historical volatility of comparable publicly-traded companies.

Exercise price	\$ 0.19 - \$ 0.24
Market value	\$ 0.19 - \$ 0.24
Expected dividend yield	0%
Expected volatility	36% - 39%
Risk free interest rate	4.03% - 4.54%
Expected life of option	5 years

The fair value of the granted stock options shares was approximately \$237,000 or \$0.09 per share. Approximately \$114,000 was charged to compensation expense in 2007. The remaining amount will be amortized to compensation expense over future periods based on the vesting schedule of the respective stock option shares. The total compensation cost related to nonvested awards not yet recognized amounted to approximately \$112,000 at December 31, 2007. This compensation cost will be recognized over the weighted average period of the remaining terms of the stock options, unless the options are terminated sooner.

The following tables summarize all stock option grants to employees and non-employees as of December 31, 2007:

Stock Options	Number of Options	Weighted Average Exercise Price
Balance at December 31, 2005	1,219,500	\$ 0.93
Granted	-	\$ -
Exercised	-	\$ -
Forfeited	-	\$ -
Balance at December 31, 2006	1,219,500	\$ 0.93
Granted	2,657,950	\$ 0.22

Exercised	-	$ -
Forfeited	(439,500)	$ 0.73
Balance at December 31, 2007	3,437,950	$ 0.41
Options exercisable at December 31, 2007	1,839,750	$ 0.58
Weighted average fair value of options granted during 2007	2,657,950	$ 0.09

A summary of the status of the Company's nonvested shares as of December 31, 2007, and changes during the fiscal year then ended as presented below.

Nonvested Shares	Shares	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2006	-	-
Granted	2,657,950	$ 0.22
Vested	(898,250)	$ 0.09
Cancelled	(161,500)	$ 0.09
Nonvested at December 31, 2007	1,598,200	$ 0.09

Options Outstanding				Options Exercisable	
Exercise Price	**Number Outstanding as of December 31, 2007**	**Weighted Average Remaining Contractual Years**	**Weighted Average Exercise Price**	**Number Exercisable at December 31, 2007**	**Weighted Average Exercise Price**
$ 0.19	330,750	9.17	$ 0.19	330,750	$ 0.19
$ 0.20	1,000,000	9.50	$ 0.20	100,000	$ 0.20
$ 0.24	1,165,700	9.08	$ 0.24	467,500	$ 0.24
$ 0.64	250,000	7.83	$ 0.64	250,000	$ 0.64
$ 1.00	691,500	7.08	$ 1.00	691,500	$ 1.00
	3,437,950	8.72	$ 0.41	1,839,750	$ 0.57

(8) Commitments and Contingencies

Leases

The Company rents office space and production facilities in Newbury Park, California. The lease expires in September 2010. The rental expense associated with this lease was approximately $180,000 and $196,800 in 2007 and 2006, respectively. As of December 31, 2007, the total future minimum rental payments on this lease is approximately $393,900 (if stated by year, the minimum rental payments are: 2008 – 140,300, 2009 – 144,500, and 2010 – 109,100).

During 2007, the Company entered into a lease for equipment used in administration. Lease payments in 2007 totaled approximately $2,200. As of December 31, 2007, the total future minimum lease payments on this lease is approximately $9,800 (if stated by year, the minimum lease payments are: 2008 - $2,400, 2009 - $2,400, 2010 - $2,400, 2011 - $2,400, and 2012 - $200).

(9) Retirement savings plan

The Company sponsors a safe harbor 401(k) retirement savings plan (the plan) which covers most of its full-time employees. The Company contributes 3% of compensation for each payroll period to all eligible employees. Eligible employees may also elect to contribute a percentage of their compensation to the Plan. During 2007 and 2006, the Company contributed approximately $32,300 and $40,500, respectively, to the Plan.

(10) Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the net deferred taxes, as of December 31, 2007, are as follows:

Deferred tax assets:	
Net operating loss carryforward	$ 3,300,000
Less valuation allowance	(3,300,000)
Total net deferred tax assets:	$ -

The Company's net operating losses totaled approximately $8.1 million at December 31, 2007, and will expire in 2027.

