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TAYLOR DEVICES INC
Form 10KSB
August 29, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
F O R M 10-KSB

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

For the fiscal year ended May 31, 2006

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-3498

TAYLOR DEVICES, INC.
(Name of small business issuer as specified in its charter)

New York
(State or other jurisdiction of
incorporation or organization)

16-0797789
(I.R.S. Employer
Identification No.)

90 Taylor Drive, P.O. Box 748, N. Tonawanda, New York 14120-0748
(Address of principal executive offices)

Issuer's telephone number (716) 694-0800

Securities registered pursuant to Section 12(b) of the Act:

Title of each class
None

Name of each exchange on
which registered
None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock (\$.025 par value)
(Title of class)

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

Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendments to Form 10-KSB .

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

Issuer's revenues for its most recent fiscal year are \$14,750,699.

The aggregate market value of the Common Stock held by non-affiliates (as affiliates are defined in Rule 12b-2 of the Exchange Act) of the issuer, computed by reference to the average of the bid and asked price on August 17, 2006 was \$13,711,011. In addition to shares held by affiliates, this calculation also excludes shares of the issuer's common stock that are held by Schedule 13D filers.

The number of shares outstanding of each of the registrant's classes of Common Stock, as of the latest practicable date.

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Class
Common Stock, \$.025 par value

Outstanding at August 17, 2006
3,142,922

TAYLOR DEVICES, INC.

DOCUMENTS INCORPORATED BY REFERENCE

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Proxy Statement

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

The Company was incorporated in the State of New York on July 22, 1955 and is engaged in the design, development, manufacture and marketing of shock absorption, rate control, and energy storage devices for use in various types of machinery, equipment and structures. In addition to manufacturing and selling existing product lines, the Company continues to develop new and advanced technology products.

Principal Products

The Company manufactures and sells a single group of very similar products that have many different applications for customers. These similar products are included in one of six categories; namely, Seismic Dampers, Fluidicshoks®, Crane and Industrial Buffers, Self-Adjusting Shock Absorbers, Liquid Die Springs, and Vibration Dampers. Management does not track or otherwise account for sales broken down by these categories. The following is a summary of the capabilities and applications for these products.

Seismic Dampers are designed to ameliorate the effects of earthquake tremors on structures, and represent a substantial part of the business of the Company. Fluidicshoks® are small, extremely compact shock absorbers with up to 19,200 inch-pound capacities, produced in 15 standard sizes for primary use in the defense, aerospace and commercial industry. Crane and industrial buffers are larger versions of the Fluidicshoks® with up to 60,000,000 inch-pound capacities, produced in more than 60 standard sizes for industrial application on cranes, ships, container ships, railroad cars, truck docks, ladle and ingot cars, ore trolleys and car stops. Self-adjusting shock absorbers, which include versions of Fluidicshoks® and crane and industrial buffers, automatically adjust to different impact conditions, and are designed for high cycle application primarily in heavy industry. Liquid die springs are used as component parts of machinery and equipment used in the manufacture of tools and dies. Vibration dampers are used primarily by the aerospace and defense industries to control the response of electronics and optical systems subjected to air, ship, or spacecraft vibration.

Distribution

The Company utilizes the services of more than 50 sales representatives and distributors in the United States and Canada. Specialized technical sales in aerospace and custom marketing activities are serviced by three sales agents, under the direction and with the assistance of Douglas P. Taylor, the Company's President. Sales representatives typically have non exclusive, yearly agreements with the Company, which, in most instances, provide for payment of commissions on sales at 10% of the product's net aggregate selling price. Distributors also have non exclusive, yearly agreements with the Company to purchase the Company's products for resale purposes.

Competition

The Company faces competition on mature aerospace and defense programs which may use more conventional products manufactured under less stringent government specifications. Two foreign companies are the Company's competitors in the production of crane buffers.

The Company's principal competitors for the manufacture of products in the aerospace and commercial aerospace industries field are Cleveland Pneumatic Tool Company in Cleveland, Ohio, and Menasco Manufacturing Company in Burbank, California. While the Company is competitive with these companies in the areas of pricing, warranty and product performance, due to limited financing and manufacturing facilities, the Company cannot compete in the area of volume production.

The Company competes directly against two other firms supplying seismic damping devices, as well as numerous other firms which supply alternative seismic protection technologies.

Raw Materials and Supplies

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The principal raw materials and supplies used by the Company in the manufacture of its products are provided by numerous U.S. suppliers. The loss of any one of these would not materially affect the Company's operations.

Patents, Trademarks and Licenses

Under a License Agreement ("License Agreement") dated November 1, 1959, between the Company and Tayco Developments, Inc. ("Developments"), an affiliate of the Company, the Company was granted preferential rights to market, in the United States and Canada, all existing and future inventions and patents developed by Developments. The term of this License Agreement is the life of the last-to-expire patent on which the Company is paying royalties, which is the year 2021. During the life of each patent, the Company records a royalty payable to Developments, equal to five percent of sales value of patented items sold and shipped. The Company incurred royalty charges from Developments of \$97,000 and \$165,000 in the years ended May 31, 2006 and 2005, respectively. Under the License Agreement, payments of royalties are required to be made quarterly.

The License Agreement also provides for Developments to pay the Company 10% of the gross royalties received from third parties who are permitted to make, use and sell machinery and equipment under patents not subject to the License Agreement, as well as on apparatus and equipment subject to the License Agreement but modified by the Company, with rights to such modification having been assigned to Developments. No royalties were owed to the Company in the years ended May 31, 2006 and 2005. Royalties, if any, are paid quarterly.

Although the Company and Developments share common management and a close business relationship, as separate corporations responsible to their own shareholders, interests may diverge regarding development and licensing of future inventions and patents. In that case, Developments would be permitted to license future inventions and patents to parties other than the Company, rendering the Company's option on future inventions and patents under its License Agreement only minimally beneficial.

Terms of Sale

The Company does not carry significant inventory for rapid delivery to customers, and goods are not normally sold with return rights such as are available for consignment sales. The Company has no inventory out on consignment and no consignment sales for the years ended May 31, 2006 and 2005. No extended payment terms are offered. During the year ended May 31, 2006, delivery time after receipt of orders averaged 12 to 14 weeks for the Company's standard products. Due to the volatility of construction and aerospace/defense programs, progress payments are usually required for larger projects utilizing custom designed components of the Company.

Dependence Upon Customers\Government Contracts

The Company is not dependent on any one or a few major customers. Sales to two customers approximated 28% (14% each) of net sales for 2006.

Contracts between the Company and the federal government or its independent contractors are subject to termination at the election of the federal government. Contracts are generally entered into on a fixed price basis. From time to time, the Company has also entered into a "cost plus" defense contract. If the federal government should limit defense spending, these contracts could be reduced or terminated, which would not have a materially adverse effect on the Company.

Research and Development

The Company does not normally engage in any major product research and development activities in connection with the design of its products, except when funded by aerospace customers or the federal government. See Item 1. Description of Business, "Patents, Trademarks and Licenses". The Company, however, engages in research testing of its products. For the fiscal years ended May 31, 2006 and 2005, the Company expended \$129,000 and \$257,000, respectively, on manufacturing research through Developments. For the years ended May 31, 2006 and 2005, defense sponsored research and development totaled \$63,000 and \$176,000, respectively.

Government Regulation

Compliance with federal, state and local laws and regulations which have been enacted or adopted regulating the discharge of materials into the environment has had no material effect on the Company, and the Company believes that it is in substantial compliance with such provisions.

The Company is subject to the Occupational Safety and Health Act ("OSHA") and the rules and regulations promulgated thereunder, which establish strict standards for the protection of employees, and impose fines for violations of such standards. The Company believes that it is in substantial compliance with OSHA provisions and does not anticipate any material corrective expenditures in the near future. The Company is currently incurring only moderate costs with respect to disposal of hazardous waste and compliance with OSHA regulations.

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The Company is also subject to regulations relating to production of products for the federal government. These regulations allow for frequent governmental audits of the Company's operations and fairly extensive testing of Company products. The Company believes that it is in substantial compliance with these regulations and does not anticipate corrective expenditures in the future.

Employees

Exclusive of Company sales representatives and distributors, as of May 31, 2006, the Company had 89 employees, including three executive officers, and three part time employees. The Company has good relations with its employees.

ITEM 2. DESCRIPTION OF PROPERTY

The Company's production facilities occupy approximately six acres on Tonawanda Island in North Tonawanda, New York and are comprised of four interconnected buildings and one adjacent building. The production facilities consist of a small parts plant (approximately 4,400 square feet), a large parts plant (approximately 13,500 square feet), and include a facility of approximately 7,000 square feet constructed in 1995 (see below), a test facility, storage area, pump area and the Company's general offices. The adjacent building is a 17,000 square foot seismic assembly test facility. These facilities total more than 45,000 square feet. The Company has two separate remote test facilities used for shock testing. One facility is 800 square feet, and a newer, state-of-the-art test facility is 1,225 square feet. The small parts plant consists of a complete small machine shop and tool room that produces all of the Company's product items which are less than two inches in diameter. The large parts plant consists of a complete large machine shop and tool room. Both plants contain custom-built machinery for boring, deep-hole drilling and turning of parts.

In November 1994, as part of certain tax-exempt bond financing arrangements, the Company and the Niagara County Industrial Development Agency ("NCIDA") entered into a 15 year Series Lease by NCIDA to the Company of approximately 7,000 square feet of manufacturing space adjacent to the Company's existing large machine shop. The expansion partially accommodated the Company's increased need for additional manufacturing space for its seismic damper devices.

