

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

**FORM 10-Q**

☒ [X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED  
MARCH 31, 2005

☐ [ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_ TO \_\_\_\_

Commission File Number: 0-12254

**SCIENTIFIC TECHNOLOGIES INCORPORATED**

(Registrant)

Oregon  
(State of incorporation)

77-0170363  
(I.R.S. Employer Identification Number)

6550 Dumbarton Circle, Fremont, California  
(Address of principal executive offices)

94555  
(Zip Code)

(510) 608-3400  
(Registrant's telephone number)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 an accelerated filer (as defined in Rule 12-b2 of the Exchange Act). Yes \_\_\_\_ No X

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common stock outstanding as of April 15, 2005 was 9,768,401 shares.

**SCIENTIFIC TECHNOLOGIES INCORPORATED**  
**Quarter Ended March 31, 2005**

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## PART 1 - FINANCIAL INFORMATION

### ITEM 1 - FINANCIAL STATEMENTS

#### SCIENTIFIC TECHNOLOGIES INCORPORATED

#### CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited, in thousands, except for per share data)

<u>Assets</u>	<u>Mar. 31, 2005</u>	<u>Dec. 31, 2004</u>
Current assets:		
Cash and cash equivalents	\$ 764	\$ 1,107
Short-term investments	2,350	2,350
Accounts receivable, net	8,511	7,746
Inventories	10,153	10,584
Deferred income taxes	3,826	3,826
Receivable from Parent	938	941
Prepaid expenses and other assets	429	394
Total current assets	26,971	26,948
Property and equipment, net	3,396	3,470
Goodwill	216	216
Other intangible assets, net	2,015	2,097
Other non-current assets	641	605
Total assets	<u>\$33,239</u>	<u>\$33,336</u>
<u>Liabilities and Shareholders' Equity</u>		
Current liabilities:		
Bank overdraft	\$ 533	\$ 517
Accounts payable	3,607	3,246
Accrued expenses	1,151	1,711
Accrued compensation	2,292	2,209
Current portion of capital lease with Parent	68	68
Total current liabilities	7,651	7,751
Capital lease with Parent	79	96
Deferred income taxes	118	118
Total liabilities	<u>7,848</u>	<u>7,965</u>
Commitments and contingencies (Note 6)		
Shareholders' equity:		
Common stock, \$.001 par value; 100,000 shares authorized; 9,768 and 9,764 shares issued and outstanding	10	10
Capital in excess of par value	5,992	5,992
Retained earnings	19,389	19,369
Total shareholders' equity	<u>25,391</u>	<u>25,371</u>
Total liabilities and shareholders' equity	<u>\$33,239</u>	<u>\$33,336</u>

The accompanying notes are an integral part of these financial statements.

SCIENTIFIC TECHNOLOGIES INCORPORATED  
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS  
(Unaudited, in thousands, except per share data)

	<u>Three Months Ended</u>	
	<u>Mar. 31, 2005</u>	<u>Mar. 31, 2004</u>
Sales	\$14,298	\$14,634
Cost of sales	<u>8,820</u>	<u>8,566</u>
Gross profit	<u>5,478</u>	<u>6,068</u>
Operating expenses:		
Selling, general and administrative	4,421	4,407
Research and development	1,041	1,017
Amortization of intangible assets	<u>47</u>	<u>165</u>
Total operating expenses	<u>5,509</u>	<u>5,589</u>
Income (loss) from operations	(31)	479
Interest and other income, net	<u>62</u>	<u>44</u>
Income before income taxes	31	523
Provision for income taxes	<u>11</u>	<u>199</u>
Net income	\$ <u>20</u>	\$ <u>324</u>
Net income per share:		
Basic and diluted	\$ <u>0.00</u>	\$ <u>0.03</u>
Shares used to compute net income		
per share:		
Basic	<u>9,768</u>	<u>9,723</u>
Diluted	<u>9,787</u>	<u>9,793</u>

The accompanying notes are an integral part of these financial statements

SCIENTIFIC TECHNOLOGIES INCORPORATED  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
(Unaudited, in thousands)