SFAS No. 109 requires a valuation allowance to reduce the deferred tax assets reported, if any, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Management has determined that a valuation allowance of $3,300,000 at December 31, 2007 is necessary to reduce the deferred tax assets to the amount that will more likely than not be realized. The change in the valuation allowance during 2007 and 2006 was an increase of approximately $1,300,000 and $1,100,000 respectively.

The federal statutory tax rate reconciled to the effective tax rate during 2007 and 2006, respectively, is as follows:

	2007	2006
Tax at U.S. Statutory Rate:	35.0%	35.0%
State tax rate, net of federal benefits	5.7	5.7
Change in valuation allowance	(40.7)	(40.7)
Effective tax rate	0.0%	0.0%

(11) Subsequent events

On March 28, 2008, the Company received $5.5 million from an investor, $3.5 million of which will be for the purchase of common stock of the Company, and $2.0 million of which will be in exchange for a 9% convertible debenture to be issued by the Company. The Company will issue to the investor common stock shares at a price of $0.0405 per share. The 9% convertible debenture will have a five (5)-year term, and the conversion rate of the debenture will be at $0.0486. A condition of the new investment requires the Company to use $3.5 million to extinguish the 8% convertible debentures held by the current holders.

A Conversion and Termination Agreement entered into with the current debentures holders on February 26, 2008, provides that in exchange for $3.5 million, the current debenture holders will convert $3.5 million of the principal amount of their 8% convertible debentures, together with interest thereon, at a conversion price of $0.35 per share of Common Stock. Upon receipt of the foregoing sum and the conversion shares of Common Stock, the current debenture holders agreed to cancel the remainder of their 8% convertible debentures and 50% of the shares of Common Stock underlying warrants. With respect to the remaining 6,065,158 shares of Common Stock underlying the warrants, they will otherwise continue in full force and effect in accordance with their terms.

Absent other transactions which would warrant the same accounting treatment, the Company will discontinue the recognition of derivative liabilities once it can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares. As a result of the satisfaction of the Company's obligations under its convertible debentures, the Company can assert that it has a sufficient amount of authorized and unissued shares to settle its obligations which can be settled in shares at March 31, 2008. Accordingly, the Company will reclassify all contracts, warrants, and other convertible instruments outstanding at March 31, 2008 from liability to equity.

ELECTRONIC SENSOR TECHNOLOGY, INC.
CONSOLIDATED BALANCE SHEET

ASSETS

	June 30, 2008 (Unaudited)	December 31, 2007 (Audited)
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,347,286	$ 248,587
Certificate of deposit-restricted	12,384	12,384
Accounts receivable, net	189,237	281,400
Prepaid expenses	195,618	80,761
Inventories	879,022	818,989
TOTAL CURRENT ASSETS	2,623,547	1,442,121
DEFERRED FINANCING COSTS, net	-	347,967
PROPERTY AND EQUIPMENT, net	142,448	174,111
SECURITY DEPOSITS	12,817	12,817
	$ 2,778,812	$ 1,977,016

LIABILITIES AND STOCKHOLDERS' EQUITY

	June 30, 2008 (Unaudited)	December 31, 2007 (Audited)
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 747,652	$ 520,685
Deferred revenues	16,667	41,667
Derivative liabilities	-	2,376,543
Convertible debentures - current portion	-	2,333,333
Obligation under capital lease due within one year	18,919	17,875
TOTAL CURRENT LIABILITIES	783,238	5,290,103
CONVERTIBLE DEBENTURES - long-term portion, net of unamortized discount	1,945,323	2,527,777
LONG-TERM OBLIGATION UNDER CAPITAL LEASE	26,879	36,607
TOTAL LIABILITIES	2,755,440	7,854,487
STOCKHOLDERS' EQUITY		
Preferred stock, $.001 par value 50,000,000 shares authorized, none issued and outstanding	-	-
Common stock, $.001 par value 200,000,000 shares authorized, 155,853,385 issued and outstanding	155,854	56,756
Additional paid-in capital	15,133,341	8,939,562
Accumulated deficit	(15,265,823)	(14,873,789)
TOTAL STOCKHOLDERS' EQUITY	23,372	(5,877,471)
	$ 2,778,812	$ 1,977,016