Rental payments, equivalent to payments of principal and interest due, are made quarterly by the Company over the term of the Lease, and are sufficient to amortize the \$1,250,000 tax-exempt industrial development revenue Series A Bonds (the "Bond") issued by the NCIDA. The payments reimburse HSBC Bank, N.A. ("HSBC"), as issuer of the five year direct-pay irrevocable letter of credit, which is drawn upon by Deutsche Bank Trust Company, Americas, as Trustee, for the benefit of the bondholders. The letter of credit was renewed by HSBC in November, 2004 for another five-year period. The Bond bears interest at the HSBC Adjustable Rate Service ("HSBC ARS") rate, plus an incremental amount designated by HSBC Securities, Inc. (the "Remarketing Agent"). The HSBC ARS rate reflects the current bid-side yield of the highest rated short-term, federally tax exempt obligations currently being traded, announced weekly by the Remarketing Agent, not to exceed 15% per annum, and is the minimum rate of interest necessary to enable the Remarketing Agent to remarket the Bond at par. Annual principal payments by the Company in June of each year range from \$25,000 to \$150,000, including a final principal payment of \$45,000 upon maturity of the Bond on June 1, 2009. The Bond may be redeemed in whole, or in part, on any quarterly interest payment date, without penalty or premium. The principal amount outstanding on the Bond as of May 31, 2006 is \$145,000.

Rental payments are secured by the liens of the Master Indenture between the NCIDA and the Trustee, the Series Supplemental Indenture between the NCIDA and the Trustee, and the Series Mortgage from the NCIDA, the Company, and Tayco Realty Corporation, an affiliate of the Company ("Tayco Realty"), to HSBC, as well as by other collateral security arrangements. When the Bond matures on June 1, 2009, the Company must purchase the Facility from the NCIDA for \$1.00.

A renewal note dated June 1, 1998 due June 1, 2008 in the face amount of \$174,778 is held by HSBC and is secured by property located at 90 Taylor Drive, North Tonawanda, New York. The principal balance at May 31, 2006 is \$39,001.

A mortgage note dated January 1998, due January 1, 2013 in the face amount of \$400,000 is also held by HSBC on property located at 90 Taylor Drive, North Tonawanda, New York, with an interest rate equal to the bank's prime interest rate plus 1%. A monthly payment of \$2,222 is due on the first of each month. The principal balance at May 31, 2006 is \$180,000. All payments on the above obligations are current.

Additional information regarding the Company's long-term debt is contained in Note 9 to the Consolidated Financial Statements filed with this report.

Except for the premises leased from the NCIDA, the Company leases portions of both the building and the property on which it is located from Tayco Realty. Pursuant to the Lease Agreement between the Company and Tayco Realty, rental payments from June 1, 2005 to May 31, 2006 totaled \$159,600. The Lease Agreement, which contains standard terms and conditions, was renewed on November 1, 2005 for a term of ten years. Annual rentals are renegotiated by management of the two companies. The total rent paid by the Company is determined by a base rate, subject to adjustment for increases in taxes, maintenance costs and for utilization of additional space by the Company. The Company also pays for certain expenses incurred for the operation of the facilities. In addition, the Company leases a separate warehouse for storage from an unrelated third party, consisting of approximately 3,600 square feet at \$825 per month. The warehouse is located approximately one-quarter

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mile from the above-referenced production facilities and office space. The total rental expense incurred by the Company for this facility in fiscal 2006 was \$9,900.

The Company believes it is carrying adequate insurance coverage on its facilities and their contents.

The following tables provide information regarding the properties discussed in this Item 2. Description of Property.

TAYLOR DEVICES, INC. AND SUBSIDIARY
DISCLOSURE FOR REG. 228.102(c) FOR FILING 10-KSB

05/31/06

Reg. 228.102(c)-Real Estate

Property Location / Description		Book		Net Book	
90 & 100 Taylor Drive N. Tonawanda, NY 14120 (see below)	Cost	Accumulated Depreciation 5/31/2006		Value 5/31/2006	Percentage of Total Assets
Land	\$ 141,483	\$ -		\$ 141,483	
Buildings	1,154,353	746,642		407,711	
Improvements	2,631,231	841,578		1,789,653	
Total	\$ 3,927,067	\$ 1,588,220		\$ 2,338,847	13.5%
<u>90 Taylor Drive</u>					
Land	\$ 107,363	\$ -		\$ 107,363	
Building	428,506	428,506		-	
Building Improvements-Realty	297,664	62,316		235,348	
Building Improvements-Devices	2,333,567	779,262		1,554,305	
Total	\$ 3,167,100	\$ 1,270,084		\$ 1,897,016	10.9%
<u>100 Taylor Drive</u>					
Land	\$ 34,120	\$ -		\$ 34,120	
Building	725,847	318,136		407,711	
Total	\$ 759,967	\$ 318,136		\$ 441,831	2.5%
Taylor Devices, Inc. & Subsidiary					
Total Assets as of May 31, 2006			\$ 17,384,705		

Reg. 228.102(c)(3)

Pursuant to the Lease Agreement dated July 1, 2000 between the Company and Developments, the Company, which leases the parcel from Tayco Realty, sub-leases approximately 800 square feet of office and research and development space located at 100 Taylor Drive, North Tonawanda, to Developments at a base annual rental of \$12,000. The rate of any rental increase may not exceed 10% annually and may be waived by both parties in writing. The sublease automatically renews on each anniversary of its commencement date, unless either party gives three months' written notice to the other of termination. The sublease provides that on April 1 of each year, management of both companies will review the agreement to determine possible increases for expenses due to increased taxes, maintenance costs, or for additional space utilized by Developments. In fiscal 2006, the Company received total rental payments of \$12,000 from Developments.

Reg.228.102(c)(7)(vi)(A-D)

Property Location / Description	Federal Tax Depreciation Methods	Federal Tax Life Claim	Federal Tax Cost	Federal Tax Accumulated Depreciation	Net Tax Basis 5/31/2006
90 & 100 Taylor Drive N. Tonawanda, NY 14120 (see below)					
Building	Straight Line, MACRS	15-40 Yrs.	\$ 1,154,353	\$ 778,621	\$ 375,732
Building Improvements	Straight Line ACRS, MACRS	7-40 Yrs.	2,631,231	893,040	1,738,191
Total			\$ 3,785,584	\$ 1,671,661	\$ 2,113,923
<u>90 Taylor Drive</u>					
Building	Straight Line, MACRS	15-31.5 Yrs.	\$ 428,506	\$ 428,506	\$ -
Building Improvements-Realty	Straight Line	7-39 Yrs.	297,664	69,830	227,834

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	Straight Line ACRS,					
Building Improvements-Devices	MACRS	15-40 Yrs.	2,333,567	823,210	1,510,357	
Total			\$ 3,059,737	\$ 1,321,546	\$ 1,738,191	
<u>100 Taylor Drive</u>						
Building	Straight Line	19-40 Yrs.	\$ 725,847	\$ 350,115	\$ 375,732	

Reg. 228.102(c)(7)(vii)

The Company recorded \$43,000 expense during the year for real property taxes and payments in lieu of taxes. This represents a combined tax rate of \$37.77 per \$1,000 of assessed valuation including a 50% reduction in taxes for the property leased from the NCIDA. This reduction will cease upon payment in full of the Bond and the Company's purchase for \$1.00 of the land leased from the NCIDA.

ITEM 3. LEGAL PROCEEDINGS

None except for routine litigation incidental to the business.

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

None.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

The Company's Common Stock trades on the Small Cap Market tier of the National Association of Securities Dealers Automated Quotation ("NASDAQ") stock market under the symbol TAYD. The high and low market prices noted below for the quarters of FY06 and FY05 are obtained from NASDAQ.

	<u>Fiscal 2006</u>		<u>Fiscal 2005</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
First Quarter	3.750	2.630	2.570	2.020
Second Quarter	4.680	2.838	2.900	2.020
Third Quarter	6.200	3.080	9.190	2.200
Fourth Quarter	8.250	5.000	6.440	2.560

Holders

As of August 17, 2006, the number of issued and outstanding shares of Common Stock was 3,142,922, and the approximate number of record holders of the Company's Common Stock was 892. Due to a substantial number of shares of the Company's Common Stock held in street name, the Company believes that the total number of beneficial owners of its Common Stock exceeds 2,000.

Dividends

No cash or stock dividends have been declared during the last two fiscal years. Except as described below, under the terms of the Company's credit arrangement with its major lender, the Company is prohibited from issuing cash dividends.

On October 5, 1998, the Company's Board of Directors adopted a shareholder rights plan designed to deter coercive or unfair takeover tactics and prevent an acquirer from gaining control of the Company without offering a fair price to shareholders. Under the plan, certain rights ("Rights") were distributed as a dividend on each share of Common Stock (one Right for each share of Common Stock) held as of the close of business on or after October 19, 1998. Each whole Right entitles the holder, under certain defined conditions, to buy one two-thousandths (1/2000) of a newly issued share of the Company's Series A Junior Participating Preferred Stock ("Series A Preferred Stock") at an exercise

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price of \$5.00. Rights attach to and trade with the shares of Common Stock, without being evidenced by a separate certificate. No separate Rights certificates will be issued unless and until the Rights detach from Common Stock and become exercisable for shares of the Series A Preferred Stock.