	For the three months ended	
	<u>Mar. 31, 2005</u>	<u>Mar. 31, 2004</u>
Cash flows from operating activities		
Net income (loss)	\$ 20	\$ 324
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Allowance for doubtful accounts	(57)	52
Depreciation and amortization	441	625
Loss on disposal of property and equipment	13	--
Warranty reserve	15	42
Changes in assets and liabilities		
Accounts receivable	(708)	(726)
Inventories	431	(833)
Receivable from Parent	3	359
Prepaid expense and other assets	(71)	253
Accounts payable	377	1,120
Accrued expenses	<u>(492)</u>	<u>353</u>
Cash flows provided by (used in) operating activities	<u>(28)</u>	<u>1,569</u>
Cash flows from investing activities		
Purchase of property and equipment	<u>(298)</u>	<u>(162)</u>
Cash flows used in investing activities	<u>(298)</u>	<u>(162)</u>
Cash flows from financing activities		
Repayment of capital lease with Parent	(17)	(17)
Issuance of common stock	<u>--</u>	<u>32</u>
Cash flows provided by (used in) financing activities	<u>(17)</u>	<u>15</u>
Change in cash and cash equivalents	(343)	1,422
Cash and cash equivalents at beginning of period	<u>1,107</u>	<u>2,379</u>
Cash and cash equivalents at end of period	\$ <u><u>764</u></u>	\$ <u><u>3,801</u></u>
Supplemental disclosure of cash flow information:		
Cash paid to Parent for income taxes	\$ <u><u>--</u></u>	\$ <u><u>199</u></u>
Supplemental disclosure of non-cash activities:		
Cash paid to Parent for capital lease	\$ <u><u>--</u></u>	\$ <u><u>17</u></u>

The accompanying notes are an integral part of these financial statements.

SCIENTIFIC TECHNOLOGIES INCORPORATED  
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. INTERIM FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements for the three months ended March 31, 2005 and 2004 are unaudited and have been prepared in accordance with generally accepted accounting principles in the United States of America and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, considered necessary to present fairly the financial position, results of operations and cash flows of Scientific Technologies Inc. (the "Company") and its subsidiaries for all periods presented.

To prepare these condensed consolidated financial statements in conformity with generally accepted accounting principles, management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period. Actual results could differ from those estimates.

The results of operations are not necessarily indicative of the results to be expected in the future or for the full fiscal year. It is recommended that these condensed consolidated financial statements be read in conjunction with the Company's audited consolidated financial statements and the notes thereto included in its 2004 Annual Report on Form 10-K.

The Company is an Oregon corporation and is substantially owned by Scientific Technology Incorporated, a California corporation (the "Parent"). See discussion of intercompany activities below.

BASIS OF PRESENTATION

The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions.

RECLASSIFICATIONS

Certain items previously reported in specific financial statement captions have been reclassified to conform to 2005 presentation as follows:

1. Certain sales reserves have been reclassified from accrued expenses to accounts contra accounts receivable.
2. Adjust rate short-term investments ("auction rate securities") have been reclassified from cash and cash equivalents.
3. Bank overdrafts have been reclassified from cash and cash equivalents.

## STOCK-BASED COMPENSATION

The following table sets forth the effect on the Company's net income and net income per share as if the Company had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts).

	Three Months Ended March 31	
	2005	2004
Net income, as reported	\$ 20	\$ 324
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of tax	<u>25</u>	<u>23</u>
Pro forma net loss	\$ <u>(5)</u>	\$ <u>301</u>
Net income (loss) per share - basic and diluted:		
As reported	\$ <u>(0.00)</u>	\$ <u>0.03</u>
Pro forma	\$ <u>(0.00)</u>	\$ <u>0.03</u>

No options to purchase shares of common stock were granted in the three months ended March 31, 2005.

## 2. INVENTORIES

Inventories consist of the following (in thousands):

	Mar. 31, 2005	Dec. 31, 2004
Raw materials	\$ 4,685	\$ 5,705
Subassemblies	1,590	1,518
Work in process	887	616
Finished goods	<u>2,991</u>	<u>2,745</u>
	<u>\$10,153</u>	<u>\$10,584</u>

## 3. NET INCOME PER SHARE

A reconciliation of the numerators and denominators used to compute basic and diluted income per common share is provided below.

