

SCANNER TECHNOLOGIES CORP

Form 10QSB

November 03, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-QSB

(Mark One)

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

For the quarterly period ended September 30, 2004

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

Commission File Number: 000-08149

### **SCANNER TECHNOLOGIES CORPORATION**

(Name of small business issuer in its charter)

**New Mexico**

(State or other jurisdiction of  
incorporation or organization)

**85-0169650**

(IRS Employer Identification No.)

**14505 21st Avenue North, Suite 220, Minneapolis, MN 55447**

(Address of principal executive offices)

**(763) 476-8271**

(Issuer's telephone number)

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

The Issuer had 11,991,068 shares of Common Stock, no par value, outstanding as of October 31, 2004.

Transitional Small Business Disclosure Format (Check one): Yes  No

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SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB

## Table of Contents

<u>PART I.</u>	FINANCIAL INFORMATION	3
<u>Item 1.</u>	Financial Statements	3
<u>Item 2.</u>	Management's Discussion and Analysis or Plan of Operation	10
<u>Item 3.</u>	Controls and Procedures	14
<u>PART II.</u>	OTHER INFORMATION	14
<u>Item 1.</u>	Legal Proceedings	14
<u>Item 2.</u>	Changes in Securities and Small Business Issuer Purchases of Equity Securities	14
<u>Item 3.</u>	Defaults Upon Senior Securities	14
<u>Item 4.</u>	Submissions Of Matters To A Vote of Security Holders	15
<u>Item 5.</u>	Other Information	15
<u>Item 6.</u>	Exhibits	15
<u>SIGNATURE</u>		16
<u>EXHIBIT INDEX</u>		

2

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
REVENUES	\$ 707,962	\$ 1,348,646	\$ 1,599,851	\$ 4,350,589
COST OF GOODS SOLD	194,729	363,883	466,938	1,205,870
GROSS PROFIT	513,233	984,763	1,132,913	3,144,719

OPERATING EXPENSES

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	Three Months Ended September 30,		Nine Months Ended September 30,	
Selling, general and administrative	337,760	539,668	964,277	1,632,056
Research and development	124,312	88,066	379,951	276,358
Legal fees	90,246	92,643	311,573	225,171
	<u>552,318</u>	<u>720,377</u>	<u>1,655,801</u>	<u>2,133,585</u>
INCOME (LOSS) FROM OPERATIONS	(39,085)	264,386	(522,888)	1,011,134
OTHER INCOME (EXPENSE)				
Other income, net	396	364	240,391	334,306
Interest expense	(141,958)	(12,545)	(308,835)	(218,740)
INCOME (LOSS) BEFORE INCOME TAXES	(180,647)	252,205	(591,332)	1,126,700
INCOME TAXES	0	0	2,800	1,800
NET INCOME (LOSS)	<u>\$ (180,647)</u>	<u>\$ 252,205</u>	<u>\$ (594,132)</u>	<u>\$ 1,124,900</u>
NET INCOME (LOSS) PER SHARE BASIC	<u>\$ (0.02)</u>	<u>\$ 0.02</u>	<u>\$ (0.06)</u>	<u>\$ 0.11</u>
NET INCOME (LOSS) PER SHARE DILUTED	<u>\$ (0.02)</u>	<u>\$ 0.02</u>	<u>\$ (0.06)</u>	<u>\$ 0.09</u>
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	10,413,132	11,196,948	10,221,968	10,438,054
WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	10,413,132	13,174,789	10,221,968	12,003,375

See notes to condensed consolidated financial statements.

SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY  
CONDENSED CONSOLIDATED BALANCE SHEETS

December 31,  
2003

September 30,  
2004

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	(audited)	(unaudited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 170,082	\$ 1,645,757
Accounts receivable, less allowance of \$40,000	984,338	1,322,024
Inventory, less allowance of \$20,000 and \$42,500	911,382	2,005,792
Prepaid expenses	37,418	38,946
<b>TOTAL CURRENT ASSETS</b>	<b>2,103,220</b>	<b>5,012,519</b>
PROPERTY AND EQUIPMENT, net	41,294	47,850
PATENT RIGHTS, net	283,025	236,712
OTHER	17,873	9,842
	<b>\$ 2,445,412</b>	<b>\$ 5,306,923</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Bank line of credit	\$ 701,000	\$ 690,000
Notes payable	113,340	
Accounts payable	804,128	232,729
Accrued expenses	157,709	213,244
Customer deposits	20,940	
<b>TOTAL CURRENT LIABILITIES</b>	<b>1,797,117</b>	<b>1,135,973</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS EQUITY</b>		
Preferred stock, no par value, 50,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value, 50,000,000 shares authorized; 10,426,459 and 11,984,198 shares issued and outstanding	4,128,528	5,776,757
Warrants	411,561	863,165
Deferred financing costs, net	(176,822)	
Notes receivable for common stock	(275,000)	(153,900)
Accumulated deficit	(3,439,972)	(2,315,072)
	<b>648,295</b>	<b>4,170,950</b>
	<b>\$ 2,445,412</b>	<b>\$ 5,306,923</b>

See notes to condensed consolidated financial statements.

SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

	Nine Months Ended September 30,	
	2003	2004
<b>OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (594,132)	\$ 1,124,900
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation	17,771	16,014
Amortization of deferred financing costs	265,233	176,822
Amortization of patent rights	46,313	46,313
Interest expense added to debt principal	14,148	
Lawsuit settlement		(322,432)
Changes in operating assets and liabilities:		
Accounts receivable	(574,939)	(337,686)
Income taxes receivable	235,900	
Inventory	(91,474)	(1,094,410)
Prepaid expenses and other	(6,754)	6,503
Accounts payable	47,562	(248,967)
Accrued expenses	(1,242)	55,535
Customer deposits	70,894	(20,940)
Net cash used by operating activities	<u>(570,720)</u>	<u>(598,348)</u>
<b>INVESTING ACTIVITY</b>		
Purchases of property and equipment	(12,575)	(22,570)
<b>FINANCING ACTIVITIES</b>		
Net proceeds (payments) on bank line of credit	21,000	(11,000)
Proceeds from notes payable	100,000	
Payments on notes payable	(185,668)	(113,340)
Proceeds from notes receivable for common stock		275,000
Proceed from the exercise of warrants	375,477	577,589
Net proceeds from the sale of common stock and warrants	250,000	1,368,344
Net cash provided by financing activities	<u>560,809</u>	<u>2,096,593</u>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(22,486)</b>	<b>1,475,675</b>
<b>CASH AND CASH EQUIVALENTS</b>		
Beginning of period	<u>31,037</u>	<u>170,082</u>
End of period	<u>\$ 8,551</u>	<u>\$ 1,645,757</u>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid for:		
Interest	\$ 27,446	\$ 44,989
Income taxes	2,800	1,800

Nine Months Ended September 30,

Noncash operating, financing and investing activities:		
Notes receivable issued for purchase of common stock	275,000	153,900
Warrants exercised	163,110	148,653
Warrants issued in connection with sale of stock and warrants		23,087
Warrants issued in connection with line of credit	574,671	

See notes to condensed consolidated financial statements.

5

SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements  
(unaudited)

1. Basis of Presentation and Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. For further information, refer to the financial statements and footnotes for the year ended December 31, 2003 included in our Annual Report on Form 10-KSB.

Nature of Business

The Company invents, develops and markets vision inspection products that are used in the semiconductor industry for the inspection of integrated circuits. The Company's customer base is small in numbers and global in location.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Scanner Technologies Corporation and its wholly owned subsidiary, Scanner Technologies Corporation International, incorporated in the United States and registered in Singapore. All significant intercompany balances and transactions have been eliminated.

Revenue Recognition

Revenue is earned primarily through sales of inspection equipment to third party customers and also to distributors. For sales to distributors, revenue is recognized upon shipment as the distributors have no acceptance provisions and title passes at shipment. For sales to third party customers, title passes at shipment; however, the customer has certain acceptance provisions relating to installation and training. These provisions require the Company to defer revenue recognition until the equipment is installed and the customer's personnel are trained. As a result, revenue is recognized for third party customers once the product has been shipped, installed and customer personnel are trained. This process typically is completed within two weeks to a month after shipment.

