SCANNER TECHNOLOGIES CORP
Form 10QSB
November 07, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended September 30, 2005

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

Commission File Number: 000-08149

SCANNER TECHNOLOGIES CORPORATION

(Exact name of small business issuer as specified in its charter)

New Mexico	**85-0169650**
(State or other jurisdiction of incorporation or organization)	(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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

The Issuer had 12,216,068 shares of Common Stock, no par value, outstanding as of October 31, 2005.

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

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SCANNER TECHNOLOGIES CORPORATION

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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,	
	2005	**2004**	**2005**	**2004**
REVENUES	$ 355,280	$ 1,348,646	$ 1,310,618	$ 4,350,589
COST OF GOODS SOLD	125,542	363,883	591,808	1,205,870
GROSS PROFIT	229,738	984,763	718,810	3,144,719
OPERATING EXPENSES				
Selling, general and administrative	385,802	539,668	1,479,258	1,632,056
Research and development	31,670	88,066	109,430	276,358
Legal fees	3,366	92,643	633,178	225,171
	420,838	720,377	2,221,866	2,133,585
INCOME (LOSS) FROM OPERATIONS	(191,100)	264,386	(1,503,056)	1,011,134
OTHER INCOME (EXPENSE)				
Other income, net	2,116	364	6,289	334,306
Interest expense	(19,857)	(12,545)	(34,292)	(218,740)
INCOME (LOSS) BEFORE INCOME TAXES	(208,841)	252,205	(1,531,059)	1,126,700
INCOME TAXES			1,900	1,800
NET INCOME (LOSS)	$ (208,841)	$ 252,205	$ (1,532,959)	$ 1,124,900
NET INCOME (LOSS) PER SHARE BASIC	$ (0.02)	$ 0.02	$ (0.13)	$ 0.11

	Three Months Ended September 30,		Nine Months Ended September 30,	
NET INCOME (LOSS) PER SHARE DILUTED	$ (0.02)	$ 0.02	$ (0.13)	$ 0.09
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	12,216,068	11,196,948	12,127,207	10,438,054
WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	12,216,068	13,174,789	12,127,207	12,003,375

See notes to condensed consolidated financial statements.

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SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2005	December 31, 2004
	(unaudited)	(audited)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 1,625,261	$ 1,455,423
Accounts receivable, less allowance of $40,000	155,443	1,518,477
Inventories, less allowances of $138,000 and $63,000	1,668,522	1,850,852
Prepaid expenses	25,291	52,431
TOTAL CURRENT ASSETS	3,474,517	4,877,183
PROPERTY AND EQUIPMENT, net	34,108	42,239
PATENT RIGHTS, net	174,961	221,274
OTHER	7,199	9,590
	$ 3,690,785	$ 5,150,286

	September 30, 2005	December 31, 2004
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Bank line of credit	$ 490,000	$ 490,000
Accounts payable	55,301	404,838
Accrued expenses	100,655	149,804
TOTAL CURRENT LIABILITIES	645,956	1,044,642
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
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; 12,216,068 and 11,991,068 shares issued and outstanding	6,434,551	5,783,627
Warrants	724,528	863,165
Stock options	29,103	
Deferred financing costs, net	(69,246)	
Note receivable for common stock	(153,900)	(153,900)
Accumulated deficit	(3,920,207)	(2,387,248)
	3,044,829	4,105,644
	$ 3,690,785	$ 5,150,286

See notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30,

	Nine Months Ended September 30,	
	2005	2004
OPERATING ACTIVITIES		
Net income (loss)	$ (1,532,959)	$ 1,124,900
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation	15,738	16,014
Amortization of patent rights	46,313	46,313
Stock option compensation expense	62,103	
Amortization of deferred financing costs	11,541	176,822
Lawsuit settlement		(322,432)
Changes in operating assets and liabilities:		
Accounts receivable	1,363,034	(337,686)
Inventories	182,330	(1,094,410)
Prepaid expenses and other	29,531	6,503
Accounts payable	(349,537)	(248,967)
Accrued expenses	(49,149)	55,535
Customer deposits		(20,940)
Net cash used by operating activities	(221,055)	(598,348)
INVESTING ACTIVITY		
Purchases of property and equipment	(7,607)	(22,570)
FINANCING ACTIVITIES		
Net payments on bank line of credit		(11,000)
Payments on notes payable		(113,340)
Proceeds from the exercise of warrants and stock options	398,500	577,589
Net proceeds from the sale of common stock and warrants		1,368,344
Proceeds from notes receivable for common stock		275,000
Net cash provided by financing activities	398,500	2,096,593
NET INCREASE IN CASH AND CASH EQUIVALENTS	169,838	1,475,675
CASH AND CASH EQUIVALENTS		
Beginning of period	1,455,423	170,082
End of period	$ 1,625,261	$ 1,645,757
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for:		
Interest	$ 17,251	$ 44,989
Income taxes	1,900	1,800
Noncash financing activities:		
Warrants exercised and expired	219,424	148,653
Stock options exercised	33,000	
Warrants issued in connection with line of credit for deferred financing costs	80,787	
Notes receivable issued for purchase of common stock		153,900
Warrants issued in connection with the sale of common stock and warrants		23,087

