SCANNER TECHNOLOGIES CORP
Form 10QSB
August 13, 2004

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

FORM 10-QSB

(Mark One)

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

For the quarterly period ended June 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	**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 Issuer was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

The Issuer had 10,454,698 shares of Common Stock, no par value, outstanding as of July 31, 2004.

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

SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB

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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 June 30,		Six Months Ended June 30,	
	2003	**2004**	**2003**	**2004**
REVENUES	$ 767,981	$ 1,752,159	$ 891,889	$ 3,001,943
COST OF GOODS SOLD	210,002	489,387	272,209	841,987
GROSS PROFIT	557,979	1,262,772	619,680	2,159,956
OPERATING EXPENSES				

	Three Months Ended June 30,		Six Months Ended June 30,	
Selling, general and administrative	304,349	528,216	626,517	1,092,388
Research and development	118,433	95,002	255,639	188,292
Legal fees	187,995	64,025	221,327	132,528
	610,777	687,243	1,103,483	1,413,208
INCOME (LOSS) FROM OPERATIONS	(52,798)	575,529	(483,803)	746,748
OTHER INCOME (EXPENSE)				
Other income (expense), net	240,033	11,510	239,995	333,942
Interest expense	(153,310)	(54,616)	(166,877)	(206,195)
INCOME (LOSS) BEFORE INCOME TAXES	33,925	532,423	(410,685)	874,495
INCOME TAXES	300	0	2,800	1,800
NET INCOME (LOSS)	$ 33,625	$ 532,423	$ (413,485)	$ 872,695
NET INCOME (LOSS) PER SHARE BASIC	$ 0.00	$ 0.05	$ (0.04)	$ 0.08
NET INCOME (LOSS) PER SHARE DILUTED	$ 0.00	$ 0.04	$ (0.04)	$ 0.07
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	10,229,798	10,432,785	10,126,386	10,429,755
WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	11,532,836	12,418,094	10,126,386	11,756,315

See notes to condensed consolidated financial statements.

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SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2003	June 30, 2004
	(audited)	(unaudited)
ASSETS		
CURRENT ASSETS		
Cash	$ 170,082	$ 299,153
Accounts receivable, less allowance of $40,000	984,338	1,371,706
Inventory, less allowance of $20,000 and $40,500	911,382	1,644,866

	December 31, 2003	June 30, 2004
Prepaid expenses	37,418	36,455
TOTAL CURRENT ASSETS	2,103,220	3,352,180
PROPERTY AND EQUIPMENT, net	41,294	48,528
PATENT RIGHTS, net	283,025	252,149
OTHER	17,873	29,594
	$ 2,445,412	$ 3,682,451
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Bank line of credit	$ 701,000	$ 690,000
Notes payable	113,340	
Accounts payable	804,128	742,968
Accrued expenses	157,709	223,432
Customer deposits	20,940	
TOTAL CURRENT LIABILITIES	1,797,117	1,656,400
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; 10,426,459 and 10,454,698 shares issued and outstanding	4,128,528	4,195,924
Warrants	411,561	397,404
Deferred financing costs, net	(176,822)	
Notes receivable for common stock	(275,000)	
Accumulated deficit	(3,439,972)	(2,567,277)
	648,295	2,026,051
	$ 2,445,412	$ 3,682,451

See notes to condensed consolidated financial statements.

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SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Six Months Ended June 30, 2003	Six Months Ended June 30, 2004
OPERATING ACTIVITIES		
Net income (loss)	$ (413,485)	$ 872,695
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation	11,169	10,244
Amortization of deferred financing costs	132,616	176,822
Amortization of patent rights	30,876	30,876
Interest expense added to debt principal	9,808	
Lawsuit settlement		(322,432)
Changes in operating assets and liabilities:		
Accounts receivable	(176,538)	(387,368)
Income taxes receivable	235,900	
Inventory	(18,710)	(733,484)
Prepaid expenses and other	(6,248)	(10,758)
Accounts payable	44,388	261,272
Accrued expenses	4,828	65,723
Customer deposits		(20,940)
Net cash used by operating activities	(145,396)	(57,350)
INVESTING ACTIVITY		
Purchases of property and equipment	(3,003)	(17,478)
FINANCING ACTIVITIES		
Net payments on bank line of credit	(279,000)	(11,000)
Proceeds from notes payable	100,000	
Payments on notes payable	(49,968)	(113,340)
Proceeds from notes receivable for common stock		275,000
Proceed from the exercise of warrants	350,477	53,239
Proceeds from the sale of common stock	175,000	
Net cash provided by financing activities	296,509	203,899
NET INCREASE IN CASH	148,110	129,071
CASH		
Beginning of period	31,037	170,082
End of period	$ 179,147	$ 299,153
Supplemental Disclosures of Cash Flow Information:		
Cash paid for:		
Interest	$ 23,517	$ 32,444
Income taxes	2,800	1,800
Noncash operating, financing and investing activities:		
Warrants exercised	163,110	14,157
Warrants issued in connection with line of credit	574,671	
Notes receivable issued for purchase of common stock	300,000	

See notes to condensed consolidated financial statements.

