SCANNER TECHNOLOGIES CORP
Form 10QSB
November 13, 2006

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, 2006

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

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 [ ]

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

The Issuer had 12,216,068 shares of Common Stock, no par value, outstanding as of October 31, 2006.

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 September 30,		Nin Se
	2006	2005	2006
REVENUES	$ 572,784	$ 355,280	$ 2,144,
COST OF GOODS SOLD	326,866	125,542	957,
GROSS PROFIT	245,918	229,738	1,186,
OPERATING EXPENSES			
Selling, general and administrative	406,653	385,802	1,439,
Research and development	12,294	31,670	29,
Legal fees	33,597	3,366	87,
	452,544	420,838	1,556,
LOSS FROM OPERATIONS	(206,626)	(191,100)	(369,
OTHER INCOME (EXPENSE)			
Interest expense	(17,312)	(19,857)	(55,
Miscellaneous	6,221	2,116	5,
LOSS BEFORE INCOME TAXES	(217,717)	(208,841)	(419,
INCOME TAXES	-	-	2,

NET LOSS	$ (217,717)	$ (208,841)	$ (422,
NET LOSS PER SHARE - BASIC AND DILUTED	$ (0.02)	$ (0.02)	$ (0
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED	12,216,068	12,216,068	12,216,

See notes to condensed consolidated financial statements.

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SCANNER TECHNOLOGIES CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (unaudited)	Decem 2 (au
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 960,950	$
Accounts receivable, less allowance of $18,000	285,098	
Inventories, less allowances of $236,000 and $152,000	1,212,286	
Prepaid expenses	28,462	
TOTAL CURRENT ASSETS	2,486,796	
PROPERTY AND EQUIPMENT, net	18,222	
PATENT RIGHTS, net	113,210	
OTHER	7,199	
	$ 2,625,427	$
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Bank line of credit	$ -	$
Accounts payable	130,773	
Accrued expenses	99,566	
TOTAL CURRENT LIABILITIES	230,339	
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 shares issued and outstanding	6,436,116	
Warrants	728,697	
Stock options	86,221	
Deferred financing costs, net	-	
Note receivable for common stock	(153,900)	

Accumulated deficit	(4,702,046)	
	2,395,088	
	$ 2,625,427	$

See notes to condensed consolidated financial statements.

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

	Nine Months Ended September	
	2006	2005
OPERATING ACTIVITIES		
Net loss	$ (422,181)	$ (1,5
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Depreciation	11,782	
Amortization of patent rights	46,313	
Stock option and warrant compensation expense	62,852	
Amortization of deferred financing costs	51,934	
Changes in operating assets and liabilities:		
Accounts receivable	45,987	1,3
Inventories	407,741	1
Prepaid expenses and other	712	
Accounts payable	23,130	(3
Accrued expenses	54,389	(
Net cash provided (used) by operating activities	282,659	(2
INVESTING ACTIVITY		
Purchases of property and equipment	(241)	
FINANCING ACTIVITIES		
Payments on bank line of credit	(490,000)	
Proceeds from the exercise of stock options and warrants	-	3
Net cash provided (used) by financing activities	(490,000)	3
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(207,582)	1
CASH AND CASH EQUIVALENTS		
Beginning of period	1,168,532	1,4
End of period	$ 960,950	$ 1,6
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for:		
Interest	$ 3,583	$
Income taxes	2,800	

Noncash financing activities:		
Warrants exercised and expired	1,565	2
Stock options exercised	-	
Warrants issued in connection with line of credit for deferred financing costs	-	

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, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2005 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 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 may 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 inventory allowance and 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.

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 undiscounted 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. Prior to January 1, 2006, the Company accounted for its stock-based employee compensation plan in accordance with the provisions of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," whereby the difference between the exercise price and the fair value on the date of grant was recognized as compensation expense. Under the intrinsic value method of accounting, no compensation expense was recognized in the Company's Consolidated Statement of Operations when the exercise price of the Company's employee/director stock option and warrant grants equaled or exceeded the market price of the underlying common stock on the date of grant and the measurement date of the option or warrant grant was certain. The measurement date was certain when the date of grant was fixed and determinable. Compensation cost for employee/director stock options and warrants was measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the amount that the employee/director was required to pay for the stock. Stock-based employee compensation expense of $0 and $33,000 was recognized in the three and nine month periods ended September 30, 2005, respectively, as the vesting date on certain employee stock options granted in 2004 was accelerated in the first quarter of 2005 and the market price of the Company's stock at that time exceeded the exercise price of the stock options. Options and warrants issued to non-employee/non-directors were accounted for as required by Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation."