Management Estimates

The preparation of these condensed consolidated 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 reported amounts and disclosures in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant management estimates relate to the valuation allowance on deferred tax assets.

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### Fair Value of Financial Instruments

The carrying amounts of financial instruments consisting of cash, receivables, bank line of credit, notes payable, accounts payable, accrued expenses and customer deposits approximate their fair values.

### Cash Equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

6

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### Accounts Receivable

Accounts receivable arise from the normal course of selling products on credit to customers. An allowance for doubtful accounts has been provided for estimated uncollectable accounts. Accounts receivable, historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment terms and practices are analyzed when evaluating the adequacy of the allowance for doubtful accounts. Individual accounts are charged against the allowance when collection efforts have been exhausted.

### Inventory

Inventory is stated at the lower of cost or market with cost determined on the first-in, first-out method. The Company has provided an allowance for obsolescence for estimated excess and obsolete inventory equal to the difference between the cost of the inventory and the estimated fair value based on assumptions about future demand and market conditions.

### Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Depreciation is provided using accelerated methods. Leasehold improvements are amortized straight-line over the lease term.

### Patent Rights

Patent rights are stated at cost less accumulated amortization. Amortization is provided using the straight-line method over six years, the deemed useful lives of the patents.

### Long-Lived Assets

All long-lived assets are reviewed at least annually for impairment when events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. An impairment loss is recognized when estimated discounted cash flows to be generated by those assets are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount is reduced to its estimated fair value, based on appraisals or other reasonable methods to estimate value.

### Product Warranty

The Company provides an accrual for estimated incurred but unidentified product warranty issues based on historical activity. The warranty accrual and related expenses were not significant.

### Accounting for Stock-Based Compensation

The Company has a stock-based employee compensation plan consisting of stock options. The Company has not adopted Statement of Financial Accounting Standards (SFAS) No. 123 to expense stock options and continues to apply the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for stock options. Accordingly, any compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the measurement date over the employee's option exercise price. Any resulting compensation expense is

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amortized ratably over the related vesting period. Options and warrants to non-employees are accounted for as required by SFAS No. 123.

The Company estimates the fair value of options and warrants at the grant date using the Black-Scholes option pricing model. The model takes into consideration weighted average assumptions related to the following: risk-free interest rate; expected live years; expected volatility; and expected dividend rate. Since the Company's stock is thinly traded, volatility is set at 0% as permitted by SFAS 123. The costs associated with the valuation of the warrants issued in 2003 in connection with the line of credit were recorded as deferred financing costs. These costs were amortized over the term of the line of credit, and the net unamortized balance at December 31, 2003 was offset against stockholders' equity.

7

If the Company recognized stock option compensation expense based on fair value at date of grant, consistent with the methods prescribed by SFAS No. 123, net income (loss) and per share disclosures would remain the same for the three and nine month periods ended September 30, 2003. For the three and nine month periods ended September 30, 2004, net income and per share disclosures would change to the pro forma amounts below:

	Periods Ended September 30, 2004	
	Three Months	Nine Months
Net income:		
As reported	\$ 252,205	\$ 1,124,900
Stock option amortization cost	4,803	13,180
Pro forma	\$ 247,402	\$ 1,111,720
Net income per share - basic:		
As reported	\$ .02	\$ .11
Stock option amortization cost	--	--
Pro forma	\$ .02	\$ .11
Net income per share - diluted:		
As reported	\$ .02	\$ .09
Stock option amortization cost	--	--
Pro forma	\$ .02	\$ .09

### Income Taxes

The Company is taxed as a domestic U.S. corporation under the Internal Revenue Code. Deferred income tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the consolidated financial statements or tax returns. Deferred income tax assets and liabilities are determined based on the differences between the financial statement and tax bases of assets and liabilities using currently enacted tax rates in effect for the years in which the differences are expected to reverse. Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the tax asset will not be utilized. The Company had an insignificant tax provision for the nine months ended September 30, 2004 because of utilization of available net operating loss carryforwards.