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007
REVENUES	$ 759,642	$ 1,167,778	$ 366,109	$ 690,504
COST OF SALES	460,644	585,105	232,503	331,262
GROSS PROFIT	298,998	582,673	133,606	359,242
OPERATING EXPENSES:				
Research and development	348,937	411,109	171,614	192,322
Selling, general and administrative	1,140,705	1,386,748	652,943	609,289
TOTAL OPERATING EXPENSES	1,489,642	1,797,857	824,557	801,611
LOSS FROM OPERATIONS	(1,190,644)	(1,215,184)	(690,951)	(442,369)
OTHER INCOME (EXPENSE)				
Other income – derivative	323,210	459,043	-	332,013
Gain from extinguishment of debt	1,261,864	-	-	-
Other income (expense)	-	1,751	-	(103)
Interest (expense)	(786,466)	(1,429,452)	(52,197)	(719,954)
TOTAL OTHER INCOME (EXPENSE)	798,608	(968,658)	(52,197)	(388,044)
NET (LOSS)	$ (392,036)	$ (2,183,842)	$ (743,148)	$ (830,413)
Loss per share, basic	$ (0.00)	$ (0.04)	$ (0.00)	$ (0.02)
Weighted average number of shares, basic	109,764,305	54,173,745	155,690,885	54,173,745
Loss per share, diluted	$ (0.01)	$ (0.05)	$ (0.00)	$ (0.02)
Weighted average number of shares, diluted	109,764,305	54,173,745	155,690,885	54,173,745

See unaudited notes to consolidated financial statements

ELECTRONIC SENSOR TECHNOLOGY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss)	$ (392,036)	$ (2,183,841)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	24,167	26,184
Decrease in allowance for doubtful accounts	-	(4,784)
Issuance of shares for payment of interest	280,000	-
Stock based compensation	21,931	72,357
Amortization of debt discount	586,269	1,166,667
Amortization of deferred financing costs	45,387	90,774
Gain on extinguishment of debt	(1,261,864)	-
Decrease in fair value of derivative liability	(323,210)	(450,293)
Changes in assets and liabilities:		
Accounts receivable	92,163	(227,855)
Inventories	(60,032)	124,173
Prepaid expenses	(114,857)	28,249
Accounts payable and accrued expenses	226,970	482,083
Deferred revenues	(25,000)	(25,000)
Net cash provided by (used in) operating activities	(900,112)	(901,286)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Increase in certificate of deposit	-	(21,000)
Proceeds from sale of property and equipment	9,884	-
Purchase of property and equipment	(2,389)	(63,675)
Net cash provided by (used in) investing activities	7,495	(84,675)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Decrease in capital lease obligation	(8,684)	-
Proceeds from issuance of 9% convertible debentures	2,000,000	-
Proceeds from issuance of equity	3,500,000	-
Repayment of 8% convertible debentures	(3,500,000)	-
Net cash provided by financing activities	1,991,316	-
NET INCREASE (DECREASE) IN CASH	1,098,699	(985,961)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	248,587	1,094,141
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,347,286	$ 108,180
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for interest	$ 4,482	$ 281,790
NONCASH FINANCING AND INVESTING ACTIVITY:		
Reclassification of derivative liability to paid-in-capital	$ 2,053,333	$ -
Conversion of 8% convertible debentures into equity	$ 500,000	$ -
Debt discount related to 9% convertible debentures	$ 54,678	$ -

See unaudited notes to consolidated financial statements.