Compensation expense for options granted to non-employee/non directors was $29,103 in the three and nine month periods ended September 30, 2005. In addition, the pro forma disclosures required by SFAS No. 123 for companies accounting for stock-based compensation plans in accordance with APB No. 25 have been included in the consolidated financial statements in prior periods.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, "Share-Based Payment (as amended)," using the modified prospective application method and the interpretations in SEC Staff Accounting Bulletin No. 107, "Share-Based Payment." Among other items, SFAS No. 123R eliminates the use of APB No. 25 and the intrinsic value method of accounting for stock-based compensation, and requires

companies to recognize the cost of employee/director services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

Under the modified prospective application method, awards that are granted or modified after the date of adoption of SFAS No. 123R are measured and accounted for in accordance with SFAS No. 123R. Compensation cost for awards granted prior to, but not vested, as of the date SFAS No. 123R was adopted is based on the grant date attributes similar to those originally used to value those awards for the pro forma purposes under SFAS No. 123. The unaudited Condensed Consolidated Statement of Operations for the three and nine months ended September 30, 2006, reflects share-based compensation expense of $14,805 ($0.00 per basic and diluted share) and $62,852 ($0.01 per basic and diluted share), respectively. At September 30, 2006, unamortized share-based compensation expense related to options currently outstanding of approximately $42,500 will be expensed over the next four quarters.

Results for the three and nine months ended September 30, 2005 have not been restated. If the Company recognized warrant and stock option compensation based on fair value at date of grant, consistent with the methods prescribed in SFAS No. 123, the net loss and per share data for the three and nine months ended September 30, 2005 would change to the pro forma amounts below:

	Periods Ended September 30, 2005	
	Three Months	Nine Months
Net loss:		
As reported	$(208,841)	$(1,532,959)
Warrant and stock option amortization cost	(286,683)	(431,972)
Pro forma	$(495,524)	$(1,964,931)
Net loss per share - basic and diluted:		
As reported	$(.02)	$(.13)
Warrant and stock option amortization cost	(.02)	(.03)
Pro forma	$(.04)	$(.16)

The fair value of options and warrants granted in 2006 and 2005 was estimated at grant date using the Black-Scholes-Merton option pricing model with the following weighted average assumptions:

	2006	2005
Risk-free interest rate	4.93%	4.17%
Dividend yield	0%	0%
Volatility factor of expected market price of common stock	139%	176%
Weighted average expected life	2.5 years	3.0 years

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.

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 Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted-average common shares outstanding for the reported period. Diluted net 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. All warrants and options were antidulitive in the three and nine month periods ended September 30, 2006 and 2005.

Options and warrants to purchase 6,361,182 and 5,275,749 shares of common stock with a weighted average exercise price of $1.59 and $1.86 were excluded from the diluted computation for the three months ended September 30, 2006 and 2005, respectively, because they were antidulitive. Options and warrants to purchase 6,416,068 and 5,327,982 shares of common stock with a weighted average exercise price of $1.59 and $1.90 were excluded from the diluted computation for the nine months ended September 30, 2006 and 2005, 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 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.

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. Pursuant to the settlement agreement, ICOS made a one-time payment of $400,000 to the Company, in 2003 to settle all issues with regard to these one-light source inspection systems. The U.S. District Court for the Southern District of

New York 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. 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 District Court 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. The judge has not issued a decision on the case as of October 31, 2006. The Company intends to continue to vigorously enforce its patent rights and expects to incur significant additional expenses to pursue its claims. The Company believes that any unfavorable decision will not have a material adverse effect on its consolidated financial statements. Some of the proceeds received or to be received by Scanner in connection with the foregoing lawsuit or subsequent litigation with respect to patent litigation have been or will be distributed to its President and Senior Vice President in accordance with agreements noted previously.

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 in 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 it 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.

In September 2006, the Company filed a lawsuit in the United States District Court, Eastern District of Texas against nVidia Corporation claiming willful and deliberate infringement of U.S. Patents numbered 7,079,678 and 7,085,411 which disclose methods of three-dimensional inspection that allow ball grid array ("BGA") devices to be manufactured more precisely and efficiently. The complaint alleges that nVidia has sold and/or is presently selling throughout the United States infringing BGA devices that are covered by one or more claims of the Company's Patents. The complaint also alleges that nVidia has induced others to infringe. These BGA devices are a component in graphics cards, motherboards, computers, video game consoles, cell phones and handheld devices that are sold in the United States. In addition to requesting preliminary and permanent injunctions, the complaint asks the court to award the Company all damages it is entitled to recover, including reasonable royalties on infringing products, treble damages and attorneys' fees

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 not guarantees of future performance. Our future results and shareholder value may differ materially from those expressed in these forward-looking statements. We caution you not to put undue reliance on any forward-looking statements included in this document.