### Credit Risk



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Significant concentrations of credit risk exist in accounts receivable, which are due from customers located primarily in the Far East and the United States.

### Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income (loss) by the weighted-average common shares outstanding for the reported period. Diluted net income (loss) per share reflects the potential dilution that could occur if holders of warrants and options that are not antidilutive converted their holdings into common stock. The dilutive effect of options and warrants included 1,977,841 and 1,565,321 additional shares for the three and nine months ended September 30, 2004, respectively.

Options and warrants to purchase 3,312,124 and 1,158,125 shares of common stock with a weighted average exercise price of \$1.52 and \$2.95 were excluded from the diluted computation for the three months ended September 30, 2003 and 2004, respectively, because they were antidilutive. Options and warrants to purchase 2,885,511 and 933,267 shares of common stock with a weighted average exercise price of \$1.41 and \$2.71 were excluded from the diluted computation for the nine months ended September 30, 2003 and 2004, respectively, because they were antidilutive.

8

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## 2. Contingencies and Uncertainty

In an agreement dated April 19, 2002, the Company's President and Chief Executive Officer (President) forgave the payment of his accrued salary and released the Company, its successors, its officers and directors from any liability in connection with the accrued salary. In exchange, the Company agreed that its President will receive certain proceeds, if any, that Scanner may receive out of litigation involving patents that Scanner had licensed. Under the agreement, the Company keeps 60% of any proceeds of the currently ongoing litigation and pays its President 40% of such proceeds until the Company has been reimbursed for all attorney fees and other expenses incurred in connection with the current litigation, and its President has received the total of \$1,254,575. If one party receives all the amounts owing to such party before the other party's claim under this provision is satisfied, the other party receives 100% of the proceeds until its claim is satisfied. If any proceeds remain after such payment, the Company's President receives 50% of such remainder. He also has a right to receive part of the proceeds, if any, the Company may receive out of any subsequent litigation involving the licensed patents. The Company keeps 60% of any such proceeds until its attorney fees and other expenses incurred in connection with the current and any subsequent litigation have been reimbursed, and its President receives 40% of any such proceeds until he has received a total of \$1,254,575 of the proceeds of the currently ongoing and any subsequent litigation. If any proceeds of the subsequent litigation remain after such distribution, the Company will pay 25% of such remaining proceeds to its President. The unearned compensation forgiven (\$1,254,575) less the related deferred tax benefit (\$436,000) was recorded as additional paid-in capital in stockholders' equity.

To provide the Company's Senior Vice President with an incentive to continue his employment with the Company, and to compensate him for compensation in recent years which the Company believes was less than he might have received in a comparable position elsewhere, the Senior Vice President was also a party to the agreement regarding the distribution of litigation proceeds. The Company agreed to pay to him 20% of the remaining proceeds, if any, Scanner receives out of the current ongoing litigation, and 25% of the remaining proceeds, if any, that Scanner may receive out of any future litigation involving the licensed patents, and that remain after the aforesaid payments to the Company and its President have been made out of such proceeds.

In 2000, the Company instituted a lawsuit against a Belgian corporation for infringement of two of its patents. The patents related to three-dimensional ball array inspection apparatus and method. In June 2003, the Company and the Belgian corporation reached a settlement concerning one illumination source inspection systems. Pursuant to the settlement agreement, the Belgian corporation made a one-time payment of \$400,000 to the Company to settle all issues with regard to these one light source inspection systems. The court found no infringement with regard to the two illumination source devices that the Belgian corporation sold. The Company agreed to the settlement in order to allow it to immediately appeal the court's ruling concerning inspection systems involving two light sources, eliminating the need, delay and expense of a trial with regard to these systems at this stage. On April 23, 2004, the United States Court of Appeals ruled in favor of Scanner, finding that the claim terms "an illumination apparatus" and "illuminating" in its patents encompass one or more illumination sources and overturned the District Court's entry of summary judgment of non-infringement. The Company intends to continue to vigorously enforce its patent rights and expects to incur significant additional expenses in 2004 to pursue their lawsuit. The Company believes that any unfavorable decision will not have a material or adverse effect on the consolidated financial statements. In connection with the settlement in 2003, the Company paid its President \$160,000 pursuant to the agreement noted above. The \$400,000 settlement less the \$160,000 paid to the President was recorded as net in other income in the condensed consolidated statement of operations for the three months ended June 30, 2003 and is included in the nine months ended September 30, 2003 in the accompanying

condensed consolidated statement of operations.