ELECTRONIC SENSOR TECHNOLOGY, INC.
Notes to Consolidated Financial Statements
(Unaudited)
June 30, 2008

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-Q and Item 10 of Regulation S-K. 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, 2007, included in the Annual Report filed on Form 10-KSB 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, 2008, and the results of operations and cash flows for the six month period ending June 30, 2008 have been included. The results of operations for the six month period ended June 30, 2008 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 as filed with the Securities and Exchange Commission for the year ended December 31, 2007.

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.

c) Certificate of Deposit – Restricted

The Company's credit card liability is secured and collateralized with a certificate of deposit in the amount of approximately $12,000.

d) Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the Company's assessment of the collectibility of customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than the Company's historical experience, the Company's estimates of the recoverability of amounts due it could be adversely affected. The Company regularly reviews the adequacy of the Company's allowance for doubtful accounts through identification of specific receivables where it is expected that payments will not be received. The Company also establishes an unallocated reserve that is applied to all amounts that are not specifically identified. In determining specific receivables where collections may not be received, the Company reviews past due receivables and gives consideration to prior collection history and changes in the customer's overall business condition. The allowance for doubtful accounts reflects the Company's best estimate as of the reporting dates. Changes may occur in the future, which may require the

Company to reassess the collectibility of amounts and at which time the Company may need to provide additional allowances in excess of that currently provided.

e) ***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.

f) ***Shipping and Handling***

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

g) ***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.

h) ***Deferred Financing Costs***

Deferred financing costs consist of direct costs incurred by the Company in connection with the issuance of its 8% 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. On March 31, 2008, $3.5 million of the $7.0 million 8% convertible debentures was retired and the remaining $3.5 million was converted into equity. As such, the unamortized deferred financing costs related to the 8% convertible debentures were fully amortized at March 31, 2008.

i) ***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.

j) ***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.

k) ***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.

l) ***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. The fair value as of June 30, 2008 of the 9% convertible debentures issued by the Company on March 28, 2008 amounts to $2,000,000, based on the Company's incremental borrowing rate.

m) ***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, 2008 no assets were impaired.

n) **Capital Lease**

On June 28, 2007, the Company entered into a capital lease under which the present value of the minimum lease payments amounted to \$59,200. The present value of the minimum lease payments was calculated using a discount rate of 11.41%. The principal balance of the capital lease obligation amounted to approximately \$45,800 at June 30, 2008, including approximately \$18,900 in the current portion of capital lease obligations in the accompanying consolidated balance sheet.

o) ***Derivative Liabilities***

The Company accounts for its liquidated damages pursuant to FASB Staff Position No. EITF 00-19-2 "Accounting for Registration Payment Arrangements" ("FSP 00-19-2"). FSP 00-19-2 provides that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, should be separately recognized and measured in accordance with FASB Statement No.5, "Accounting for Contingencies". The registration statement payment arrangement should be recognized and measured as a separate unit of account from the financial instrument(s) subject to that arrangement. If the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, such contingent liability is included in the allocation of proceeds from the related financing instrument. The Company had registered all shares underlying the 8% convertible debentures as well as all shares underlying the warrants related to the 8% convertible debentures, but no longer maintains such registration, in light of the partial conversion and partial cancellation of the debentures and a portion of the warrants.

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.

p) ***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 by dividing income available to stockholders, adjusted for interest savings on the convertible debenture and changes in income or loss associated with the derivative contract that would result if the contract had been recorded as an equity instrument for accounting purposes during the period, by the weighted average number of common shares outstanding during the period plus the net effect of stock options and warrants, effect of the convertible debentures, and embedded conversion features.

The outstanding options, warrants and shares equivalent issuable pursuant to embedded conversion features and warrants at June 30, 2008 are excluded from the loss per share computation for that period due to their antidilutive effect.