GENERAL

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

During recent years, the Company's operations were adversely affected by a lack of demand in the semiconductor marketplace, which caused many of the Company's potential customers to cease or defer purchases of capital equipment such as the inspection equipment offered by the Company. According to information provided by Semiconductor Equipment and Materials International ("SEMI"), a trade association of semiconductor equipment and material manufacturers, sales of semiconductor equipment for 2005 totaled $32.88 billion, a decline of approximately 11.3% from sales levels in 2004. SEMI expects the market for semiconductor equipment to recover in 2006 and to increase by double-digits in 2007 and 2008, to reach approximately $46.63 billion in 2008. The Company believes that operations in 2006 and 2005 were 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 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 ease of use and technological advancement. 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 our proprietary rights and enter into appropriate licenses.

During the nine months ended September 30, 2006, the Company's working capital position decreased primarily due to the net effect of the operating loss. The Company believes that its working capital at September 30, 2006 is adequate for at least the next twelve months of operations and does not currently anticipate a need for additional financing.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of financial condition and results of operations is based upon the condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates, on an on-going basis, its estimates and judgments, including those related to bad debts, excess 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 deferred 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.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment - an amendment of Financial Accounting Standards Board Statement No. 123," using the modified, prospective application method. Among other items, SFAS No. 123R eliminated the use of the intrinsic value method of accounting for stock-based compensation, which was previously used by the Company, and requires companies to recognize the cost of employee/director services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. See Note 1 to the unaudited condensed consolidated financial statements for additional information.

The Company estimates the fair value of warrants at the grant date using the Black-Scholes-Merton 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.

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RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2005

Sales for the three months ended September 30, 2006, were $572,784 compared to $355,280 for the three months ended September 30, 2005. The sales increase in 2006 relates primarily to increased sales of the Company's VisionFlex robotic inspection systems.

Cost of goods sold increased by $201,324 to $326,866 in the three months ended September 30, 2006, from $125,542 in 2005. Cost of goods sold as a percentage of sales increased by 21.8% to 57.1% in 2006 compared to 35.3% in 2005. In 2006, material costs increased 25.1% as a percent of sales because of a change in the sales mix. This increase was reduced by a decrease in manufacturing costs as a percent of sales primarily because of the large increase in sales, which caused fixed manufacturing costs to be spread over a larger base.

Selling, general and administrative expenses increased by $20,851 to $406,653 for the three months ended September 30, 2006, compared to $385,802 in the same quarter of 2005. The increase in expenses related primarily to increases of salaries and related expenses of approximately $72,000 related primarily to additional personnel and to personnel whose salaries were included in research and development expenses in the prior year, offset by a decrease in stock based compensation expense of approximately $14,000 and by a decrease in expenses related to the Singapore office which was closed during the first quarter of 2006 of approximately $40,000.

Research and development expenses were $12,294 in the three months ended September 30, 2006 compared to $31,670 for the three months ended September 30, 2005. The research and development activities related to the Company's development and improvement of its own line of robotic inspection systems.

The decrease in expenses was related primarily to reduced personnel costs. As noted above, certain salaries and related costs that were previously included in research and development expenses are now included in selling, general and administrative expenses as the responsibilities of certain employees were changed.

Legal fees increased by $30,231 to $33,597 in the three months ended September 30, 2006, from $3,366 in the same quarter of 2005. A significant portion of the legal fees in both periods related to the patent infringement claims brought by the Company against a competitor and others.

Other expense was $11,091 in the three months ended September 30, 2006, compared to $17,741 in the same quarter of 2005. Interest expense was approximately $3,000 lower in the third quarter of 2006 than it was in the third quarter of 2005.

The Company recognized no income tax benefit to offset the loss before income taxes in the three months ended September 30, 2006 and 2005, as no tax benefit was available to the Company.

The net loss for the three months ended September 30, 2006 was $217,717, or $.02 per share, compared to a net loss of $208,841, or $.02 per share in the same quarter of 2005. The change was primarily the result of increased operating expenses of $31,706 being partially offset by an increase in gross profit of $16,180 and by a decrease in nonoperating expenses of $6,650.

NINE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2005

Sales for the nine months ended September 30, 2006, were $2,144,521 compared to $1,310,618 for the nine months ended September 30, 2005. The sales increase in 2006 relates primarily to increased sales of the Company's VisionFlex robotic inspection systems.

Cost of goods sold increased by $365,900 to $957,708 in the nine months ended September 30, 2006, from $591,808 in 2005. Cost of goods sold as a percentage of sales decreased by 0.5% to 44.7% in 2006 compared to 45.2% in 2005. In 2006, material costs increased 10.3% as a percent of sales because of a change in the sales mix. This increase was offset by a decrease in manufacturing costs as a percent of sales primarily because of the large increase in sales, which caused fixed manufacturing costs to be spread over a larger base.