In 2002, the Company brought suit against two law firms that previously represented the Company in the aforementioned patent litigation. The Company demanded a full and complete accounting for the fees and expenses, the payment of which these firms demand in connection with the patent litigation. The Company has paid the law firms \$558,652 in legal fees and costs. The law firms claim that the Company owes them an additional \$402,984. When the Company brought the patent suit, the law firms estimated that legal fees and costs through the discovery stage of the patent litigation would be \$447,000 to \$585,000. The Company, therefore, contends that it does not owe any further payments to the defendants. At December 31, 2003, the \$402,984 was included in accounts payable in the consolidated balance sheet.

9

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A trial was conducted in December 2003 relating to the above legal fees dispute. In January 2004, the court held that, the number of hours billed by the Defendants (law firms) was grossly excessive. In its ruling, the court reduced the outstanding balance due the law firms by \$322,432. The Company believes that this decision will not be appealed by the law firms. Consequently, Scanner reflected the reduction in accounts payable and recorded other income in its condensed consolidated statement of operations for the three months ended March 31, 2004 and is included in the nine months ended September 30, 2004 in the accompanying condensed consolidated statement of operations.

3. Line of Credit Subsequent Event

In October 2004, the Company renewed its previous line of credit through August 1, 2005. The line was decreased by \$600,000 from \$1,300,000 to \$700,000 with an interest rate at prime (4.75% at September 30, 2004), and the Company provided the bank with a security interest in its general business assets. The new line is guaranteed by five individuals who received three-year warrants to purchase 175,000 shares of common stock at \$3.50 per share for their financial support. The value assigned to the warrants was insignificant. The Company's outstanding indebtedness under the line was \$690,000 at September 30, 2004.

4. Private Placement

On August 17, 2004, the Company issued 1,150,000 units (each consisting of one share of common stock and a five year warrant to purchase one share of common stock at \$2.90 per share) for \$1.30 per unit to an investor in a private placement. The common stock issued in this private placement was valued at \$917,830 and the warrants were valued at \$577,170 using the Black-Scholes option pricing model. In connection with the private placement, the Company also issued a five-year warrant to purchase 46,000 shares of common stock at \$2.90 per share to a selling agent and incurred additional expenses of \$126,656. This warrant was valued at \$23,087 using the Black-Scholes option pricing model.

Item 2. Management's Discussion and Analysis or Plan of Operation

This Quarterly Report on Form 10-QSB includes forward-looking statements within the meaning of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements are based on our beliefs and assumptions and on information currently available to us. Forward-looking statements include, among others, the information concerning possible or assumed future results of operations of Scanner Technologies Corporation and its subsidiary (Scanner) set forth under the heading Management's Discussion and Analysis or Plan of Operation. Forward-looking statements also include statements in which words such as may, will, should, could, expect, anticipate, intend, plan, believe, estimate, predict, potential, or similar expressions are used. Forward-looking statements are not guarantees of future performance. Our future results and shareholder values may differ materially from those expressed in these forward-looking statements. We caution you not to put undue reliance on any forward-looking statements included in this document.

GENERAL

The Company generates revenues from the sale of machine-vision inspection products used in the semiconductor industry for the inspection of integrated circuits. The products include machine-vision modules sold to original equipment manufacturers that use the modules as a component of inspection systems they sell to end users, as well as complete machine-vision inspection systems that the Company sells to end users. Because the Company sells relatively few of its products each year, the Company's business is characterized by uneven quarterly results that are dependent on the timing of sales and revenue recognition.