	(In thousands)		(Per share)
Three months ended March 31, 2005	Income	Shares	Amount
Basic earnings per share calculation	\$ <u>20</u>	9,768	\$ <u>0.00</u>
Effect of dilutive securities			
Stock options		<u>19</u>	
Diluted earnings per share calculation	\$ <u>20</u>	<u>9,787</u>	\$ <u>0.00</u>
Three months ended March 31, 2004	Income	Shares	Amount
Basic earnings per share calculation	\$ <u>324</u>	9,723	\$ <u>0.03</u>
Effect of dilutive securities			
Stock options		<u>70</u>	
Diluted earnings per share calculation	\$ <u>324</u>	<u>9,793</u>	\$ <u>0.03</u>

## 4. RELATED PARTY TRANSACTIONS

The Company provides certain management services to the Parent such as general management and accounting services. The Company charges the cost of these services to the Parent based upon the amount of time employees spent providing these services. Management services charged by the Company to the Parent for the three months ending March 31, 2005 totaled \$82,000. Management services charged by the Company to the Parent for the three months ending March 31, 2004 totaled \$77,000.

The Company leases essentially all of a 95,000 square foot facility owned by an affiliate of the Parent. The Company also leases another 25,000 square feet in another facility owned by the same affiliate. Overhead costs are allocated primarily on the basis of square footage utilized. Amounts paid to this affiliate was \$257,000 per quarter during the quarters ended March 31, 2005 and 2004.

The Company utilizes a receivable from/payable to Parent account to record activity including cash received, cash disbursed and amounts owed to and receivable from the Parent for allocated charges. The net effect of transactions with the Parent resulted in a receivable from Parent of \$926,000 at March 31, 2005. In addition, the Company is party to a capital equipment lease of \$147,000 at March 31, 2005 under which the Parent is the lessor.

The Company is included in the consolidated tax return of the Parent, but provides for income taxes on a separate return basis pursuant to a tax sharing arrangement, which limits the Company's tax liability to the amount payable to the Parent. Income taxes payable are recorded as a reduction to the receivable from Parent account or as an increase to the payable to Parent account.

The Company owns 50% of Aurora Technology Pte. Ltd ("Aurora"), in a joint venture with Amplus Communication Pte. Ltd. Aurora, a Singapore manufacturing company, manufactures and sells sub-assemblies and other components to the Company and others. The carrying value of our investment in Aurora, which is accounted for under the equity method, amounted to approximately \$571,000 at March 31, 2005 and \$550,000 at December 31, 2004.

## 5. SEGMENT REPORTING AND OTHER INFORMATION

The Company is organized into two business segments: Safety Products Group, whose products include safety light curtains, safety interlocks and relays, safety mats and controllers, safety contact strips, and optical profiling scanners, and installation services, and Automation Products Group, whose products include photoelectric and fiberoptic sensors, control components, power monitoring electronics, defense electronics, industrial control microcomputers, peripherals and software, level and flow sensors, non-contact ultrasonic sensors and controllers, pressure transducers, digital pressure gauges, displacement and velocity transducers and pressure comparators.

Financial information for each product group is as follows: (in thousands)

	Three months ended March 31,	
	2005	2004
<u>Safety Products</u>		
Sales	\$12,373	\$12,356
Group operating profit (loss)	439	805
<u>Automation Products</u>		
Sales	\$ 1,925	\$ 2,278
Group operating profit (loss)	(470)	(326)
	At	
	Mar. 31	Dec. 31
	2005	2004
<u>Total Assets</u>		
Safety Products	\$24,576	\$25,868
Automation Products	<u>8,663</u>	<u>7,468</u>
Total	<u>\$33,239</u>	<u>\$33,336</u>



The Company operates principally in the United States. Sales to foreign customers represented 13% of total sales in the three months ended March 31, 2005, compared to 12% in the comparable period in 2004.

## 6. COMMITMENTS AND CONTINGENCIES

The Company offers warranties on certain products and records a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and the Company's estimate of the level of future costs. A reconciliation of the changes in the Company's warranty liability follows (in thousands):

	Three months ended March	
	<u>2005</u>	<u>2004</u>
Warranty accrual at beginning of period	\$285	\$221
Accruals for warranties issued	15	42
Expenses incurred	<u>(65)</u>	<u>(42)</u>
Warranty accrual at end of period	<u>\$235</u>	<u>\$221</u>

As permitted under Oregon law the Company has agreements whereby the Company indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving at the Company's request in such capacity. The indemnification term is for the period that the officer or director is serving in such capacity or is subject to any possible claim or action by reason of the fact that the Indemnitee was serving in that capacity. The maximum potential amount of future payments by the Company could be unlimited; however the Company has a director and officer insurance policy that limits the Company's exposure and enables the Company to recover a portion of any future amounts paid. As a result of the insurance policy coverage, the Company believes that the estimated fair value of these agreements is minimal.