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

	2008	2007
Numerator:		
Net (loss)	$ (392,036)	$ (2,183,842)
Net other (income)/expense associated with derivative contracts	(323,210)	(459,043)
Interest expense in convertible debentures	-	-
Net income (loss) for diluted earnings per share purposes	$ (715,246)	$ (2,642,885)
Denominator:		
Denominator for basic earnings per share-Weighted average shares outstanding	109,764,305	54,173,745
Effect of dilutive stock options and warrants, determined under the treasury stock method	-	-
Assume issued common shares for convertible debentures, determined under the if-converted method	-	-
Denominator for diluted earnings per share-Weighted average shares outstanding	109,764,305	54,173,745
Basic earnings (loss) per share	$ 0.00	$ (0.04)
Diluted earnings (loss) per share	$ (0.01)	$ (0.05)

q) ***Stock Based Compensation***

The Company adopted SFAS No. 123R, "Share Based Payments." SFAS No. 123R requires companies to expense the value of employee stock options and similar awards and applies to all outstanding and vested stock-based awards.

In computing the impact, the fair value of each option is estimated on the date of grant based on the Black-Scholes options-pricing model utilizing certain assumptions for a risk free interest rate; volatility; and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and the Company uses different assumptions, the Company's stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what we have recorded in the current period. The impact of applying SFAS No. 123R approximated $22,000 in additional compensation expense during for the six month period ended June 30, 2008. Such amount is included in general and administrative expenses on the statement of operations.

r) ***Recently Issued Accounting Pronouncements***

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FAS 115 ("SFAS No. 159"). SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. The Company is currently evaluating the impact of adopting SFAS No. 159 on our consolidated financial position, results of operations and cash flows.

FASB Statement Number 141 (revised 2007)

In December 2007, the FASB issued FASB Statement No. 141 (revised 2007), Business Combinations. This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. This Statement's scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. By applying the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses, this Statement improves the comparability of the information about business combinations provided in financial reports.

This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces Statement 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values.

This Statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquirer), including those sometimes referred to as "true mergers" or "mergers of equals" and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This Statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to: (a) The formation of a joint venture, (b) The acquisition of an asset or a group of assets that does not constitute a business, (c) A combination between entities or businesses under common control, (d) A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

FASB Statement Number 160

In December 2007, the FASB issued FASB Statement No. 160 - Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51. This Statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. Not-for-profit organizations should continue to apply the guidance in Accounting Research Bulletin No. 51, Consolidated Financial Statements, before the amendments made by this Statement, and any other applicable standards, until the Board issues interpretative guidance.

This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Before this Statement was issued, limited guidance existed for reporting noncontrolling interests. As a result, considerable diversity in practice existed. So-called minority interests were reported in the consolidated statement of financial position as liabilities or in the mezzanine section between liabilities and equity. This Statement improves comparability by eliminating that diversity.

A noncontrolling interest, sometimes called a minority interest, is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. The objective of this Statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require: (a) The ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity, (b) The amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income, (c) Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. A parent's ownership interest in a subsidiary changes if the parent purchases additional ownership interests in its subsidiary or if the parent sells some of its ownership interests in its subsidiary. It also changes if the subsidiary reacquires some of its ownership interests or the subsidiary issues additional ownership interests. All of those transactions are economically similar, and this Statement requires that they be accounted for similarly, as equity transactions, (d) When a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value. The gain or loss on the deconsolidation of the subsidiary is measured using the fair value of any noncontrolling equity investment rather than the carrying amount of that retained investment, (e) Entities provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners.

This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall be applied retrospectively for all periods presented. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

<u>FASB 161 - Disclosures about Derivative Instruments and Hedging Activities</u>

In March 2008, the FASB issued FASB Statement No. 161, which amends and expands the disclosure requirements of FASB Statement No. 133 with the intent to provide users of financial statements with an enhanced understanding of; how and why an entity uses derivative instruments, how the derivative instruments and the related hedged items are accounted for and how the related hedged items affect an entity's financial position, performance and cash flows. This Statement is effective for financial statements for fiscal years and interim periods beginning after November 15, 2008. Management believes this Statement will have no impact on the financial statements of the Company once adopted.