Selling, general and administrative expenses decreased by $39,312 to $1,439,946 for the nine months ended September 30, 2006, compared to $1,479,258 in the same period of 2005. The decrease in expenses related primarily to decreases in expenses related to the Singapore office which was closed during the first quarter of 2006 of approximately $144,000, a decrease in professional fees of approximately $65,000 and decreases in marketing related expenses of approximately $74,000 consisting primarily of trade show and travel expenses, offset by increases of salaries and related expenses of approximately $235,000 related primarily to additional personnel and to personnel whose salaries were included in research and development expenses in the prior year, and by an increase in commission expense of approximately $26,000.

Research and development expenses were $29,551 in the nine months ended

September 30, 2006 compared to $109,430 for the nine months ended September 30, 2005. The research and development activities related to the Company's development and improvement of its own line of robotic inspection systems. The decrease in expenses was related primarily to reduced personnel costs. As noted above, certain salaries and related costs that were previously included in research and development expenses are now included in selling, general and administrative expenses as the responsibilities of certain employees were changed.

Legal fees decreased by $546,114 to $87,064 in the nine months ended September 30, 2006, from $633,178 in the same period of 2005. A significant portion of the legal fees in 2005 related to the patent infringement claims brought by the Company against a competitor, which claims went to trial in March 2005.

Other expense was $49,633 in the nine months ended September 30, 2006, compared to $28,003 in the same period of 2005. Interest expense was approximately $21,000 higher in the first nine months of 2006 than it was in the first nine months of 2005. 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 nine months ended September 30, 2006 and 2005, as no tax benefit was available to the Company. The taxes provided in both periods represented minimum state taxes.

The net loss for the nine months ended September 30, 2006 was $422,181, or $.03 per share, compared to a net loss of $1,532,959, or $.13 per share in the same period of 2005. The change was primarily the result of increased gross profit of $468,003 and decreased operating expenses of $665,305 being partially offset by increased nonoperating expenses of $21,630.

LIQUIDITY AND CAPITAL RESOURCES (FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006)

The Company has a $500,000 bank line of credit with an interest rate at prime (8.25% at September 30, 2006) through October 1, 2006. The Company provided the bank with a security interest in its general business assets and the line is guaranteed by four stockholders. The Company had no outstanding indebtedness under the line at September 30, 2006. The Company is currently negotiating a new bank line of credit.

The Company believes that its existing working capital will be adequate to satisfy projected operating and capital requirements for the next twelve months.

Net cash provided by operating activities for the nine months ended September 30, 2006 totaled $282,659. Positive operating cashflows resulted primarily from the net loss of $422,181 for the period being more than offset by net non-cash adjustments of $172,881 relating to stock option and warrant compensation expense and depreciation and amortization and by net changes in operating assets and liabilities of $531,959 relating primarily to decreases in inventories and receivables and increases in accounts payable and accrued expenses.

Net cash used by investing activities for the nine months ended September 30, 2006 totaled $241. The funds were used to purchase property and equipment.

Net cash used by financing activities for the nine months ended September 30, 2006 totaled $490,000. The amount relates to payments made on the bank line of credit.

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, except as set forth in the final paragraph of this Item 3, 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, 2006, we did not maintain effective internal control over financial reporting based on the criteria proposed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management believes that the control deficiency discussed above presents only a small and manageable risk of errors or misstatements in the financial statements and that the cost of remediating this control deficiency exceeds the benefits that would be obtained by such remediation. Management has therefore elected not to hire the additional personnel that would be required to remediate the control deficiency.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

On September 18, 2006, the Company filed a lawsuit in the United States District Court, Eastern District of Texas against nVidia Corporation, claiming willful and deliberate infringement of U.S. Patents numbered 7,079,678 and 7,085,411 which disclose methods of three-dimensional inspection that allow ball grid array ("BGA") devices to be manufactured more precisely and efficiently. The complaint alleges that nVidia has sold and/or is presently selling throughout the United States infringing BGA devices that are covered by one or more claims of the Company's Patents. The complaint also alleges that nVidia has induced others to infringe. These BGA devices are a component in graphics cards, motherboards, computers, video game consoles, cell phones and handheld devices that are sold in the United States. In addition to requesting preliminary and permanent injunctions, the complaint asks the court to award the Company all damages it is entitled to recover, including reasonable royalties on infringing products, treble damages and attorneys' fees.

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

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index on page following signature page.

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 10, 2006 By: /s/ Elwin M. Beaty

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

EXHIBIT INDEX

SCANNER TECHNOLOGIES CORPORATION

FORM 10-QSB FOR QUARTER ENDED SEPTEMBER 30, 2006

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
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.