## 7. RECENT ACCOUNTING PRONOUNCEMENTS

The FASB has issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R). Under the provisions of SFAS 123R, companies are required to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exception). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. On April 14, 2005, the Securities and Exchange Commission (SEC) approved a delay to the effective date of SFAS 123R. Under the new SEC rule, SFAS 123R is effective for annual periods that begin after June 15, 2005. SFAS 123R applies to all awards granted, modified, repurchased or cancelled by us after December 31, 2005 and to unvested options at the date of adoption. We do not expect the adoption of SFAS 123R to have a material impact on our results of operations, financial position or liquidity.

The FASB has issued Statement of Financial Accounting Standards No. 151, "Inventory Costs – an amendment of ARB No. 43, Chapter 4" (SFAS 151). The provisions of SFAS 151 are intended to eliminate narrow differences between the existing accounting standards of the FASB and the International Accounting Standards Board (IASB) related to inventory costs, in particular, the treatment of abnormal idle facility expense, freight, handling costs and spoilage. SFAS 151 requires that these costs be recognized as current period charges regardless of the extent to which they are considered abnormal. The provisions of SFAS 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on our results of operations, financial position or liquidity.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This interim report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Act of 1934. Such forward-looking statements include, but are not limited to, statements regarding the sufficiency of existing cash and future cash flows to satisfy future operating and capital requirements. The Company's actual results could differ materially from those projected in such forward-looking statements as a result of many factors, including, without limitation, those set forth under this section, the section entitled "Business Factors" below and elsewhere in this report on Form 10-Q.

### Results of Operations

(Amounts in thousands, except percentages)

Scientific Technologies Incorporated (the "Company") is located in Fremont, California and designs, manufactures and distributes electrical and electronic industrial controls such as machine safety and automation sensing products. Our product lines include safety light curtains, safety interlock switches, safety relays, profiling scanners, factory automation sensors, controls, fiber optics, power monitoring, safety mats, safety contact strips, non-contact ultrasonic sensors and controllers, pressure transducers and other electronic equipment supplied to industrial automation, commercial and defense customers.

Sales for the three months ended March 31, 2005 declined 2% to \$14,298 from \$14,634 in the first quarter of 2004 primarily due to decreased sales by the Automation Products Group ("APG") that were partially offset by increased sales by the Safety Products Group ("SPG"). Sales by the APG decreased 16% to \$1,925 for the first quarter of 2005 from \$2,278 for the comparable period in 2004 due to decreased sales of level and pressure products which were partially offset by increased sales of ultrasonic products.

Gross profit as a percentage of sales, or gross margin, declined to 38% for the first quarter of 2005 from 42% in the comparable quarter of 2004. Gross margin at SPG declined during the first quarter of 2005 primarily due to lower sales by our Machine Services Division and a shift in the mix of products sold by SPG to include a higher percentage of products we distribute for other manufacturers, which reduced the overhead absorbed at our Fremont, California factory. Gross margin at APG declined primarily due to decreased sales. Gross profit declined \$590 to \$5,478 in the three months ended March 31, 2005 from \$6,068 during the same period of 2004.

Selling, general and administrative expenses for the three months ended March 31, 2005 increased to \$4,421 from \$4,407 in the same period of 2004. This increase was primarily the result of higher commission and personnel expenses that were partially offset by lower meeting expense and literature freight. As a percentage of sales for the three months ended March 31, 2005, selling, general and administrative expenses were 31% compared to 30% for the same period in 2004.

Research and development expenses increased 2% to \$1,041 for the three months ended March 31, 2005 from \$1,017 for the comparable period in 2004. This increase was primarily the result of higher personnel, consulting and outside contractor expenses that were partially offset by reduced material expenses. As a percentage of sales, research and development expenses were 7% in the first quarter of 2005 and the first quarter of 2004.

Our effective income tax rate for the three months ended March 31, 2005 and 2004 was 38%.