<u>FASB 161 – The Hierarchy of Generally Accepted Accounting Principles</u>

In May 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 162, "The Hierarchy of Generally Accepted Accounting Principles." The new standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP) for non-governmental entities. We are currently evaluating the effects, if any, that SFAS No. 162 may have on our financial reporting.

4) Convertible debentures

<u>8% Convertible Debentures</u>

During December 2005, we issued in a private offering, $7,000,000 aggregate principal amount of 8% convertible debentures due December 7, 2009. The convertible debentures were 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, which was subsequently reduced to $0.4000 as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the convertible debentures and can be redeemed at the lesser of $0.4000 or 90% of the average of the volume weighted average price for the 20 consecutive trading days immediately prior to the conversion date. Interest on the convertible debentures was payable in cash or stock, at the Company's option.

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, which was subsequently reduced to $0.4300 per share as per a Forbearance and Amendment Agreement, dated September 7, 2006, with the holders of the warrants.

We paid professional fees of approximately $592,000 and issued 485,213 warrants with a fair value of approximately $136,000 relating to the issuance of the convertible debentures and warrants. The payments of professional fees and the fair value of the warrants, aggregating approximately $729,000, were recorded as deferred financing costs.

A Conversion and Termination Agreement was entered into with the debentures holders on February 26, 2008. Pursuant to the agreement, the convertible debentures holders agreed that in exchange for $3,500,000, the debenture holders would convert $3,500,000 of the principal amount of their 8% convertible debentures, together with accrued interest thereon, at a conversion price of $0.35 per share of Common Stock. Upon receipt of the foregoing sum and the conversion shares of Common Stock, the debenture holders agreed to cancel the remainder of their 8% convertible debentures and 50% of the shares of Common Stock underlying warrants. With respect to the remaining 6,065,157 shares of Common Stock underlying the warrants, they will otherwise continue in full force and effect in accordance with their terms. On March 31, 2008, we remitted $3,500,000 in cash and transferred 10,400,000 shares of common stock to the debenture holders to completely retire the 8% convertible debentures.

The extinguishment of the convertible debentures resulted in a gain of approximately $1,261,900, which included the write off of related unamortized deferred financing costs of approximately $302,600.

<u>9% Convertible Debentures</u>

On March 28, 2008, we received $5,500,000 from an investor, $3,500,000 of which was for Common Stock of the Company, and $2,000,000 for a convertible debenture bearing an interest rate of 9%, payable semi-annually in cash. The common stock shares were issued at a price of $0.0405 per share. The 9% convertible debenture has a five (5)-year term, and the conversion rate of the debenture is $0.0486. The difference between the conversion rate of the debenture and the closing price of the Company's common stock on the date of issuance resulted in a note discount of approximately $58,000. The note discount will be amortized over the term of the convertible debenture.

A condition of the new investment required the Company to use $3,500,000 to extinguish the 8% convertible debentures and this event occurred on March 31, 2008.

5) Derivative Liabilities

In connection with the issuance of the 8% convertible debentures in December 2005, 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.

A Conversion and Termination Agreement was entered into with the 8% convertible debenture holders on February 26, 2008. Pursuant to the agreement, the convertible debenture holders agreed that in exchange for $3,500,000, the debenture holders would convert $3,500,000 of the principal amount of their 8% convertible debentures, together with accrued interest thereon, at a conversion price of $0.35 per share of Common Stock. Upon receipt of the foregoing sum and the conversion shares of Common Stock, the debenture holders agreed to cancel the remainder of their 8% convertible debentures and 50% of the shares of Common Stock underlying warrants. With respect to the remaining shares of

Common Stock underlying the warrants, they will otherwise continue in full force and effect in accordance with their terms. On March 31, 2008, we remitted $3,500,000 in cash and transferred 10,400,000 shares of Common Stock to the debenture holders.

As a result of the satisfaction of the Company's obligations under its 8% convertible debentures, the Company reclassified the derivative liabilities balance outstanding at March 31, 2008 from liability to equity. The amount of derivative liabilities that was reclassified to equity approximated $2,053,000.