During recent years, the Company's operations were adversely affected by a lack of demand in the semiconductor marketplace, which caused many of the Company's potential customers to cease or defer purchases of capital equipment such as the inspection equipment offered by the Company. According to information provided by Semiconductor Equipment and Materials International (SEMI), a trade association of semiconductor equipment and material manufacturers, sales of semiconductor equipment rose

from \$19.7 billion in 2002 to \$22.2 billion in 2003. SEMI expects the market for semiconductor equipment to increase by 63% in 2004 to \$36.2 billion in sales and 24% in 2005, to reach \$44.8 billion. SEMI projects a small decrease in 2006 due to the cyclical nature of the market, followed by a low double-digit growth in 2007 to an aggregate of \$48 billion in semiconductor equipment sales. The Company believes the general improvement in industry conditions contributed to the improvement in the Company's operations in 2003 and the first nine months of 2004. The Company will continue to be subject to the cyclical nature of the semiconductor marketplace.

In addition to general trends in the semiconductor marketplace, the Company must compete for sales with other providers of machine-vision inspection equipment, most of whom are larger, better financed and offer a broader selection of products. The Company must compete on the basis of price, product performance including speed and size of defects detected, ease of use and technological advancement. During 2003, the Company commenced sales of its VisionFlex inspection systems, which were introduced in July 2002. The Company must continue research and development to improve existing products and introduce new products in order to compete effectively with other providers of inspection equipment.

The Company's working capital position improved in 2004 primarily due to the sale of common stock and warrants in a private placement, the exercise of warrants and the payment of notes receivable for common stock. The Company believes that its working capital at September 30, 2004 is adequate for at least the next twelve months of operations and does not currently anticipate a need for additional financing.

#### CRITICAL ACCOUNTING POLICIES

The discussion and analysis of financial condition and results of operations is based upon the condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates, on an on-going basis, its estimates and judgments, including those related to bad debts, excess inventory, warranty obligations, income taxes, contingencies and litigation. Its estimates are based on historical experience and assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its condensed consolidated financial statements.

- Revenue recognition;
- Allowances for doubtful accounts and excess and obsolete inventory;
- Patent rights;
- Accounting for income taxes;
- Accounting and valuation of options and warrants;

Revenue is earned primarily through sales of inspection products to third party customers and also to distributors. For sales to distributors, revenue is recognized upon shipment as the distributors have no acceptance provisions and title passes at shipment. For sales to third party customers, title passes at shipment, however the customer has certain acceptance provisions relating to installation and training. These provisions require the Company to defer revenue recognition until the equipment is installed and the customer's personnel are trained. As a result, revenue is recognized for third party customers once the product has been shipped, installed and customer personnel are trained. This process typically is completed within two weeks to a month after shipment.

Accounts receivable arise from the normal course of selling products on credit to customers. An allowance for doubtful accounts has been provided for estimated uncollectable accounts. Accounts receivable, historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment terms and practices are analyzed when evaluating the

adequacy of the allowance for doubtful accounts. Individual accounts are charged against the allowance when collection efforts have been exhausted.

Inventory is stated at the lower of cost or market with cost determined on the first-in, first-out method. The Company has provided an allowance for estimated excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based on assumptions about future demand and market conditions.

Patent rights are stated at cost less accumulated amortization. Amortization is provided using the straight-line method over six years. Patent rights are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. An impairment loss is recognized when estimated discounted cash flows to be generated by those assets are less than the carrying value of the asset. When impairment loss is recognized, the carrying amount is reduced to its estimated fair value, based on appraisals or other reasonable methods to estimate value.

The Company accounts for income taxes using the asset and liability approach in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. The asset and liability approach requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. The effect on deferred taxes of a change in tax rates is recognized in operations in the period that includes the enactment date. Additionally, deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the tax asset will not be utilized.

The Company accounts for employee stock options under Accounting Principles Opinion No. 25, Accounting for Stock Issued to Employees, and provides the disclosures required by Statement of Financial Accounting Standards (SFAS) No 123, Accounting for Stock-Based Compensation. Options and warrants to non-employees are accounted for as required by SFAS No. 123.