See notes to condensed consolidated financial statements.

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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 and nine month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the financial statements and footnotes for the year ended December 31, 2004 included in our Annual Report on Form 10-KSB.

Nature of Business

The Company invents, develops and markets machine-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 vision inspection products to distributors and to third party customers. 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 customers 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.

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.

Cash Equivalents

All highly liquid investments purchased with an original maturity of three months or less are considered to be cash equivalents.

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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 balances, 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.

Fair Value of Financial Instruments

The carrying amounts of financial instruments consisting of cash and cash equivalents, accounts receivable, bank line of credit, accounts payable and accrued expenses approximate their fair values.

Inventories

Inventories are 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 inventories equal to the difference between the cost of inventories 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 using the straight-line method over the shorter of the useful life or 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 for impairment when events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. This evaluation is performed at least annually. An impairment loss is recognized when estimated cash flows to be generated by those assets are less than the carrying value of the assets. 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

An accrual is provided 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 and warrants. The Company has not adopted Statement of Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation or SFAS No. 123R which 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 employee/director stock options and warrants. Accordingly, any compensation cost for stock options and warrants 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/director s option and warrant exercise price. Any resulting compensation expense is amortized ratably over the related vesting period. Options and warrants to non-employees are accounted for as required by SFAS No. 123. The Company issued 70,000 stock options to non-employees in the third quarter of 2005. The options had a fair value of $29,103 as determined by the Black-Scholes option pricing model.

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Although the Company has elected to follow APB Opinion No. 25, SFAS No. 123 requires pro forma disclosures of net income (loss) and per share disclosures as if the Company had accounted for its stock options and warrants under that statement. The fair value of each option and warrant grant was estimated on the grant date using the Black-Scholes option pricing model with the following assumptions:

	2005	**2004**
Risk-free interest rates	4.21%	3.15%
Dividend yields	0%	0%
Volatility factors of expected market price of common stock	186%	186%
Weighted average expected life	3.4 years	4.2 years

The following table illustrates the effect on net income (loss) and per share amounts as if the Company had applied the fair value provisions of SFAS No. 123 to stock-based employee compensation.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	**2004**	**2005**	**2004**
Net income (loss):				
As reported	$ (208,841)	$ 252,205	$ (1,532,959)	$ 1,124,900
Warrant and stock option amortization cost	(286,683)	(82,684)	(431,972)	(214,702)
Pro forma	$ (495,524)	$ 169,521	$ (1,964,931)	$ 910,198
Net income (loss) per share basic:				
As reported	$ (.02)	$ .02	$ (.13)	$ .11
Warrant and stock option amortization cost	(.02)		(.03)	(.02)
Pro forma	$ (.04)	$ .02	$ (.16)	$ .09
Net income (loss) per share diluted:				
As reported	$ (.02)	$ .02	$ (.13)	$ .09
Warrant and stock option amortization cost	(.02)	(.01)	(.03)	(.01)
Pro forma	$ (.04)	$ .01	$ (.16)	$ .08

In all prior periods, the expected volatility used by the Company to determine the fair value of options and warrants at date of grant for the pro forma disclosures was 0% because the Company s stock was thinly traded. The fair value calculation has been changed to reflect the volatility shown in the above table at date of grant.

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.

Credit Risk

The Company maintains cash and cash equivalents in bank accounts which may exceed federally insured limits. The Company has not experienced any losses on such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents.

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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 in the three and nine months ended September 30, 2004, respectively.

Options and warrants to purchase 5,275,749 and 1,158,125 shares of common stock with a weighted average exercise price of $1.86 and $2.95 were excluded from the diluted computation for the three months ended September 30, 2005 and 2004, respectively, because they were antidulitive. Options and warrants to purchase 5,327,982 and 933,267 shares of common stock with a weighted average exercise price of $1.90 and $2.71 were excluded from the diluted computation for the nine months ended September 30, 2005 and 2004, respectively, because they were antidulitive.