Such an event will occur if (1) a person or group acquires beneficial ownership of 30% or more of the Company's Common Stock (except through a tender or exchange offer for all shares which the Board determines is fair and in the best interests of the Company and its shareholders); or (2) a person or group commences a tender or exchange offer which will result in the person or group beneficially owning 24% or more of the Common Stock; or (3) the Board determines that a person or group holding at least 24% of the Common Stock intends to cause or pressure the Company into taking actions adverse to its or its shareholders' interests, or that the person or group is causing or is likely to cause a material adverse impact on the business or prospects of the Company. The Rights expire on October 5, 2008.

Equity Compensation Plan Information

The following table sets forth information regarding equity compensation plans of the Company as of May 31, 2006.

Equity Compensation Plan Information			
Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights <i>(a)</i>	Weighted-average exercise price of outstanding options, warrants and rights <i>(b)</i>	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column <i>(a)</i>) <i>(c)</i>
Equity compensation plans approved by security holders			
1994 Stock Option Plan	1,000	\$5.56	-
1998 Stock Option Plan	30,000	\$3.79	-
2001 Stock Option Plan	40,000	\$3.56	-
2005 Stock Option Plan	14,250	\$5.89	125,750
Equity compensation plans not approved by security holders			
2004 Employee Stock Purchase Plan (1)	-	-	249,339
Total	85,250		375,089

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(1) The Company's 2004 Employee Stock Purchase Plan (the "Employee Plan") permits eligible employees to purchase shares of the Company's common stock at fair market value through payroll deductions and without brokers' fees. Such purchases are without any contribution on the part of the Company. As permitted by its terms, the Employee Plan had been suspended by the Board of Directors from August 10, 2004 until August 4, 2005. As of May 31, 2006, 249,339 shares were available for issuance.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Cautionary Statement

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. Information in this Item 6, "Management's Discussion and Analysis or Plan of Operation," and elsewhere in this 10-KSB that does not consist of historical facts, are "forward-looking statements." Statements accompanied or qualified by, or containing words such as "may," "will," "should," "believes," "expects," "intends," "plans," "projects," "estimates," "predicts," "potential," "outlook," "forecast," "anticipates," "presume," and "assume" constitute forward-looking statements and, as such, are not a guarantee of future performance. The statements involve factors, risks and uncertainties, the impact or occurrence of which can cause actual results to differ materially from the expected results described in such statements. Risks and uncertainties can include, among others, fluctuations in general business cycles and changing economic conditions; changing product demand and industry capacity; increased competition and pricing pressures; advances in technology that can reduce the demand for the Company's products, as well as other factors, many or all of which may be beyond the Company's control. Consequently, investors should not place undue reliance on forward-looking statements as predictive of future results. The Company disclaims any obligation to update the forward-looking statements in this report.

Results of Operations

A summary of the period to period changes in the principal items included in the consolidated statements of income is shown below:

Summary comparison of the years ended May 31, 2006 and 2005

	Increase / (Decrease)
Sales, net	\$ 3,535,000
Cost of goods sold	\$ 2,729,000
Selling, general and administrative expenses	\$ 365,000
Income before provision for income taxes, equity in net income of affiliate and minority stockholder's interest	\$ 443,000
Provision for income taxes	\$ 131,000
Income before equity in net income of affiliate and minority stockholder's interest	\$ 312,000
Equity in net income (loss) of affiliate	\$ (28,000)
Net income	\$ 284,000

Sales under certain fixed-price contracts, requiring substantial performance over several periods prior to commencement of deliveries, are accounted for under the percentage-of-completion method of accounting whereby revenues are recognized based on estimates of completion prepared on a ratio of cost to total estimated cost basis. Costs include all material and direct and indirect charges related to specific contracts.

Adjustments to cost estimates are made periodically and any losses expected to be incurred on contracts in progress are charged to operations in the period such losses are determined. However, any profits expected on contracts in progress are recognized over the life of the contract.

For financial statement presentation purposes, the Company nets progress billings against the total costs incurred on uncompleted contracts. The asset, "costs and estimated earnings in excess of billings," represents revenues recognized in excess of amounts billed. The liability, "billings in excess of costs and estimated earnings," represents billings in excess of revenues recognized.

For the year ended May 31, 2006 (All figures being discussed are for the year ended May 31, 2006 as compared to the year ended May 31, 2005.)

	Year ended		Change Increase / (Decrease)	Percent Change
	May 31, 2006	May 31, 2005		
Net Revenue	\$14,751,000	\$11,216,000	\$ 3,535,000	32%
Cost of sales	10,438,000	7,709,000	2,729,000	35%

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Gross profit	\$ 4,313,000	\$3,507,000	\$ 806,000	23%
...as a percentage of net revenues	29%	31%		

The Company's consolidated results of operations showed a 32% increase in net revenues and an increase in net income of 140%. Gross profit increased by 23%. Revenues recorded in the current period for long-term construction projects increased by 84% over the unusually low level recorded in the prior year. The increase in revenue in the current year is primarily attributable to 1.) a 42% increase in the quantity of long-term construction projects this year compared to last year, and 2.) a 23% increase in the average total sales value of long-term construction projects this year compared to last year. Management has noticed an increase in the global level of construction activity of structures requiring seismic protection, primarily in Asia. This has resulted in an increased number of inquiries and quotes for our products. Many of our bids to supply our products for these projects have been successful this year. These current year's projects contributed a gross profit margin of 33% as compared to 29% in the prior year's period. The overall gross profit as a percentage of net revenues for the current and prior year periods was 29% and 31%. Management is optimistic that the level of construction activity of structures requiring seismic protection will remain strong through the next fiscal year. The Company's revenues and net income fluctuate from period to period. The increases in the current period, compared to the prior period, are not necessarily representative of future results.

Selling, General and Administrative Expenses

	Year ended		Change	
	May 31, 2006	May 31, 2005	Increase / (Decrease)	Percent Change
Outside Commissions	\$ 875,000	\$ 461,000	\$ 414,000	90%
Royalties	97,000	165,000	(68,000)	-41%
Other SG&A	2,423,000	2,405,000	18,000	1%
Total SG&A	\$3,395,000	\$3,031,000	\$ 364,000	12%
...as a percentage of net revenues	23%	27%		

Selling, general and administrative expenses increased by 12% from the prior year. Commission expense increased by 90% over last year's level. Commission expense was higher in this period due to higher commission rates on a few large, long-term construction projects in production, in addition to a higher volume of sales subject to commission. Royalty expense is 41% less than the amount recorded in the prior year period. There were fewer shipments that were subject to royalty during the current year. Other selling, general and administrative expenses increased by only 1% from last year to this.

The above factors resulted in operating income of \$918,000 for the year ended May 31, 2006, up 93% from the \$476,000 in the same period of the prior year.

Interest expense of \$164,000 is slightly less than in the prior year. The average level of use of the Company's operating line of credit decreased by approximately 18% while the average interest rate on the line increased by approximately 2 percentage points as compared to last year. The line of credit is used primarily to fund the production of larger projects that do not allow for advance payments or progress payments.

Capital Resources, Line of Credit and Long-Term Debt

The Company's primary liquidity is dependent upon its working capital needs. These are primarily inventory, accounts receivable, costs and estimated earnings in excess of billings, accounts payable, accrued commissions, billings in excess of costs and estimated earnings, and debt service. The Company's primary sources of liquidity have been operations and bank financing.

Capital expenditures for the year ended May 31, 2006 were \$253,000 compared to \$140,000 in the prior year. The Company has commitments to pay \$22,000 for production machinery in the fiscal year ending May 31, 2007.

The Company has a \$5,000,000 line of credit with a bank. There is a \$3,011,000 principal balance outstanding as of May 31, 2006, which is up from the \$1,390,000 balance outstanding as of May 31, 2005. The outstanding balance on the line of credit will fluctuate as the Company's various long-term projects progress. The Company is in compliance with restrictive covenants under the line of credit and other financing arrangements, including the NCIDA Bond financing. In these covenants, the Company agrees to:

- Maintain a minimum working capital position of \$2,000,000 at all times;
- limit annual capital expenditures to \$650,000;
- maintain a minimum debt service coverage ratio of no less than 1:1; and
- advise the bank of any litigation where the claim amount is \$100,000 or greater.

Additional information regarding the Company's long-term debt appears in Part I, item 2 of this Report.

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Principal maturities of long-term debt for the subsequent five years are as follows: 2007 - \$248,000; 2008 - \$232,000; 2009 - \$138,000; 2010 - \$72,000; and 2011 - \$27,000.

Inventory and Maintenance Inventory

	May 31, 2006		May 31, 2005		Increase
Raw Materials	\$	413,000	\$	404,000	\$ 9,000 2%
Work in process		3,404,000		4,029,000	(625,000) -16%
Finished goods		400,000		338,000	62,000 18%
Inventory		4,217,00088%		4,771,00088%	(554,000) -12%
Maintenance and other inventory		543,00012%		662,00012%	(119,000) -18%
Total		\$4,760,000 100%		\$5,433,000100%	\$ (673,000) -12%
Inventory turnover		2.0		1.5	

Inventory, at \$4,217,000 as of May 31, 2006, is 12% lower than the prior year-end. Of this, approximately 81% is work in process, 9% is finished goods, and 10% is raw materials.