The Company estimates the fair value of options and warrants at the grant date using the Black-Scholes option pricing model. The model takes into consideration weighted average assumptions related to the following: risk-free interest rate; expected live years; expected volatility; and expected dividend rate. Since the Company's stock is thinly traded, the Company is essentially a nonpublic entity. Therefore, volatility is set at 0% as permitted by SFAS 123.

## RESULTS OF OPERATIONS

### THREE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2003

Sales for the three months ended September 30, 2004, were \$1,348,646 compared to \$707,962 for the three months ended September 30, 2003. The sales increase in 2004 relates primarily to sales of the Company's robotic inspection systems to end users and an increase in the purchases of capital equipment by customers in the semiconductor industry.

Cost of goods sold increased by \$169,154 to \$363,883 in the three months ended September 30, 2004, from \$194,729 in 2003. Cost of goods sold as a percentage of sales decreased by .5% to 27.0% in 2004 compared to 27.5% in 2003. In 2004, material cost decreased 1.2% as a percentage of sales. This decrease was offset by an increase in manufacturing costs, primarily labor through increased personnel, as a percentage of sales.

Selling, general and administrative expenses increased by \$201,908 to \$539,668 for the three months ended September 30, 2004, compared to \$337,760 in the prior year. The increase in expenses related primarily to increases of approximately \$130,000 in salaries and related items, as a result of increased personnel, and increases in marketing expenses, primarily commissions and travel, of approximately \$40,000.

Research and development expenses were \$88,066 for the three months ended September 30, 2004 compared to \$124,312 for the three months ended September 30, 2003. The research and development activities related to the Company's development of its own line of robotic inspection systems for sale to end users. The decrease related primarily to reduced personnel costs of approximately \$33,000.

Legal fees increased by \$2,397 to \$92,643 in the three months ended September 30, 2004, from \$90,246 in 2003. A significant portion of the legal fees in both periods related to the patent infringement claims brought by the Company against a competitor. For 2004, fees were also incurred relating to evaluating and obtaining additional financing.

Other income (expense) was (\$12,181) for the three months ended September 30, 2004, compared to (\$141,562) in 2003. Interest expense was \$129,413 lower in 2004 than it was in 2003, due primarily to the amortization in 2003 of the warrant valuation related to the renewal of the line of credit.

Net income for the three months ended September 30, 2004 was \$252,205 compared to a net loss of \$180,647 in 2003. The change was the result of increased gross profit of \$471,530, decreased net nonoperating expense of \$129,381 offset by increased operating expenses of \$168,059.

#### NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2003

Sales for the nine months ended September 30, 2004, were \$4,350,589 compared to \$1,599,851 for the nine months ended September 30, 2003. The sales increase in 2004 relates primarily to sales of the Company's robotic inspection systems to end users and an increase in the purchases of capital equipment by customers in the semiconductor industry.

Cost of goods sold increased by \$738,932 to \$1,205,870 in the nine months ended September 30, 2004, from \$466,938 in 2003. Cost of goods sold as a percentage of sales decreased by 1.5% to 27.7% in 2004 compared to 29.2% in 2003. In 2004, material cost decreased 0.5% as a percentage of sales. The decrease in manufacturing costs as a percentage of sales was primarily the result of the increase in sales.

Selling, general and administrative expenses increased by \$667,779 to \$1,632,056 for the nine months ended September 30, 2004, compared to \$964,277 in the prior year. The increase in expenses related primarily to increases of approximately \$420,000 in salaries and related items, as a result of increased personnel, and increases in marketing expenses, primarily commissions and travel, of approximately \$150,000.

Research and development expenses were \$276,358 for the nine months ended September 30, 2004 compared to \$379,951 for the nine months ended September 30, 2003. The research and development activities related to the Company's development of its own line of robotic inspection systems for sale to end users was in its early stages in 2003. The decrease related primarily to reduced personnel costs of approximately \$90,000. The development process is continuing in 2004.