6) Stockholders' Equity

Options

In 2005, the Board of Directors adopted the Electronic Sensor Technology, Inc. 2005 Stock Incentive Plan. The purpose of the Stock Incentive Plan is to attract and retain the services of experienced and knowledgeable individuals to serve as our employees, consultants and directors. On the date the Stock Incentive Plan was adopted, the total number of shares of common stock subject to it was 5,000,000. The Stock Incentive Plan is currently administered by the Board of Directors, and may be administered by any Committee authorized by the Board of Directors, so long as any such Committee is made up of Non-Employee Directors, as that term is defined in Rule 16(b)-3(b) of the Securities Exchange Act of 1934.

The Stock Incentive Plan is divided into two separate equity programs: the Discretionary Option Grant Program and the Stock Issuance Program. Under the Discretionary Option Grant Program, eligible persons may, at the discretion of the administrator, be granted options to purchase shares of common stock and stock appreciation rights. Under the Stock Issuance Program, eligible persons may, at the discretion of the administrator, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered for Electronic Sensor Technology (or a parent or subsidiary of Electronic Sensor Technology).

Pursuant to the terms of the Discretionary Option Grant Program, the exercise price per share is fixed by the administrator, but may not be less than 85% of the fair market value of the common stock on the date of grant, unless the recipient of a grant owns 10% or more of Electronic Sensor Technology's common stock, in which case the exercise price of the option must not be less than 110% of the fair market value. An option grant may be subject to vesting conditions. Options may be exercised in cash, with shares of the common stock of Electronic Sensor Technology already owned by the person or through a special sale and remittance procedure, provided that all applicable laws relating to the regulation and sale of securities have been complied with. This special sale and remittance procedure involves the optionee concurrently providing irrevocable written instructions to: (i) a designated brokerage firm to effect the immediate sale of the purchased shares and remit to Electronic Sensor Technology, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable federal, state and local income and employment taxes required to be withheld by Electronic Sensor Technology by reason of such exercise and (ii) Electronic Sensor Technology to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale. The term of an option granted pursuant to the Discretionary Option Grant Program may not be more than 10 years.

The Discretionary Option Grant Program also allows for the granting of Incentive Options to purchase common stock, which may only be granted to employees, and are subject to certain dollar limitations. Any options granted under the Discretionary Option Grant Program that are not Incentive Options are considered Non-Statutory Options and are governed by the aforementioned terms. The exercise price of an Incentive Option must be no less than 100% of the fair market value of the common stock on the date of grant, unless the recipient of an award owns 10% or more of Electronic Sensor Technology's common stock, in which case the exercise price of an incentive stock option must not be less than 110% of the fair market value. The term of an Incentive Option granted may not be more than five years if the option is granted to a recipient who owns 10% or more of Electronic Sensor Technology's common stock, or 10 years for all other recipients of Incentive Options. Incentive Options are otherwise governed by the general terms of the Discretionary Option Grant Program.

Pursuant to the terms of the Stock Issuance Program, the purchase price per share of common stock issued is fixed by the administrator, but may not be less than 85% of the fair market value of the common stock on the issuance date, unless the recipient of a such common stock owns 10% or more of Electronic Sensor Technology's common stock, in which case the purchase price must not be less than 100% of the fair market value. Common stock may be issued in exchange for cash or past services rendered to Electronic Sensor Technology (or any parent or subsidiary of Electronic Sensor Technology). Common stock issued may be fully and immediately vested upon issuance or may vest in one or more installments, at the discretion of the administrator.

Management used Black Scholes methodology to determine the fair value of the options on the date of issue based on the following assumptions. The expected volatility was based on the average historical volatility of comparable publicly-traded companies.