Maintenance and other inventory represent stock that is estimated to have a product life cycle in excess of twelve months. This stock represents certain items that the Company is required to maintain for service of products sold and items that are generally subject to spontaneous ordering. This inventory is particularly sensitive to technical obsolescence in the near term due to its use in industries characterized by the continuous introduction of new product lines, rapid technological advances and product obsolescence. Management of the Company has recorded an allowance for potential inventory obsolescence. The provision for potential inventory obsolescence was \$140,000 for the year ended May 31, 2006 and \$87,000 for the same period last year. The Company continues to rework slow-moving inventory, where applicable, to convert it to product to be used on customer orders. There was an insignificant amount of slow-moving inventory used during the year ended May 31, 2006. The Company disposed of approximately \$310,000 of obsolete inventory during the year ended May 31, 2006.

Accounts Receivable, Costs and Estimated Earnings in Excess of Billings, and Billings in Excess of Costs and Estimated Earnings

	May 31, 2006	May 31, 2005	Increase /(Decrease)
Accounts receivable	\$2,423,000	\$2,719,000	\$ (296,000) -11%
Costs and estimated earnings in excess of billings	5,062,000	1,657,000	3,405,000 205%
Less: Billings in excess of costs and estimated earnings	95,000	288,000	(193,000)-67%
Net	\$7,390,000	\$4,088,000	\$ 3,302,000 81%

The Company combines the totals of accounts receivable, the asset "costs and estimated earnings in excess of billings", and the liability, "billings in excess of costs and estimated earnings", to determine how much cash the Company will eventually realize from revenue recorded to date. As the accounts receivable figure rises in relation to the other two figures, the Company can anticipate increased cash receipts within the ensuing 30-60 days.

Accounts receivable of \$2,423,000 as of May 31, 2006 includes approximately \$374,000 of amounts retained by customers on long-term construction projects. The Company expects to collect all of these amounts, including the retainage, during the next twelve months.

As noted above, the current asset, "costs and estimated earnings in excess of billings," represents revenues recognized in excess of amounts billed. Whenever possible, the Company negotiates a provision in sales contracts to allow the Company to bill, and collect from the customer, payments in advance of shipments. Unfortunately, provisions such as this are often not possible. The \$5,062,000 balance in this account at May 31, 2006 is a 205% increase from the prior year-end. This significant increase from last year-end is a reflection of 1.) the increase in the number of projects in progress at the two balance sheet dates (25 at May 31, 2006 compared to 16 at May 31, 2005) and 2.) the amount of progress billings permitted per the terms of the various sales agreements for the projects (19% of the aggregate order value of the projects in progress at May 31, 2006 has been invoiced to the customers compared to 41% at May 31, 2005). In the aggregate, the projects in progress at May 31, 2006 are 53% complete at that date while the projects in progress at May 31, 2005 were 59% complete at that date. The average total sales value of long-term construction projects in process at the end of this year is 45% higher than the end of last year. Generally, if progress billings are permitted under the terms of a project sales agreement, then the more complete the project is, the more progress billings will be permitted. The Company expects to bill the entire amount during the next twelve months.

The year-end balances in this account are comprised of the following components:

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	<u>May 31, 2006</u>	<u>May 31, 2005</u>
Costs	\$ 4,792,000	\$ 1,794,000
Estimated earnings	2,760,000	1,291,000
Less: Billings to customers	2,490,000	1,428,000
Costs and estimated earnings in excess of billings	\$ 5,062,000	\$ 1,657,000
Number of projects in progress	23	12

As noted above, the current liability, "billings in excess of costs and estimated earnings", represents billings to customers in excess of revenues recognized. The \$95,000 balance in this account at May 31, 2006 is a \$193,000 decrease from the balance at the end of the prior year. The balance in this account fluctuates in the same manner and for the same reasons as the account "costs and estimated earnings in excess of billings", discussed above. Final delivery of product under these contracts is expected to occur during the next twelve months.

The year-end balances in this account are comprised of the following components:

	<u>May 31, 2006</u>	<u>May 31, 2005</u>
Billings to customers	\$ 254,000	\$ 1,195,000
Less: Costs	110,000	705,000
Less: Estimated earnings	49,000	202,000
Billings in excess of costs and estimated earnings	\$ 95,000	\$ 288,000
Number of projects in progress	2	4

Summary of factors affecting the year-end balances in the asset "costs and estimated earnings in excess of billings", and the liability, "billings in excess of costs and estimated earnings":

	<u>2006</u>	<u>2005</u>
Number of projects in progress at year-end	25	16
Aggregate percent complete at year-end	53%	59%
Average total value of projects in progress at year-end	\$578,000	\$399,000
Percentage of total value invoiced to customer	19%	41%

The Company's backlog of sales orders at May 31, 2006 is \$12.4 million, up from the backlog at the end of the prior year of \$7.3 million. \$6.7 million of the current backlog is on projects already in progress.

Accounts payable, at \$1,315,000 as of May 31, 2006, is approximately \$545,000 more than the prior year-end. This significant increase is primarily attributable due to the increase in production activity for manufacture of the products subject to sales orders.

Commission expense on applicable sales orders is recognized at the time revenue is recognized. The commission is paid following receipt of payment from the customers. Accrued commissions as of May 31, 2006 are \$983,000. This is 70% higher than the \$577,000 accrued at the prior year-end. This significant increase is reasonable due to the increase in the current asset, "costs and estimated earnings in excess of billings". Commission expense related to long-term construction projects is recorded at the same time as revenue on the projects is recorded. This liability will not decrease until progress billings on the projects have been issued by the Company and are paid by our customers. The Company expects the current accrued amount to be paid during the next twelve months. Other current liabilities increased by only \$57,000 from the prior year-end, to \$394,000.

The Company paid \$329,000 to Developments during the year ended May 31, 2006, reducing the principal balance on the note payable to \$242,000.

Management believes that the Company's cash flows from operations and borrowing capacity under the bank line of credit will be sufficient to fund ongoing operations, capital improvements and share repurchases for the next twelve months.

ITEM 7.FINANCIAL STATEMENTS

For information concerning this Item, see the Company's balance sheet and related financial statements at Item 13.

ITEM 8.CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

There have been no disagreements between the Company and its accountants as to matters which require disclosure.

ITEM 8A. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.*

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The Company's principal executive officer and principal financial officer have evaluated the Company's disclosure controls and procedures as of May 31, 2006 and have concluded that as of the evaluation date, the disclosure controls and procedures were effective to ensure that material information relating to the Company was accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, to allow for timely decisions regarding required disclosure.

(b) *Changes in internal controls.*

There have been no changes in the Company's internal controls over financial reporting that occurred during the fiscal quarter ended May 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's control over financial reporting.

ITEM 8B. OTHER INFORMATION

None.

PART III

The information required by Items 9, 10, 11 and 12 of this part will be presented in the Company's Proxy Statement to be issued in connection with the Annual Meeting of Shareholders to be held on November 10, 2006, which information is hereby incorporated by reference into this Annual Report. The proxy materials, including the Proxy Statement and Annual Report to Shareholders, will be filed within 120 days after the Company's fiscal year end.

ITEM 13. EXHIBITS

DOCUMENTS FILED AS PART OF THIS REPORT:

Index to Financial Statements:

- (i) Report of Independent Registered Public Accounting Firm
- (ii) Consolidated Balance Sheets May 31, 2006 and 2005
- (iii) Consolidated Statements of Income for the years ended May 31, 2006 and 2005
- (iv) Consolidated Statements of Stockholders' Equity for the years ended May 31, 2006 and 2005
- (v) Consolidated Statements of Cash Flows for the years ended May 31, 2006 and 2005
- (vi) Notes to Consolidated Financial Statements May 31, 2006 and 2005

(a) EXHIBITS:

- (3) Articles of incorporation and by-laws
 - (i) Restated Certificate of Incorporation incorporated by reference to Exhibit (3)(i) of Annual Report on Form 10-K, dated August 24, 1983.
 - (ii) Amendment to Certificate of Incorporation incorporated by reference to Exhibit (3)(iv) to Form 8 [Amendment to Application or Report], dated September 24, 1993.
 - (iii) Amendment to Certificate of Incorporation creating Series A Junior Participating Preferred Stock, \$.05 par value, incorporated by reference to Exhibit (3)(i)(viii) to Quarterly Report on Form 10-QSB for the period ending November 30, 1998, dated January 12, 1999.