Legal fees decreased by \$86,402 to \$225,171 for the nine months ended September 30, 2004, from \$311,573 in 2003. A significant portion of the legal fees in both periods related to the patent infringement claims brought by the Company against a competitor and costs relating to internally developed new patents.

Other income (expense) was \$115,566 for the nine months ended September 30, 2004, compared to (\$68,444) in 2003. For the nine months ended September 30, 2004, the Company won a lawsuit relating to fees and expenses charged by the two law firms previously handling their patent infringement claim. The court ruled that the legal fees and expenses billed by the firms were excessive in the amount of \$322,432. This amount which was included in accounts payable at December 31, 2003 was recorded as other income in the three months ended March 31, 2004. In 2003, the Company settled a portion of its litigation relating to its patent infringement claim for \$400,000. In connection with the settlement and a prior agreement, the Company paid its President \$160,000. Interest expense was \$90,095 lower in 2004 than it was in 2003, due primarily to the amortization of the warrant valuation related to the renewal of the line of credit.

The net income for the nine months ended September 30, 2004 was \$1,124,900 compared to a net loss of \$594,132 in 2003. The change was primarily the result of increased gross profit of \$2,011,806, increased net nonoperating income of \$184,010 offset by increased operating expenses of \$477,784.

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### LIQUIDITY AND CAPITAL RESOURCES (FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004)

In October 2004, the Company renewed its previous line of credit through August 1, 2005. The line was decreased by \$600,000 from \$1,300,000 to \$700,000 with an interest rate at prime (4.75% at September 30, 2004), and the Company provided the bank with a security interest in its general business assets. The new line is guaranteed by five individuals who received three-year warrants to purchase 175,000 shares of common stock at \$3.50 per share for their financial support. The Company's outstanding indebtedness under the line was \$690,000 at September 30, 2004.

On August 17, 2004, the Company issued 1,150,000 units (each unit consisting of one share of common stock and a warrant to purchase one share of common stock at \$2.90 per share) for \$1.30 per unit to an investor in a private placement.

The Company believes that the new line of credit, existing working capital and anticipated cash flows from operations and equity investments will be adequate to satisfy projected operating and capital requirements for the next 12 months.

Net cash used by operating activities for the nine months ended September 30, 2004 totaled \$598,348. Negative operating cashflows resulted primarily from the net income of \$1,124,900 for the period being offset by net non-cash adjustments of \$83,283 relating primarily to a lawsuit settlement and to depreciation and amortization and by net changes in operating assets and liabilities of \$1,639,965 relating primarily to increases in inventory and accounts receivable and a decrease in accounts payable.

Net cash used by investing activities for the nine months ended September 30, 2004 totaled \$22,570. The funds were used to purchase property and equipment.

Net cash provided by financing activities for the nine months ended September 30, 2004 totaled \$2,096,593. The amount relates primarily to proceeds from the sale of common stock and warrants, the exercise of warrants, and payments on notes receivable for common stock offset by net debt payments.

### Item 3. Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures are effective.

There were no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

None.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

### Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index on page following signature page.

15

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SIGNATURE

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

Scanner Technologies Corporation

Dated: November 3, 2004

By: /s/ Elwin M. Beaty

\_\_\_\_\_  
Elwin M. Beaty  
Its Chief Executive Officer  
and Chief Financial Officer  
(Principal executive officer and principal  
financial and accounting officer)

EXHIBIT INDEX

SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB FOR QUARTER ENDED SEPTEMBER 30, 2004

<u>Exhibit Number</u>	<u>Description</u>
3.1	Amended and Restated Articles of Incorporation of the Registrant incorporated by reference to Exhibit 2.3 to the Registrant's Current Report on Form 8-K filed on August 15, 2002
3.2	Amended and Restated Bylaws of the Registrant incorporated by reference to Exhibit 2.4 to the Registrant's Current Report on Form 8-K filed on August 15, 2002
10.1*	Business Loan Agreement dated March 28, 2002 between the Company and Bremer Bank, N.A.
10.2*	Change in Terms Agreements dated June 22, 2004 and October 22, 2004 between the Company and Bremer Bank, N.A.
31*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\*Filed herewith.