2. Bank Line of Credit

On August 1, 2005, the Company renewed its previous line of credit through October 1, 2006. The line was decreased by $200,000 from $700,000 to $500,000 with an interest rate at prime (6.75% at September 30, 2005), and the Company provided the bank with a security interest in its general business assets. The line is guaranteed by four individuals, all of whom are shareholders, who received three-year warrants to purchase an aggregate of 250,000 shares of common stock at $.70 per share for their financial support. The warrants issued to the guarantors had a market value of $80,787 as determined by the Black-Scholes option pricing model. The $80,787 was recorded as deferred financing costs. These costs are amortized over the term of the line of credit, and the net unamortized balance is offset against stockholders equity. The Company s outstanding indebtedness under the line was $490,000 at September 30, 2005.

3. 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 of $1,254,575 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.

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 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.

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In 2000, the Company instituted a lawsuit against ICOS Vision Systems Corp. N.V., a Belgian corporation (ICOS) for infringement of two of its patents. The patents relate to three-dimensional ball array inspection apparatus and methods. In June 2003, the Company reached a settlement with ICOS concerning one-illumination source inspection systems. In 2003, pursuant to the settlement agreement, ICOS 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 District Court found no infringement with regard to the two-illumination source devices that ICOS sold. The Company agreed to the settlement agreement with respect to one-light source devices 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. In connection with the settlement, the Company paid its President $160,000 pursuant to the agreement noted above. The Company recorded the $400,000 settlement less the $160,000 paid to its President in other income in its consolidated financial statements for the year ended December 31, 2003. On April 23, 2004, the United States Court of Appeals ruled in the Company s favor with regard to the two-illumination source devices, finding that the claim terms an illumination apparatus and illuminating in the Company s patents encompass one or more illumination sources and overturned the District Court s entry of summary judgment of no infringement. A trial, to be decided by the judge, was held in March 2005 in the U. S. District Court for the Southern District of New York regarding the Company s ongoing litigation with ICOS. Scanner s prayer for relief includes requests for damages in the form of lost profits, a trebling of damages pursuant to 35 USC 284, and attorneys fees and costs. In its answer to the complaint, ICOS included counterclaims alleging various forms of unfair competition as well as seeking a declaration that the patents are invalid and not infringed. In addition, ICOS is requesting attorneys fees and costs. It is not known when the judge will issue his decision on the case. The Company intends to continue to vigorously enforce its patent rights and expects to incur significant additional expenses in 2005 to pursue its claims.

In 2002, the Company brought suit against two law firms that previously represented the Company in the patent litigation described above. The Company demanded a full and complete accounting for the fees and expenses charged by these firms in connection with the patent litigation. The Company paid the law firms the total amount of $558,652 in legal fees and costs. The law firms claimed that the Company owed them an additional $402,984. The trial took place in December 2003. In January 2004, the court decided that the number of hours billed by the law firms was grossly excessive and, therefore, reduced the amount still payable to the law firms by $322,432. At December 31, 2003, the entire amount requested by the law firms of $402,984 was included in accounts payable in the consolidated balance sheet. Scanner reflected the reduction in accounts payable and recorded other income in its consolidated financial statements for the quarter ended March 31, 2004.

In July 2005, ICOS Vision Systems Corp. N.V. and ICOS Vision Systems, Inc. (collectively, ICOS) filed a lawsuit against the Company in the U.S. District Court for the Southern District of New York. ICOS is seeking a declaratory judgment with respect to certain patents held by Scanner finding that ICOS does not infringe such patents and that such patents are invalid. ICOS is also seeking a declaratory judgment finding that U.S. companies that purchase electronic components such as Ball Grid Array devices inspected on ICOS systems in foreign countries are not liable as infringers of such patents and injunctive relief enjoining Scanner from threatening such purchasers with claims of infringement. ICOS is seeking damages of unspecified amounts, as well as costs, expenses and attorney s fees. The Company believes that this lawsuit is without merit and intends to vigorously defend itself and the Company s intellectual property rights.