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- (iv) Certificate of Change incorporated by reference to Exhibit (3)(i) to Quarterly Report on Form 10-QSB for the period ending November 30, 2002.
 - (v) Proxy Review Guidelines incorporated by reference to Exhibit (3)(ii) to Quarterly Report on Form 10-QSB for the period ending February 28, 1998, dated April 10, 1998.
 - (vi) By-laws incorporated by reference to Exhibit (3)(i) to Quarterly Report on Form 10-QSB for the period ending February 28, 2004, dated April 14, 2004.
- (4) Instruments defining rights of security holders, including indentures
- (i) Mortgage to Marine Midland Bank dated May 28, 1993 incorporated by reference to Exhibit (10)(vii) to Annual Report on Form 10-KSB, dated September 10, 1993.
 - (ii) Master Indenture between Niagara County Industrial Development Agency and Bankers Trust Company, as Trustee, dated as of November 1, 1994 (\$1,250,000 Niagara County Industrial Development Agency, 1994 Adjustable Rate Demand, Industrial Development Revenue Bonds, Series A [MMARS Second Program]), incorporated by reference to Exhibit (4)(iv) to Annual Report on Form 10-KSB, dated August 21, 1995.
 - (iii) Series Supplemental Indenture between Niagara County Industrial Development Agency and Bankers Trust Company, as Trustee, (\$1,250,000 Niagara County Industrial Development Agency, 1994 Adjustable Rate Demand, Industrial Development Revenue Bonds, Series A [MMARS Second Program]), incorporated by reference to Exhibit (4)(v) to Annual Report on Form 10-KSB, dated August 21, 1995.
 - (iv) Series Mortgage from Niagara County Industrial Development Agency, Tayco Realty, Inc. and registrant to Marine Midland Bank, as Letter of Credit Bank, dated as of November 1, 1994, incorporated by reference to Exhibit (4)(vi) to Annual Report on Form 10-KSB, dated August 21, 1995.
 - (v) Mortgage from Niagara County Industrial Development Agency, Tayco Realty, Inc. and registrant to Marine Midland Bank, dated January 3, 1998, incorporated by reference to Exhibit (4)(v) to Annual Report on Form 10-KSB, dated August 25, 1998.
 - (vi) Rights Agreement by and between registrant and Regan & Associates, Inc, dated as of October 5, 1998 and letter to shareholders (including Summary of Rights), dated October 5, 1998, attached as Exhibits 4 and 20, respectively to Registration Statement on Form 8-A 12G, filed with the Securities and Exchange Commission on October 6, 1998.
- (10) Material Contracts
- (i) 1994 Taylor Devices, Inc. Stock Option Plan incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8, File No. 33-88152, as filed with the Securities and Exchange Commission on December 30, 1994.
 - (ii) 1998 Taylor Devices, Inc. Stock Option Plan attached as Exhibit 4.1 to Registration Statement on Form S-8, File No. 33-6905, filed with the Securities and Exchange Commission on December 24, 1998.
 - (iii) 2001 Taylor Devices, Inc. Stock Option Plan attached as Exhibit A to Definitive Proxy Statement, filed with the Securities and Exchange Commission on September 24, 2001.

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- (iv) 2005 Taylor Devices, Inc. Stock Option Plan attached as Appendix B to Definitive Proxy Statement, filed with the Securities and Exchange Commission on September 27, 2005.
 - (v) License Agreement between the registrant and Tayco Developments, Inc., dated November 1, 1959, incorporated by reference to Exhibit (10)(i) to Annual Report on Form 10-K, dated August 27, 1982.
 - (vi) Loan Agreements between the registrant and Marine Midland Bank, dated December 2, 1992, incorporated by reference to Exhibit (10)(viii) to Annual Report on Form 10-K, dated September 10, 1993.
 - (vii) Series Lease between Niagara County Industrial Development Agency and registrant, dated as of November 1, 1994 (\$1,250,000 Niagara County Industrial Development Agency, 1994 Adjustable Rate Demand, Industrial Development Revenue Bonds, Series A [MMARS Second Program]), incorporated by reference to Exhibit (10)(ix) to the Annual Report on Form 10-KSB, dated August 21, 1995.
 - (viii) Lease Agreement between registrant and Tayco Realty Corporation, dated November 1, 1995, incorporated by reference to Exhibit (10)(ix) to Annual Report on Form 10-KSB, dated August 22, 1996.
 - (ix) Form of Indemnity Agreement between registrant and certain officers and directors, incorporated by reference to Exhibit (10)(i) to Quarterly Report on Form 10-QSB for the period ending February 28, 1997, dated April 11, 1997.
 - (x) Lease Agreement dated July 1, 2000 between the Registrant and Tayco Developments, Inc., incorporated by reference to Exhibit (10)(xii) to Annual Report on Form 10-KSB, dated August 25, 2000.
 - (xi) Employment Agreement dated as of December 1, 2000 between the Registrant and Douglas P. Taylor, incorporated by reference to Exhibit (10)(x) to Annual Report on Form 10-KSB, dated August 22, 2001.
 - (xii) Employment Agreement dated as of December 1, 2000 between the Registrant and Richard G. Hill, incorporated by reference to Exhibit (10)(xi) to Annual Report on Form 10-KSB, dated August 22, 2001.
 - (xiii) Indemnity Agreement between registrant and Mark V. McDonough, incorporated by reference to Exhibit (10)(i) to Quarterly Report on Form 10-QSB for the period ending August 31, 2004, dated October 15, 2004.
 - (xiv) The 2004 Taylor Devices, Inc. Employee Stock Purchase Plan, incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8, File No. 333-114085, filed with the Securities and Exchange Commission on March 31, 2004.
 - (xv) Promissory Note between the Company and Tayco Developments, Inc., dated June 1, 2006, attached to this Annual Report on Form 10-KSB.
 - (xvi) Indemnity Agreement between registrant and Reginald B. Newman II, incorporated by reference to Exhibit (10)(i) to Quarterly Report on Form 10-QSB for the period ending November 30, 2005, dated November 11, 2005.
- (11) Statement regarding computation of per share earnings

REG. 228.601(A)(11) Statement regarding computation of per share earnings

Weighted average of common stock/equivalents outstanding - fiscal year ended May 31, 2006

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Weighted average common stock outstanding	3,112,747
Common shares issuable under stock option plans using treasury stock method	10,712
Weighted average common stock outstanding assuming dilution	3,123,459

Net income fiscal year ended May 31, 2006	(1)	\$	485,793
Weighted average common stock	(2)		3,112,747
Basic income per common share	(1) divided by (2)	\$.16

Net income fiscal year ended May 31, 2006	(3)	\$	485,793
Weighted average common stock outstanding assuming dilution	(4)		3,123,459
Diluted income per common share	(3) divided by (4)	\$.16

Weighted average of common stock outstanding - fiscal year ended May 31, 2005

Weighted average common stock outstanding	3,060,856
Common shares issuable under stock option plans using treasury stock method	-
Weighted average common stock outstanding assuming dilution	3,060,856

Net income fiscal year ended May 31, 2005	(1)	\$	202,107
Weighted average common stock	(2)		3,060,856
Basic income per common share	(1) divided by (2)	\$.07

Net income fiscal year ended May 31, 2005	(3)	\$	202,107
Weighted average common stock outstanding assuming dilution	(4)		3,060,856
Diluted income per common share	(3) divided by (4)	\$.07

(14) Code of Ethics, incorporated by reference to Exhibit 14 to Annual Report on Form 10-KSB for the period ending May 31, 2004.

(20) Other documents or statements to security holders

(i) News from Taylor Devices, Inc. Shareholder Letter, Summer 2006.

(21) Subsidiaries of the registrant

Tayco Realty Corporation is a New York corporation organized on September 8, 1977, 58% owned by the Company and 42% owned by Tayco Developments, Inc.

(23) Report and Consent of Independent Certified Public Accountants

(31) Officer Certifications

(i) Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act.

(ii) Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act.

(32) Officer Certifications

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- (i) Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act.
- (ii) Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act.

(b)REPORTS ON FORM 8-K:

None.

ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

The Audit Committee of the Company approves all professional services, including tax related services, provided to the Company by Lumsden & McCormick, LLP. With regard to "Audit and Audit-Related" services, the Committee reviews the annual audit plan and approves the estimated audit budget in advance. The aggregate fees billed by Lumsden & McCormick, LLP for professional services to the Company were \$76,200 and \$74,500 for the fiscal years ended May 31, 2006 and 2005.

Audit Fees

The aggregate fees billed by Lumsden & McCormick, LLP for professional services rendered in connection with the audit of the Company's annual financial statements, the review of the Company's quarterly financial statements and services that are normally provided in connection with statutory and regulatory filings or engagements were \$66,500 and \$70,500 for the fiscal years ended May 31, 2006 and 2005.

Audit-Related Fees

The aggregate fees billed by Lumsden & McCormick, LLP for professional assurance and related services reasonably related to the performance of the audit of the Company's financial statements, but not included under Audit Fees, were \$3,900 and zero for the fiscal years ended May 31, 2006 and 2005.

Tax Fees

The aggregate fees billed by Lumsden & McCormick, LLP for professional services for tax compliance, tax advice and tax planning were \$5,800 and \$4,000 for the fiscal years ended May 31, 2006 and 2005.

All Other Fees

None.

Pre-approval Policies and Procedures

The Audit Committee has adopted a policy that requires advance approval of all audit, audit-related, tax services, and other services performed by the independent auditor. The policy provides for pre-approval by the Audit Committee of specifically defined audit and non-audit services. Unless the specific service has been previously pre-approved with respect to that year, the Audit Committee must approve the permitted service before the independent auditor is engaged to perform it.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

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TAYLOR DEVICES, INC.
(Registrant)

By: /s/Douglas P. Taylor
Douglas P. Taylor
President and Director
(Principal Executive Officer)

Date: August 17, 2006

and

By: /s/Mark V. McDonough
Mark V. McDonough
Chief Financial Officer

Date: August 17, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

By: /s/Reginald B. Newman II
Reginald B. Newman II, Director
August 17, 2006

By: /s/Richard G. Hill
Richard G. Hill, Director
August 17, 2006

By: /s/Donald B. Hofmar
Donald B. Hofmar, Director
August 17, 2006

By: /s/Randall L. Clark
Randall L. Clark, Director
August 17, 2006

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To The Board of Directors of
Taylor Devices Inc.

Gentlemen:

We hereby consent to the incorporation by reference in this Annual Report on Form 10-KSB (Commission File Number 0-3498) of Taylor Devices Inc. of our report dated July 12, 2006 and any reference thereto in the Annual Report to Shareholders for the fiscal year ended May 31, 2006.

LUMSDEN & McCORMICK, LLP
Buffalo, New York
July 12, 2006

TAYLOR DEVICES, INC. AND SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

May 31, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Taylor Devices, Inc.