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 six-month periods ended June 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 a distributor. For sales to the distributor, revenue is recognized upon shipment as the distributor has 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. The Company provides the training but does not install the equipment. 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.

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.

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 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 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.

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 six month periods ended June 30, 2003. For the three and six month periods ended June 30, 2004, net income and per share disclosures would change to the pro forma amounts below:

	Periods Ended June 30, 2004	
	Three Months	Six Months
Net income:		
As reported	$ 532,423	$ 872,695
Stock option amortization cost	4,633	8,377
Pro forma	$ 527,790	$ 864,318
Net income per share - basic:		
As reported	$ .05	$ .08
Stock option amortization cost		
Pro forma	$ .05	$ .08
Net income per share - diluted:		
As reported	$ .04	$ .07
Stock option amortization cost		
Pro forma	$ .04	$ .07

Income Taxes

The Company is taxed as a domestic U.S. corporation under the Internal Revenue Code. Income taxes are accounted for under SFAS No. 109, Accounting for Income Taxes. 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

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 1,303,038 and 1,985,309 additional shares in the three months ended March 31, 2003 and 2004, respectively, and 1,326,560 additional shares in the six months ended June 30, 2004.

Options and warrants to purchase 307,083 and 375,000 shares of common stock with a weighted average exercise price of $2.76 and $2.77 were excluded from the diluted computation for the three months ended June 30, 2003 and 2004, respectively, because they were antidulitive. Options and warrants to purchase 2,669,287 and 672,225 shares of common stock with a weighted average exercise price of $1.34 and $2.59 were excluded from the diluted computation for the six months ended June 30, 2003 and 2004, respectively, because they were antidulitive.

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 any subsequent litigation as described above 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 consolidated financial statements for the three months ended June 30, 2003.

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.

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 financial statements for the three months ended March 31, 2004.

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3. Line of Credit

The Company s bank line of credit terminated on May 1, 2004. The bank has not called the $690,000 balance on the line at the date of termination while the Company negotiates a new line of credit or other financing arrangements.

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 no 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 manufactures 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. Semiconductor Equipment and Materials International (SEMI), a trade association of semiconductor equipment and material manufacturers, estimates that sales of semiconductor equipment rose from $19.7 billion in 2002 to $21.4 billion in 2003. SEMI expects the market for semiconductor equipment to increase by 39% in 2004 and 18% in 2005, but to decrease in 2006 by 6.6% because new capacity is anticipated to go into production at that time. The Company believes the general improvement in industry conditions contributed to the improvement in the Company s operations in 2003 and the first six 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 continues to operate with limited working capital resources and must increase revenues sufficient to generate cash flow from operations or seek additional financing, or both, in order to sustain operations. In order to obtain additional debt or equity financing, the Company may be obligated to issue additional shares of Common stock or warrants or other rights to acquire Common stock on terms that will result in dilution to existing shareholders or place restrictions on operations. The Company may also be unsuccessful in increasing revenues or obtaining additional equity financing or bank financing on any terms and in that event may be obligated to cease operations and/or attempt to negotiate with its creditors to delay payments or compromise the amounts of its indebtedness.

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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 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 a distributor. For sales to the distributor, revenue is recognized upon shipment as the distributor has 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. The Company provides the training but does not install the equipment. 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. The costs associated with the valuation of the warrants issued in connection with the line of credit are recorded as deferred financing costs. These costs are being amortized over the term of the line of credit, and the net unamortized balance is offset against stockholders equity.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2004 COMPARED TO THREE MONTHS ENDED JUNE 30, 2003

Sales for the three months ended June 30, 2004, were $1,752,159 compared to $767,981 for the three months ended June 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 $279,385 to $489,387 in the three months ended June 30, 2004, from $210,002 in 2003. Cost of goods sold as a percentage of sales increased by 0.6% to 27.9% in 2004 compared to 27.3% in 2003. In 2004, material cost decreased 1.1% as a percent of sales. This decrease was offset by an increase in manufacturing costs, primarily labor through increased personnel, as a percent of sales.

Selling, general and administrative expenses increased by $223,867 to $528,216 for the three months ended June 30, 2004, compared to $304,349 in the prior period. The increase in expenses related primarily to increases in salaries and related items, as a result of increased personnel and marketing expenses.

Research and development expenses were $95,002 in the three months ended June 30, 2004 compared to $118,433 for the three months ended June 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.

Legal fees decreased by $123,970 to $64,025 in the three months ended June 30, 2004, from $187,995 in 2003. A significant portion of the legal fees in 2003 related to the patent infringement claims brought by the Company against a competitor.

Other income (expense) was ($43,106) in the three months ended June 30, 2004, compared to $86,723 in 2003. Interest expense was $98,694 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. 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.

The net income for the three months ended June 30, 2004 was $532,423 compared to net income of $33,625 in 2003. The change was primarily the result of increased gross profit of $704,793 offset by increased operating expenses of $76,466 and increased net nonoperating expense of $129,829.

SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO SIX MONTHS ENDED JUNE 30, 2003

Sales for the six months ended June 30, 2004, were $3,001,943 compared to $891,889 for the six months ended June 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 $569,778 to $841,987 in the six months ended June 30, 2004, from $272,209 in 2003. Cost of goods sold as a percentage of sales decreased by 2.5% to 28.0% in 2004 compared to 30.5% in 2003. In 2004, material cost decreased 0.5% as a percent of sales. The decrease in manufacturing costs as a percent of sales was primarily the result of the increase in sales.

Selling, general and administrative expenses increased by $465,871 to $1,092,388 for the six months ended June 30, 2004, compared to $626,517 in the prior period. The increase in expenses related primarily to increases in salaries and related items, as a result of increased personnel, and marketing expenses.

Research and development expenses were $188,292 in the six months ended June 30, 2004 compared to $255,639 for the six months ended June 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 development process is continuing in 2004.

Legal fees decreased by $88,799 to $132,528 in the six months ended June 30, 2004, from $221,327 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 was $127,747 in the six months ended June 30, 2004, compared to $73,118 in 2003. In the six months ended June 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 that 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 $39,318 higher 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 six months ended June 30, 2004 was $872,695 compared to a net loss of $413,485 in 2003. The change was primarily the result of increased gross profit of $1,540,276, increased net nonoperating income of $54,629 offset by increased operating expenses of $309,725.

LIQUIDITY AND CAPITAL RESOURCES (FOR THE SIX MONTHS ENDED JUNE 30, 2004)

The Company has a $1,300,000 bank line of credit with an interest rate at prime (4.25% at June 30, 2004). The Company provided the bank with a security interest in its general business assets. The Company s outstanding indebtedness under the line of credit was $690,000 at June 30, 2004. The line is guaranteed by certain shareholders.

The Company s bank line of credit terminated on May 1, 2004. The bank has not called the $690,000 balance on the line at the date of termination while the Company negotiates a new line of credit or other financing arrangements.

The Company believes that the new line of credit being negotiated or other financing arrangements, 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 six months ended June 30, 2004 totaled $57,350. Negative operating cashflows resulted primarily from the net income of $872,695 for the period being offset by net non-cash adjustments of $104,490 relating primarily to a lawsuit settlement and to depreciation and amortization and by net changes in operating assets and liabilities of $825,555 relating primarily to increases in inventory and accounts receivable and a decrease in accounts payable.

Net cash used by investing activities for the six months ended June 30, 2004 totaled $17,478. The funds were used to purchase property and equipment.

Net cash provided by financing activities for the six months ended June 30, 2004 totaled $203,899. The amount relates primarily to proceeds from notes receivable for common stock and the exercise of warrants 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

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.

Item 2. Changes in Securities and Small Business Issuer Purchases of Equity Securities

The Company issued 2,709 and 265 shares of common stock to two individuals in April and May 2004, respectively, upon the exercise of warrants at $1.00 per share. The Company also issued 25,000 shares of common stock to one individual in June 2004 upon the exercise of a warrant at $2.00 per share. The Company relied upon Section 4(2) of the Securities Act for an exemption for transactions not involving a public offering.

On April 13, 2004, in exchange for services, the Company issued to a consultant a two-year stock option to purchase 40,000 shares of common stock of the Company at $2.00 per share, which option vests and becomes exercisable on August 13, 2004. The Company relied upon Section 4(2) of the Securities Act for exemptions for transactions not involving a public offering.

Item 3. Defaults Upon Senior Securities

None.

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

The Company held its Annual Meeting of Shareholders on June 17, 2004. The Company did not solicit proxies pursuant to Regulation 14A under the Securities Exchange Act of 1934, and the shareholders voted on the following matters, approving all unanimously:

(i) Set the number of directors at two (2):

For: 5,866,897 Against: 0 Abstain: 0

(ii) Election of Directors:

	For:	Withhold:
Elwin M. Beaty	5,866,897	0
David P. Mork	5,866,897	0

(iii) Approve 2004 Equity Incentive Plan:

For: 5,866,897 Against: 0 Abstain: 0

(iv) Ratifying the appointment of Lurie Besikof Lapidus & Company, LLP as independent auditors for the current fiscal year:

For: 5,866,897 Against: 0 Abstain: 0

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

Exhibits:

See Exhibit Index on page following signature page.

Reports on Form 8-K:

None.

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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: August 13, 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)

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EXHIBIT INDEX

SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB FOR QUARTER ENDED JUNE 30, 2004

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*	Employment Agreement dated January 1, 2004 between the Company and Elwin M. Beaty**
10.2*	Employment Agreement dated January 1, 2004 between the Company and David P. Mork**
10.3*	Promissory Note dated March 31, 2003 in favor of Bremer Bank, N.A., Commercial Security Agreement dated March 31, 2003 between the Company and Bremer Bank, N.A. and Change in Terms Agreement dated March 31, 2003 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.

**Designates a management contract or compensatory plan or arrangement.

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