In July 2005, American Arium (Arium), a Delaware corporation with a principal office located at 14811 Myford Road, Tustin, California, filed a lawsuit against the Company in the U.S. District Court for the Central District of California. Arium is seeking a declaratory judgment with respect to certain patents held by Scanner finding that Arium does not infringe such patents and that such patents are invalid. Arium is also seeking injunctive relief enjoining Scanner from threatening Arium and its customers with claims of infringement. Arium is seeking its costs, expenses and attorney s fees. The Company believes that this lawsuit is without merit and intends to vigorously defend itself and the Company s intellectual property rights.

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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 (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 no guarantees of future performance and are subject to various risks and uncertainties that may cause our future results and shareholder values to 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 devices 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 and particularly in 2005, 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 for 2004 totaled $37.11 billion, but are expected to decline in 2005 to a total of $32.63 billion. SEMI expects the market for semiconductor equipment to bounce back in 2006 and to increase by 8.17% to $35.28 billion, before growing 10.16% in 2007, to $38.86 billion. The Company believes the general improvement in industry conditions contributed to the improvement in the Company s operations in 2004, whereas operations in 2005 are adversely affected by a lack of demand in the semiconductor marketplace. 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 s sales in 2005 have been adversely affected by increased competitive pressures from other providers of machine-vision inspection equipment, most of whom are larger, better financed and offer a broader selection of products. Many customers prefer to reduce the number of suppliers they work with by purchasing from larger suppliers offering a broader range of products from one company. The Company must also 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. 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 is reviewing the possibility of licensing its technologies to third parties to provide additional revenues. There is, however, no assurance that the Company will be successful in obtaining licenses on financially advantageous terms, and the Company may need to initiate lawsuits, and incur legal fees and other costs, to force potential licensees to acknowledge the Company s proprietary rights and enter into appropriate licenses.

The Company s working capital position improved in 2004 primarily due to profitable operations and to the sale of common stock and warrants in a private placement, the exercise of warrants and the payments of notes receivable for common stock. During the nine months ended September 30, 2005, the working capital position decreased primarily due to the net effect of the operating loss offset by the cash proceeds from the exercise of stock options and warrants. The Company believes that its working capital at September 30, 2005 is adequate for at least the next twelve months of operations and does not currently anticipate a need for additional financing.

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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 inventories, 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 inventories;
- Patent rights;
- Accounting for income taxes;
- Accounting and valuation of options and warrants;

Revenue is earned primarily through sales of vision inspection products to distributors and to third party customers. 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 customers 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 balances, 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.

Inventories are 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 inventories equal to the difference between the cost of inventories 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. This evaluation is performed at least annually. An impairment loss is recognized when estimated cash flows to be generated by those assets are less than the carrying value of the assets. 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 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 accounts for employee stock options and warrants under Accounting Principles Opinion No. 25, Accounting for Stock Issued to Employees, and provides the disclosures required by Statement of Financial 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 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 life years; expected volatility; and expected dividend rate.

RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2004

Sales for the three months ended September 30, 2005, were $355,280 compared to $1,348,646 for the three months ended September 30, 2004. The sales decrease in 2005 relates primarily to decreased sales of the Company s robotic inspection systems to end users and a decrease in the purchases of capital equipment by customers in the semiconductor industry.

Cost of goods sold decreased by $238,341 to $125,542 in the three months ended September 30, 2005, from $363,883 for the same quarter in 2004. Cost of goods sold as a percentage of sales increased by 8.3% to 35.3% in 2005 compared to 27.0% in 2004. In 2005, material cost decreased 1.2% as a percent of sales. This decrease in material cost was offset by an increase in manufacturing costs as a percent of sales primarily because of the large decrease in sales, which caused fixed manufacturing costs to be spread over a smaller base.

Selling, general and administrative expenses decreased by $153,866 to $385,802 for the three months ended September 30, 2005, compared to $539,668 in the same quarter of 2004. The decrease in expenses related primarily to decreases in salaries and related expenses of approximately $62,000 because of fewer personnel and decreases in marketing related expenses of approximately $92,000 offset by increases in stock option compensation of approximately $29,000.

Research and development expenses were $31,670 in the three months ended September 30, 2005 compared to $88,066 for the three months ended September 30, 2004. The research and development activities related to the Company s development and improvement of its own line of robotic inspection systems for sale to end users. The decrease in expenses was related primarily to reduced personnel costs. The development process is continuing.

Legal fees decreased by $89,277 to $3,366 in the three months ended September 30, 2005, from $92,643 in the same quarter of 2004. A significant portion of the legal fees in 2004 related to the patent infringement claims brought by the Company against a competitor, which claims went to trial in March 2005.