We have audited the accompanying consolidated balance sheets of Taylor Devices, Inc. and Subsidiary as of May 31, 2006 and 2005 and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. 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 audits.

We conducted our audits 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. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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, in all material respects, the financial position of Taylor Devices, Inc. and Subsidiary as of May 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Lumsden & McCormick, LLP
Buffalo, New York
July 12, 2006

TAYLOR DEVICES, INC. AND SUBSIDIARY

Consolidated Balance Sheets

May 31,	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 60,011	\$ 63,397
Restricted funds held by Trustee (Note 9)	25,756	25,424
Accounts receivable, net (Note 2)	2,423,428	2,718,902
Inventory (Note 3)	4,216,633	4,771,086
Prepaid expenses	172,460	255,714
Prepaid income taxes	224,698	-
Costs and estimated earnings in excess of billings (Note 4)	5,062,294	1,657,170

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Deferred income taxes (Note 11)	635,015	639,500
Total current assets	12,816,295	10,131,193
Maintenance and other inventory, net (Note 5)	543,057	661,500
Property and equipment, net (Note 6)	3,419,404	3,477,672
Investment in affiliate, at equity (Note 7)	440,378	451,877
Cash value of life insurance, net	119,884	114,289
Intangible assets	45,687	54,087
	\$ 17,384,705	\$ 14,890,618
Liabilities and Stockholders' Equity		
Current liabilities:		
Short-term borrowings (Note 8)	\$ 3,011,000	\$ 1,390,000
Current portion of long-term debt (Note 9)	247,924	231,119
Payables - trade	1,315,089	770,330
Accrued commissions	982,741	576,550
Other accrued expenses	393,665	336,890
Billings in excess of costs and estimated earnings (Note 4)	95,421	288,003
Accrued income taxes	4,207	49,696
Total current liabilities	6,050,047	3,642,588
Long-term debt (Note 9)	514,788	755,519
Payables - affiliate (Note 13)	253,307	589,976
Deferred income taxes (Note 11)	246,200	243,200
Minority stockholder's interest	483,895	450,991
Stockholders' Equity:		
Common stock, \$.025 par value, authorized 8,000,000 shares, issued 3,407,156 and 3,343,858 shares	85,179	83,596
Paid-in capital	4,611,266	4,307,405
Retained earnings	6,196,105	5,710,312
	10,892,550	10,101,313
Treasury stock -- 264,853 and 241,801 shares at cost	(1,056,082)	(892,969)
Total stockholders' equity	9,836,468	9,208,344
	\$ 17,384,705	\$ 14,890,618

See accompanying notes.

TAYLOR DEVICES, INC. AND SUBSIDIARY

Consolidated Statements of Income

For the years ended May 31,	2006	2005
Sales, net (Note 10)	\$ 14,750,699	\$ 11,215,592
Cost of goods sold	10,437,843	7,709,301
Gross profit	4,312,856	3,506,291
Selling, general and administrative expenses	3,395,293	3,030,689
Operating income	917,563	475,602

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Other income (expense):		
Interest, net	(164,123)	(166,087)
Miscellaneous	14,256	15,104
	(149,867)	(150,983)
Income before provision for income taxes, equity in net income of affiliate and minority stockholder's interest	767,696	324,619
Provision for income taxes (Note 11)	237,500	106,800
Income before equity in net income of affiliate and minority stockholder's interest	530,196	217,819
Equity in net income (loss) of affiliate (Note 7)	(11,499)	16,556
Income before minority stockholder's interest	518,697	234,375
Minority stockholder's interest	(32,904)	(32,268)
	\$ 485,793	\$ 202,107
Basic and diluted earnings per common share (Note 12)	\$.16	\$ 0.07

See accompanying notes.

TAYLOR DEVICES, INC. AND SUBSIDIARY

Consolidated Statements of Stockholders' Equity

For the years ended May 31, 2006 and 2005

	Common Stock	Paid-In Capital	Retained Earnings	Treasury Stock
Balance, May 31, 2004	\$ 80,909	\$ 3,891,978	\$ 5,508,205	\$ (892,969)
Net income for the year ended May 31, 2005	-	-	202,107	-
Common stock issued for employee stock purchase plan (Note 14)	686	63,682	-	-
Common stock issued for employee stock option plans (Note 15)	2,001	234,745	-	-
Tax benefit related to employee stock option plans	-	117,000	-	-

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Balance, May 31, 2005	\$ 83,596	\$ 4,307,405	\$ 5,710,312	\$ (892,969)
Net income for the year ended May 31, 2006	-	-	485,793	-
Common stock issued for employee stock purchase plan (Note 14)	40	6,663	-	-
Common stock issued for employee stock option plans (Note 15)	1,543	217,198	-	(163,113)
Tax benefit related to employee stock option plans	-	80,000	-	-
Balance, May 31, 2006	\$ 85,179	\$ 4,611,266	\$ 6,196,105	\$ (1,056,082)

See accompanying notes.

TAYLOR DEVICES, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

For the years ended May 31,	2006	2005
Cash flows from operating activities:		
Net income	\$ 485,793	\$ 202,107
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	319,870	372,715
Bad debts expense	54,157	40,000
Provision for inventory obsolescence	140,000	87,100
Equity in net (income) loss of affiliate	11,499	(16,556)
Deferred income taxes	11,485	(90,600)
Minority stockholder's interest	32,904	32,268
Tax benefit related to employee stock option plans	80,000	117,000
Changes in other assets and liabilities:		

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Accounts receivable	241,317	(1,318,848)
Inventory	532,896	(493,946)
Prepaid expenses	83,254	(122,753)
Prepaid income taxes	(224,698)	145,221
Costs and estimated earnings in excess of billings	(3,405,124)	(119,171)
Payables - trade	544,759	(133,849)
Accrued commissions	406,191	88,314
Other accrued expenses	56,775	(127,357)
Billings in excess of costs and estimated earnings	(192,582)	288,003
Accrued income taxes	(45,489)	49,696
Net cash flows for operating activities	(866,993)	(1,000,656)

Cash flows from investing activities:

Net cash paid to trustee	(332)	(159)
Acquisition of property and equipment	(253,202)	(140,156)
Increase in cash value of life insurance	(5,595)	(25,342)
Net cash flows for investing activities	(259,129)	(165,657)

Cash flows from financing activities:

Net short-term borrowings	1,621,000	1,246,000
Payments on long-term debt	(223,926)	(220,054)
Payables - affiliate	(336,669)	(185,740)
Proceeds from issuance of common stock	225,444	301,114
Acquisition of treasury stock	(163,113)	-
Net cash flows from financing activities	1,122,736	1,141,320

Net decrease in cash and cash equivalents	(3,386)	(24,993)
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Cash and cash equivalents - beginning	63,397	88,390
Cash and cash equivalents - ending	\$ 60,011	\$ 63,397

See accompanying notes.

TAYLOR DEVICES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies:

Nature of Operations:

Taylor Devices, Inc. (the Company) is primarily engaged in the manufacture and sale of tension control, energy storage and shock absorption devices for use in various types of machinery, equipment and structures, primarily to customers which are located throughout the United States and several foreign countries. The products are manufactured at the Company's sole operating facility in the United States where all of the Company's long-lived assets reside. The Company does not track sales by category within this group of products.

53% of the Company's 2006 revenue is generated from sales to customers in the United States and 45% is from sales to customers in Asia. Remaining sales are to customers in Europe, South America and Australia.

77% of the Company's 2005 revenue is generated from sales to customers in the United States and 15% is from sales to customers in Asia. Remaining sales are to customers in Europe.

Principles of Consolidation:

The accompanying consolidated financial statements include the accounts of the Company and its 58% owned subsidiary, Tayco Realty Corporation (Realty). Minority stockholder's interest represents Tayco Developments, Inc.'s (Developments) 42% ownership interest in Realty. The Company considers the principles of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 46(R), Consolidation of Variable Interest Entities and Accounting Research Bulletin No. 51, Consolidation of Financial Statements when determining whether an entity is subject to consolidation. After such consideration, the Company otherwise accounts for its investments in companies over which it has the ability to exercise significant influence under the equity method if the Company holds 50% or less of the voting stock.

The Company's investment in its minority-owned affiliate, Developments, is reported on the equity method (see Note 7). Developments is a patent holding company engaged in research, development and licensing for use in the manufacturing operations of the Company.

All inter-company transactions and balances have been eliminated in consolidation.

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents and Short Term Investments:

The Company includes all highly liquid investments in money market funds in cash and cash equivalents on the accompanying balance sheets.

Cash and cash equivalents in financial institutions may exceed insured limits at various times during the year and subject the Company to concentrations of credit risk.

Accounts Receivable:

Accounts receivable are stated at an amount management expects to collect from outstanding balances. Management provides for probable uncollectible accounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable.

Inventory:

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Inventory is stated at the lower of average cost or market. Average cost approximates first-in, first-out cost.

Property and Equipment:

Property and equipment is stated at cost net of accumulated depreciation. Depreciation is provided primarily using the straight-line method for financial reporting purposes, and accelerated methods for income tax reporting purposes. Maintenance and repairs are charged to operations as incurred; significant improvements are capitalized.

Cash Value of Life Insurance:

Cash value of life insurance is stated at the surrender value of the contracts less outstanding policy loans.

Intangible Assets:

Intangible assets consist of financing costs associated with obtaining new financing and are capitalized and amortized over the repayment terms of the related debt obligations.