Exercise price	$ 0.19 - $ 0.24
Market value	$ 0.19 - $ 0.24
Expected dividend yield	0%
Expected volatility	36% - 39%
Risk free interest rate	4.03% - 4.54%
Expected life of option	5 years

The fair value of the granted stock options shares was approximately $237,000 or $0.09 per share. Approximately $114,000 and $22,000 were charged to compensation expense in 2007 and in the six month period ended June 30, 2008, respectively. The remaining amount will be amortized to compensation expense over future periods based on the vesting schedule of the respective stock option shares. The total compensation cost related to nonvested awards not yet recognized amounted to approximately $90,000 at June 30, 2008. This compensation cost will be recognized over the weighted average period of the remaining terms of the stock options, unless the options are terminated sooner.

The following tables summarize all stock option grants to employees and non-employees as of June 30, 2008:

Stock Options	**Number of Options**	**Weighted Average Exercise Price**
Balance at December 31, 2006	1,219,500	$ 0.93
Granted	2,657,950	$ 0.22
Exercised	-	$ -
Forfeited	(439,500)	$ 0.73
Balance at December 31, 2007	3,437,950	$ 0.41
Granted	-	$ -
Exercised	-	$ -
Forfeited	(422,600)	$ 0.48
Balance at June 30, 2008	3,015,350	$ 0.40
Options exercisable at June 30, 2008	2,031,275	$ 0.48
Weighted average fair value of options granted during 2008	-	$ -

A summary of the status of the Company's nonvested shares as of June 30, 2008, and changes during the fiscal year then ended as presented below.

Nonvested Shares	**Shares**	**Weighted Average Grant Date Fair Value**
Nonvested at December 31, 2006	-	$ -
Granted	2,657,950	$ 0.22
Vested	(898,250)	$ 0.09
Cancelled	(161,500)	$ 0.09
Nonvested at December 31, 2007	1,598,200	$ 0.09

Granted	-	$	-
Vested	(495,525)	$	0.22
Cancelled	(118,600)	$	0.24
Nonvested at June 30, 2008	984,075	$	0.21

Options Outstanding					Options Exercisable		
	Exercise Price	Number Outstanding as of June 30, 2008	Weighted Average Remaining Contractual Years		Weighted Average Exercise Price	Number Exercisable at June 30, 2008		Weighted Average Exercise Price
$	0.19	262,750	8.67	$	0.19	262,750	$	0.19
$	0.20	1,000,000	9.00	$	0.20	325,000	$	0.20
$	0.24	947,100	8.58	$	0.24	638,025	$	0.24
$	0.64	250,000	7.33	$	0.64	250,000	$	0.64
$	1.00	555,500	6.58	$	1.00	555,500	$	1.00
		3,015,350	8.24	$	0.40	2,031,275	$	0.52

7) Subsequent Event

On July 25, 2008, the board of directors accepted Barry S. Howe's resignation as President and Chief Executive Officer and a director of the company. The terms of Mr. Howe's resignation are described in the Severance Agreement and Mutual Release attached to our current report on Form 8-K filed with the Securities and Exchange Commission on July 29, 2008. The Severance Agreement provides for payment of five and one-third months' salary (totaling $82,171) as severance to Mr. Howe. The severance to Mr. Howe is included in our financial statements for June 30, 2008.

Upon written request, we will furnish to our shareholders, without charge, a copy of our annual report filed with the U.S. Securities and Exchange Commission on Form 10-KSB for the year 2007. Such request should contain a representation that the person requesting this material was a beneficial owner of our shares. Such request should be sent to the Secretary at our address indicated on the first page of this annual report.

SPECIAL NOTE OF CAUTION REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this annual report, including those relating to the company's plans regarding business and product development; product sales and distribution; market demands and developments in the homeland security, analytical instrumentation/quality control and environmental monitoring markets; and the sufficiency of the company's resources to satisfy operation cash requirements are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may contain the words "believe," "anticipate," "expect," "predict," "estimate," "project," "will be," "will continue," "will likely result," or other similar words and phrases. Risks and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those described in the forward-looking statements include: risks related to changes in technology, our dependence on key personnel, our ability to protect our intellectual property rights, emergence of future competitors, changes in our largest customer's business and government regulation of homeland security companies. The forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

END