Other expense was $17,741 in the three months ended September 30, 2005, compared to $12,181 in the same quarter of 2004. Interest expense was $7,312 higher in the third quarter of 2005 than it was in the third quarter of 2004. Interest expense increased primarily due to amortization of the warrant costs related to the line of credit.

The Company recognized no income tax benefit to offset the loss before income taxes in the three months ended September 30, 2005, as no tax benefit was available to the Company. The Company recognized no federal income tax expense to offset the income before income taxes in the three months ended September 30, 2004 because the income was offset by operating loss carryforwards.

The net loss for the three months ended September 30, 2005 was $208,841, or $.02 per share, compared to net income of $252,205, or $.02 per share in the same quarter of 2004. The change was the result of decreased gross profit of $755,025 and increased net other expense of $5,560 offset by decreased operating expenses of $299,539.

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NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2004

Sales for the nine months ended September 30, 2005, were $1,310,618 compared to $4,350,589 for the nine months ended September 30, 2004. The sales decrease in 2005 relates primarily to decreased sales of the Company s robotic inspection systems to end users and a decrease in the purchases of capital equipment by customers in the semiconductor industry.

Cost of goods sold decreased by $614,062 to $591,808 in the nine months ended September 30, 2005, from $1,205,870 in 2004. Cost of goods sold as a percentage of sales increased by 17.5% to 45.2% in 2005 compared to 27.7% in 2004. In 2005, material cost increased 3.8% as a percent of sales. This increase was supplemented by an increase in manufacturing costs as a percent of sales primarily because of the large decrease in sales, which caused fixed manufacturing costs to be spread over a smaller base.

Selling, general and administrative expenses decreased by $152,798 to $1,479,258 for the nine months ended September 30, 2005, compared to $1,632,056 in the same period of 2004. The decrease in expenses related primarily to decreased salaries and related expenses of approximately $110,000 because of fewer personnel and reduced marketing related expenses of approximately $159,000 offset by increases in professional fees of approximately $83,000, relating to Company marketing and financing activities and directors fees, and an increase of approximately $62,000 in stock option compensation.

Research and development expenses were $109,430 the nine months ended September 30, 2005 compared to $276,358 for the nine months ended September 30, 2004. The research and development activities related to the Company s development and improvement of its own line of robotic inspection systems for sale to end users. The decrease in expenses was related primarily to reduced personnel costs. The development process is continuing.

Legal fees increased by $408,007 to $633,178 in the nine months ended September 30, 2005, from $225,171 in the same period of 2004. A significant portion of the legal fees in both periods related to the patent infringement claims brought by the Company against a competitor, which claims went to trial in March 2005.

Other income (expense) was ($28,003) in the nine months ended September 30, 2005, compared to $115,566 in the same period of 2004. In 2004, the Company won a lawsuit relating to fees and expenses charged by two law firms previously handling its 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. Interest expense was $184,448 lower in the first nine months of 2005 than it was in the first nine months of 2004, due primarily to the difference in amortization of the warrant valuation related to the lines of credit.

The Company recognized no income tax benefit to offset the loss before income taxes in the nine months ended September 30, 2005, as no tax benefit was available to the Company. The Company recognized no federal income tax expense to offset the income before income taxes in the nine months ended September 30, 2004 because the income was offset by operating loss carryforwards. The taxes provided in both periods represented minimum state taxes.

The net loss for the nine months ended September 30, 2005 was $1,532,959, or $.13 per share, compared to net income of $1,124,900, or $.11 per share in the same period of 2004. The change was the result of decreased gross profit of $2,425,909, increased operating expenses of $88,281, decreased net other income of $143,569 and increased income taxes of $100.

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LIQUIDITY AND CAPITAL RESOURCES (FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005)

On August 1, 2005, the Company renewed its previous line of credit through October 1, 2006. The line was decreased by $200,000 from $700,000 to $500,000 with an interest rate at prime (6.75% at September 30, 2005) and the Company provided the bank with a security interest in its general business assets. The line is guaranteed by four individuals, all of whom are shareholders, who received three-year warrants to purchase an aggregate of 250,000 shares of common stock at $.70 per share for their financial support. The Company s outstanding indebtedness under the line was $490,000 at September 30, 2005.

The Company believes that its existing working capital 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, 2005 totaled $221,055. Negative operating cashflows resulted primarily from the net loss of $1,532,959 for the period being offset by net non-cash adjustments of $135,695 relating primarily to stock option compensation expense and depreciation and amortization and by net changes in operating assets and liabilities of $1,176,209 relating primarily to decreases in receivables and inventories offset by a decrease in accounts payable.