Revenue Recognition:

Sales are recognized when units are delivered or services are performed. Sales under fixed-price contracts are recorded as deliveries are made at the contract sales price of the units delivered. Sales under certain fixed-price contracts requiring substantial performance over several periods prior to commencement of deliveries, are accounted for under the percentage-of-completion method of accounting whereby revenues are recognized based on estimates of completion prepared on a ratio of cost to total estimated cost basis. Costs include all material and direct and indirect charges related to specific contracts. Other expenses are charged to operations as incurred. Total estimated costs for each of the contracts are estimated based on a combination of historical costs of manufacturing similar products and estimates or quotes from vendors for supplying parts or services towards the completion of the manufacturing process. Adjustments to cost estimates are made periodically, and losses expected to be incurred on contracts in progress are charged to operations in the period such losses are determined. If total costs calculated upon completion of the manufacturing process in the current period for a contract are more than the estimated total costs at completion used to calculate revenue in a prior period, then the revenue and profits in the current period will be lower than if the estimated costs used in the prior period calculation were equal to the actual total costs upon completion.

For financial statement presentation purposes, the Company nets progress billings against the total costs incurred on uncompleted contracts. The asset, "costs and estimated earnings in excess of billings," represents revenues recognized in excess of amounts billed. The liability, "billings in excess of costs and estimated earnings," represents billings in excess of revenues recognized.

Shipping and Handling Costs:

Shipping and handling costs are classified as a component of cost of goods sold.

Income Taxes:

The provision for income taxes provides for the tax effects of transactions reported in the financial statements regardless of when such taxes are payable. Deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the tax and financial statement basis of assets and liabilities. Deferred taxes are based on tax laws currently enacted with tax rates expected to be in effect when the taxes are actually paid or recovered.

Stock-Based Compensation:

The Company applies APB Opinion 25 *Accounting for Stock Issued to Employees* and related interpretations in accounting for its stock option plans. Since the option price is the fair market value per share on the date the option is granted, no compensation cost has been recognized for its stock option plans.

Had compensation cost for the stock options plans been determined based on the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income and earnings per share would have been reduced to the proforma amounts indicated below:

	2006	2005
Net income:		

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As reported	\$ 485,793	\$ 202,107
Pro forma	\$ 377,619	\$ 148,915
Basic and diluted earnings per common share:		
As reported	\$.16	\$.07
Pro forma	\$.12	\$.05

Reclassifications:

The 2005 financial statements have been reclassified to conform with the presentation adopted for 2006.

New Accounting Standards:

In November 2004, FASB issued SFAS No. 151, "Inventory Costs -- an amendment of ARB No. 43 Chapter 4". This statement requires abnormal production costs such as idle facility expense, excessive spoilage, rehandling costs and abnormal freight to be excluded from inventory costing and treated as period expenses. In addition, this standard requires the allocation of fixed production overhead to be based on normal capacity of the production facility. The adoption of this standard in 2006 did not have a significant effect on our results.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment: an amendment of FASB Statements No. 123 and 95" ("SFAS No. 123R"). SFAS No. 123R requires all share-based payments to employees, including grants of stock options, to be recognized in the financial statements based on their fair value. Implementation of the pronouncement is required no later than the beginning of the first fiscal year beginning after June 15, 2005. The Company plans on adopting this Statement in fiscal 2007.

2. Accounts Receivable:

	2006	2005
Customers	\$ 2,153,621	\$ 2,675,110
Customers - retention	374,307	143,292
Other	1,500	1,500
	2,529,428	2,819,902
Less allowance for doubtful accounts	106,000	101,000
	\$ 2,423,428	\$ 2,718,902

3. Inventory:

	2006	2005
Raw materials	\$ 413,228	\$ 403,932
Work-in-process	3,403,680	4,107,819
Finished goods	499,725	338,335
	4,316,633	4,850,086
Less allowance for obsolescence	100,000	79,000
	\$ 4,216,633	\$ 4,771,086

4. Costs and Estimated Earnings on Uncompleted Contracts:

	2006	2005
Costs incurred on uncompleted contracts	\$ 4,901,811	\$ 2,500,202
Estimated earnings	2,809,940	1,493,050
	7,711,751	3,993,252
Less billings to date	2,744,878	2,624,085
	\$ 4,966,873	\$ 1,369,167

Amounts are included in the accompanying balance sheets under the following captions:

	2006	2005
Costs and estimated earnings in excess of billings	\$ 5,062,294	\$ 1,657,170
Billings in excess of costs and estimated earnings	95,421	288,003
	\$ 4,966,873	\$ 1,369,167

5. Maintenance and Other Inventory:

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	2006	2005
Maintenance and other inventory	\$ 1,420,052	\$ 1,730,500
Less allowance for obsolescence	876,995	1,069,000
	\$ 543,057	\$ 661,500

Maintenance and other inventory represent stock that is estimated to have a product life-cycle in excess of twelve-months. This stock represents certain items the Company is required to maintain for service of products sold, and items that are generally subject to spontaneous ordering.

This inventory is particularly sensitive to technical obsolescence in the near term due to its use in industries characterized by the continuous introduction of new product lines, rapid technological advances and product obsolescence. Therefore, management of the Company has recorded an allowance for potential inventory obsolescence.

The provision for potential inventory obsolescence was \$140,000 and \$87,100 for the years ended May 31, 2006 and 2005.

6. Property and Equipment:

	2006	2005
Land	\$ 141,483	\$ 141,483
Buildings and improvements	3,785,584	3,792,263
Machinery and equipment	4,223,318	4,015,228
Office furniture and equipment	541,986	515,140
Autos and trucks	75,229	86,625
	8,767,600	8,550,739
Less accumulated depreciation	5,348,196	5,073,067
	\$ 3,419,404	\$ 3,477,672

Depreciation expense was \$311,470 and \$342,315 for the years ended May 31, 2006 and 2005.

The following is a summary of property and equipment included above which is held under capital leases:

	2006	2005
Buildings and improvements	\$ 806,707	\$ 806,707
Machinery and equipment	722,915	722,915
Office furniture and equipment	102,985	102,985
	1,632,607	1,632,607
Less accumulated amortization	969,504	920,457
	\$ 663,103	\$ 712,150

Minimum future lease payments under capital leases as of May 31, 2006 for each of the next five years and in the aggregate are included in long-term debt (see Note 9).

Amortization of property and equipment under the capital leases included in depreciation expense is \$49,047 and \$74,412 for the years ended May 31, 2006 and 2005.

7. Investment in Affiliate:

Investment in affiliate consists of the Company's 23% ownership interest in common shares of Developments acquired at a cost of \$85,619, plus the Company's cumulative equity in the net income of Developments of \$354,759 and \$366,258 through the years ended May 31, 2006 and 2005. The Pink Sheets OTC quoted market value of the Company's common shares of Developments at May 31, 2006 and 2005 was \$867,605 and \$445,218.

The Company's maximum exposure to loss as a result of its involvement with Developments represents the balance of the Company's equity investment in Developments.

8. Short-Term Borrowings:

The Company has available a \$5,000,000 bank demand line of credit with interest payable at the Company's option of 30, 60 or 90 day LIBOR rate plus 2.25% or the bank's prime rate less .25%. The line is secured by accounts receivable, equipment, inventory, and general intangibles. This line of credit is subject to the usual terms and conditions applied by the bank, and is subject to renewal annually. The amount outstanding under this line at May 31, 2006 was \$3,011,000, all of which was payable at the bank's prime rate less .25% (7.75% at May 31, 2006). The total

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amount outstanding at May 31, 2005 was \$1,390,000.

The Company uses a cash management facility under which the bank draws against the available line of credit to cover checks presented for payment on a daily basis. Outstanding checks under this arrangement totaled \$271,279 and \$150,299 as of May 31, 2006 and 2005. These amounts are included in accounts payable.

9. Long-Term Debt:

	2006	2005
Bank term note, monthly payments of \$13,713 including interest at 7.19%, secured by substantially all assets of the Company, with the remaining unpaid principal balance payable in October 2008.	\$ 367,237	\$ 499,701
Industrial Revenue Development Bonds, annual principal payments ranging from \$25,000 to \$150,000 through June 2009 plus interest at variable rates based on the highest rated short-term, federally tax exempt obligations (4.05% at May 31, 2006).	145,000	175,000
Bank mortgage note, monthly principal payments of \$1,444 plus interest at the bank's prime rate plus 1% (9 % at May 31, 2006), secured by related property, with the remaining unpaid principal balance payable in June 2008.	39,001	56,334
Bank mortgage, monthly principal payments of \$2,222 plus interest at the bank's prime rate plus 1% (9 % at May 31, 2006), secured by substantially all assets of the Company, due February 2013.	180,000	206,667
Capital lease, monthly payments of \$2,291 including interest at 7.51%, secured by related assets.	24,282	48,936
Other	7,192	-
	762,712	986,638
Less current portion	247,924	231,119
	\$ 514,788	\$ 755,519

In November 1994, the Company entered into a capital lease agreement with the Niagara County Industrial Development Agency (NCIDA) to finance certain construction costs for additions to its manufacturing/ testing facilities and for the acquisition of machinery and equipment. To finance the project, NCIDA authorized the sale of its Industrial Revenue Development Bonds, in the aggregate principal amount of \$1,250,000, under a trust indenture with a bank as trustee. The capital lease obligation is secured by a first mortgage on real estate, project machinery and equipment, and guaranteed by an irrevocable bank letter of credit in the amount of \$145,000 as of May 31, 2006.