Net cash used by investing activities for the nine months ended September 30, 2005 totaled $7,607. The funds were used to purchase property and equipment.

Net cash provided by financing activities for the nine months ended September 30, 2005 totaled $398,500. The amount relates to proceeds from the exercise of stock options and warrants.

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 participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, regarding the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rules 13a-15(b) of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer, concluded that the Company s disclosure controls and procedures are effective to ensure that information that is required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the rules of the Securities Exchange Commission. 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.

The Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, does not expect that the disclosure controls and procedures will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. The design of any system of controls also is based in part upon assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Due to the lack of sufficient accounting personnel, there was an ineffective segregation of duties in the preparation of the financial statements to prevent or detect errors. This control deficiency could result in material misstatements to annual or interim financial statements that would not be prevented or detected if left unremediated. Accordingly, management determined that this control deficiency constitutes a material weakness. Because of this material weakness, management believes that, as of September 30, 2005, we did not maintain effective internal control over financial reporting based on the COSO criteria.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

In July 2005, ICOS Vision Systems Corp. N.V. and ICOS Vision Systems, Inc. (collectively, ICOS) filed a lawsuit against the Company in the U.S. District Court for the Southern District of New York. ICOS is seeking a declaratory judgment with respect to certain patents held by Scanner finding that ICOS does not infringe such patents and that such patents are invalid. ICOS is also seeking a declaratory judgment finding that U.S. companies that purchase electronic components such as Ball Grid Array devices inspected on ICOS systems in foreign countries are not liable as infringers of such patents and injunctive relief enjoining Scanner from threatening such purchasers with claims of infringement. ICOS is seeking damages of unspecified amounts, as well as costs, expenses and attorney s fees. The Company believes that this lawsuit is without merit and intends to vigorously defend itself and the Company s intellectual property rights.

In July 2005, American Arium (Arium), a Delaware corporation with a principal office located at 14811 Myford Road, Tustin, California, filed a lawsuit against the Company in the U.S. District Court for the Central District of California. Arium is seeking a declaratory judgment with respect to certain patents held by Scanner finding that Arium does not infringe such patents and that such patents are invalid. Arium is also seeking injunctive relief enjoining Scanner from threatening Arium and its customers with claims of infringement. Arium is seeking its costs, expenses and attorney s fees. The Company believes that this lawsuit is without merit and intends to vigorously defend itself and the Company s intellectual property rights.

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

On August 1, 2005, the Company issued three-year warrants to purchase an aggregate of 250,000 shares of common stock at $.70 per share. The warrants were issued to four individuals, all of whom are shareholders, who guaranteed the Company s line of credit. The

Company relied upon Section 4(2) of the Securities Act for exemptions for transactions not involving a public offering.

On September 26, 2005, the Company issued stock options to certain employees, including two officers, consultants and two outside directors to purchase an aggregate of 1,253,000 shares of common stock of the Company. Options to purchase 513,000 common shares at $.45 per share vested immediately. Options to purchase 100,000 common shares at $.45 per share vest on January 1, 2006. Options to purchase 440,000 common shares at $.495 per share vest in two increments, 40,000 vest immediately and 400,000 on January 1, 2006. Options to purchase 200,000 shares at $.45 per share vest in two increments, on September 26, 2006 and September 26, 2007. The Company relied upon Section 4(2) of the Securities Act for exemptions for transactions not involving a public offering as applicable; provided, however, that 186,000 of such options and underlying shares were included on a Form S-8 Registration Statement previously filed by the Company, and the Company intends to register the remaining options and shares prior to any exercise of such options.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

The Company entered into a Change in Terms Agreement (the Amendment) dated August 1, 2005 with Bremer Bank, National Association (the Bank), which amends the Business Loan Agreement dated March 28, 2002 between the Company and the Bank. The Amendment reduces the Company s line of credit from $700,000 to $500,000 and extends the line of credit from August 1, 2005 to October 1, 2006.

Item 6. Exhibits

See Exhibit Index on page following signature page.

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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 7, 2005

By: /s/ Elwin M. Beaty

Elwin M. Beaty
Chief Executive Officer and
Chief Financial Officer
(Principal executive officer and principal

financial and accounting officer)

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EXHIBIT INDEX

SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB FOR QUARTER ENDED SEPTEMBER 30, 2005

Exhibit Number	Description
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*	Change in Terms Agreement dated August 1, 2005 between the Company and Bremer Bank, National Association.
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.

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