As of May 31, 2006, \$25,756 of funds were held by a trustee, representing an interest-bearing tax-free money fund restricted for principal reduction payments of the Industrial Revenue Development Bond during fiscal year ending May 31, 2007.

The term note and mortgage note are subject to restrictive covenants relating to net working capital, tangible net worth, capital expenditures and interest coverage ratio. The Company is in compliance with all of the covenants as of May 31, 2006.

The aggregate maturities of long-term debt subsequent to May 31, 2006 are:

2007	\$ 247,924
2008	232,166
2009	137,622

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2010	71,667
2011	26,667
Thereafter	46,666
	\$ 762,712

10. Sales:

Sales to two customers approximated 28% (14% each) of net sales for 2006.

11. Income Taxes:

	2006	2005
Current tax provision:		
Federal	\$ 195,900	\$ 118,200
State	30,600	27,200
	226,500	145,400
Deferred tax provision (benefit):		
Federal	7,500	(34,300)
State	3,500	(4,300)
	11,000	(38,600)
	\$ 237,500	\$ 106,800

A reconciliation of provision for income taxes at the statutory rate to income tax provision at the Company's effective rate is as follows:

	2006	2005
Computed tax provision		
at the expected statutory rate	\$ 245,700	\$ 105,000
Effect of graduated Federal rates on subsidiary income	(11,200)	(18,000)
State income tax - net of Federal tax benefit	10,400	9,900
Tax effect of permanent differences:		
Equity in net (income) loss of affiliate	4,100	(5,600)
Minority shareholder interest	11,200	11,000
Extraterritorial income exclusion	(42,900)	(6,700)
Other permanent differences	10,100	9,100
Other	10,100	2,100
	\$ 237,500	\$ 106,800

Significant components of the Company's deferred tax assets and liabilities consist of the following:

	2006	2005
Deferred tax assets:		
Allowance for doubtful receivables	\$ 38,500	\$ 36,800
Tax inventory adjustment	50,100	82,200
Allowance for obsolete inventory	354,700	416,600
Accrued vacation	36,900	32,400
Accrued professional fees	10,200	-
Accrued commissions	15,800	-
Warranty reserve	31,100	12,700
Other	16,815	7,100
FMV of stock options in excess of cost	80,900	51,700
	635,015	639,500
Deferred tax liabilities:		
Excess tax depreciation	(246,200)	(243,200)
Net deferred tax assets	\$ 388,815	\$ 396,300

Realization of the deferred tax assets is dependent on generating sufficient taxable income at the time temporary differences become deductible. The Company provides a valuation allowance to the extent that deferred tax assets may not be realized. A valuation allowance has not been recorded against the deferred tax assets since management believes it is more likely than not that the deferred tax assets are recoverable. The Company considers future taxable income and potential tax planning strategies in assessing the need for a potential valuation allowance. The amount of the deferred tax assets considered realizable however, could be reduced in the near term if estimates of future taxable income are reduced.

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Income on undistributed earnings from affiliates and subsidiary are considered to be permanently reinvested, and therefore no provision for deferred income taxes has been recorded.

The Company and its subsidiary file separate Federal and State income tax returns. As of May 31, 2006, the Company had State investment tax credit carryforwards of approximately \$204,000 expiring through May 2014.

12. Earnings Per Common Share:

Basic earnings per common share is computed by dividing income available to common stockholders by the weighted-average common shares outstanding for the period. Diluted earnings per common share reflects the weighted-average common shares outstanding and dilutive potential common shares, such as stock options.

A reconciliation of weighted-average common shares outstanding to weighted-average common shares outstanding assuming dilution is as follows:

	2006	2005
Average common shares		
outstanding	3,112,747	3,060,856
Common shares issuable under		
stock option plans	10,712	-
Average common shares		
outstanding assuming dilution	3,123,459	3,060,856

13. Related Party Transactions:

Included in cost of sales are research and development expenses charged by Developments for services performed by its research engineers in the amount of \$128,820 and \$256,910 for the years ended May 31, 2006 and 2005.

Included in selling, general and administrative expenses is royalty expense charged by Developments for the use of patents in the Company's manufacturing operations in the amount of \$97,133 and \$165,476 for the years ended May 31, 2006 and 2005.

Included in interest expense for the years ended May 31, 2006 and 2005, are \$17,629 and \$32,158 charged by Developments for non-current liabilities. During the year, the Company issued an unsecured promissory note payable to Developments for \$583,296. The outstanding balance at May 31, 2006 is \$241,957. Interest, at 7% per year, is payable monthly through June 2007, when any unpaid principal is due.

The Company leases certain office and laboratory facilities to Developments for a current annual rental of \$12,000.

14. Employee Stock Purchase Plan:

In March 2004, the Company reserved 295,000 shares of common stock for issuance pursuant to a non-qualified employee stock purchase plan. Participation in the employee stock purchase plan is voluntary for all employees of the Company. Purchase of common shares can be made by employee contributions through payroll deductions with a discretionary matching contribution by the Company of a specified percentage of the employees' contributions based on length of employment with the Company. At the end of each calendar quarter, the employer/employee contributions will be applied to the purchase of common shares at fair market value which are then held in the name of the Company as custodian for the employees' shares. These shares are distributed to the employees at the end of each calendar quarter or upon withdrawal from the plan. During the years ended May 31, 2006 and 2005, 1,576 (\$2.99 to \$5.72 price per share) and 27,442 (\$2.11 to \$2.64 price per share) common shares, respectively, were issued to employees. As of May 31, 2006, 249,339 shares were reserved for further issue. The amount of Company matching expense was zero and \$9,201 for the years ended May 31, 2006 and 2005.

15. Stock Option Plans:

In 2005, the Company adopted a stock option plan which permits the Company to grant both incentive stock options and non-qualified stock options. The incentive stock options qualify for preferential treatment under the Internal Revenue Code. Under this plan, 140,000 shares of common stock have been reserved for grant to key employees and directors of the Company and 14,250 shares have been granted as of May 31, 2006. Under the plan, the option price may not be less than the fair market value of the stock at the time the options are granted. Options expire ten years from the date of grant. Options granted under the Company's previous nonqualified and incentive stock option plans that have not been exercised will expire ten years from the date of grant and are exercisable over the period stated in each option.

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The Company has adopted the disclosure method of SFAS No. 123 *Accounting for Stock-Based Compensation*. Using the Black-Scholes option valuation model, the estimated fair value of each option granted under the plan was \$2.81 and \$5.47 during 2006 and \$1.67 and \$2.60 during 2005. Principal assumptions used in applying the Black-Scholes model to options at date of grant were as follows:

	2006	2005
Risk-free interest rate	5.125%	4.125%
Expected life in years	10	10
Expected volatility	106% and 107%	75% and 99%
Expected dividend yield	0%	0%

The following is a summary of stock option activity:

	2006	2005
Outstanding, beginning of year	110,222	154,276
Options granted	36,750	36,000
Options exercised	61,722	80,054
Options expired	-	-
Outstanding, end of year (at prices ranging from \$2.06 to \$5.89 per share)	85,250	110,222

The following table summarizes information about stock options outstanding at May 31, 2006:

Range of Exercise Prices	Number of Options	Outstanding and Exercisable Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price
\$2.00-\$3.00	35,000	6.9	\$2.57
\$3.01-\$4.00	14,250	6.2	\$3.18
\$4.01-\$5.00	-	-	-
\$5.01-\$6.00	36,000	8.5	\$5.84
\$2.00-\$6.00	85,250	7.5	\$4.05

The following table summarizes information about stock options outstanding at May 31, 2005:

Range of Exercise Prices	Number of Options	Outstanding and Exercisable Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price
\$2.00-\$3.00	66,500	8.4	\$2.54
\$3.01-\$4.00	15,222	5.4	\$3.38
\$4.01-\$5.00	1,500	7.2	\$4.26
\$5.01-\$6.00	27,000	6.5	\$5.74
\$2.00-\$6.00	110,222	7.5	\$3.46

16. Preferred Stock:

The Company has 2,000,000 authorized but unissued shares of preferred stock which may be issued in series. The shares of each series shall have such rights, preferences, and limitations as shall be fixed by the Board of Directors.

17. Treasury Stock:

During the year ended May 31, 2006, the Company received 23,052 shares of its own common stock as treasury stock at fair market value in lieu of cash payment from certain employees and directors exercising stock options granted under the Company's stock option plans. The treasury shares were received from the option holders as payment for the purchase price of 48,631 shares of the Company's stock during the year ended May 31, 2006.

There was no change in the amount of treasury stock during the year ended May 31, 2005.

18. Retirement Plan:

The Company maintains a retirement plan for essentially all employees pursuant to Section 401(k) of the Internal Revenue Code. The Company matches a percentage of employee voluntary salary deferrals subject to limitations. The Company may also make discretionary contributions as determined annually by the Company's Board of Directors. The amount expensed under the plan was \$12,763 and \$12,546 for the years ended

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May 31, 2006 and 2005.

19. Fair Value of Financial Instruments:

The carrying amounts of cash and cash equivalents, restricted funds held by trustee, accounts receivable, accounts payable, accrued liabilities, and short-term borrowings approximate fair value because of the short maturity of these instruments.

The carrying amount of long-term debt approximates fair value because the interest rates on these instruments fluctuate with market interest rates or the fixed rates are based on current rates offered to the Company for debt with similar terms and maturities.

20. Cash Flows Information:

	2006	2005
Interest paid	\$ 155,894	\$ 161,830
Income taxes paid (refunded)	\$ 496,687	\$ (114,517)