### Contractual Obligations

The Company has no raw material contracts exceeding one year in duration. In addition, the Company leases production, warehouse and corporate office space as well as certain equipment under non-cancelable operating lease agreements. All building leases have renewal options and all include cost of living adjustments. The following table summarizes the estimated annual obligations.

Payments due by period (in thousands)					
		Less than			
Contractual Obligations	Total	1 year	1 - 3 years	4 - 5 years	Over 5 years
Capital Lease Obligations	\$ 147	\$ 51	\$ 96	\$ -	\$ -
Operating Leases	\$1,666	\$794	\$ 431	\$378	\$63
Total	\$1,813	\$845	\$527	\$378	\$63

### Liquidity and Capital Resources (Amounts in thousands)

We had cash and cash equivalents at March 31, 2005 and December 31, 2004 of approximately \$764 and \$1,107 respectively. Our short-term investments were \$2,350 and \$2,350 at March 31, 2005 and December 31, 2004, respectively.

For the three months ended March 31, 2005 cash used in operations was \$28 while cash provided by operations was \$1,569 in the same period in 2004. Net income was \$304 lower in the three months ended March 31, 2005, compared to the same period in 2004. In addition, we experienced an inventory reduction of \$431 during the first quarter of 2005 compared to an increase of \$833 in the first quarter of 2004. Increased accounts payable of \$377 was offset by a \$492 reduction of accrued expenses in the first quarter of 2005, while accounts payable and accrued expenses increased \$1,120 and \$353 respectively during the comparable 2004 period.

Available bank borrowings were \$6,000, all of which were unused at March 31, 2005. The Company's revolving line of credit was renewed in 2004 through June 30, 2005. We are in compliance with all loan covenants under this facility.

We believe that our existing cash and cash equivalent balances, short-term investments and anticipated cash flows from operations will be sufficient to meet our operating and capital requirements for at least the next 12 months. However, revenues could decline below our expectations resulting in insufficient cash flow from operations or we may require additional financing to fund new product development, strategic investments in new markets, and strategic acquisitions. As a result, we could be required, or could elect, to raise additional funds during that period and we may need to raise additional capital in the future. Additional capital may not be available at all, or may only be available on terms unfavorable to us. With the exception of operating leases, we have not entered into any off-balance sheet financing arrangements, we have not established any variable interest entities, we do not have any unconditional purchase obligations, nor do we have non-cancelable commitments for capital expenditures.

### Critical Accounting Policies

There were no material changes in any of our critical accounting estimates or judgments during the first quarter of 2005.

### Revenue Recognition

The Company has product and services sales. Revenue from product sales to OEM's and distributors is recognized upon shipment when shipped FOB our plant or upon receipt by the customer when shipped FOB destination, if a signed purchase order exists, the price is fixed or determinable, collection of the resulting receivable is considered reasonably assured and product returns can be reasonably estimated. Subsequent to the sale of the products, we have no obligation to provide any modification or customization, upgrades, enhancements or post contract customer support.

Our agreements with our distributors include certain product rotation, price protection, and warranty rights. All distributors have the right to rotate slow moving products four times each fiscal year. The maximum dollar value of inventory eligible for rotation is equal to eight percent of our products purchased by the distributor during the previous fiscal year. In order to take advantage of their product rotation rights, the distributors must order and take delivery of additional products equal to at least the dollar value of the products that they want to rotate. Reserves for the right of return and restocking are established based on the requirements of Statement of Financial Accounting Standards ("SFAS") 48, *Revenue Recognition when Right of Return Exists* because we have visibility into our distributor's inventory and have sufficient history to estimate returns. We record a reserve based on historical trend. Stock rotation and returns estimates are recorded as reductions of sales and cost of sales.

Each distributor is also allowed certain rebates and price protection rights. If and when we reduce or plan to reduce the price of any of our products and the distributor is holding any of the affected products in inventory, we will credit the distributor the difference in price when it places its next order with us. We record an allowance for price protection reducing our net sales and increasing our accrued liabilities based on specific terms and historical trend. Price protection estimates are recorded as reductions of sales and warranty estimates are recorded against cost of sales.

The Company provides a warranty to its customers for a period of 12 to 18 months. Upon revenue recognition, we provide for the estimated costs that may be incurred for product warranties. We estimate sales returns and warranty costs based on historical experience and the best information we have at the time we report our financial statements. Actual results could differ from these estimates. Warranty expenses are recorded against cost of sales.

Installation and engineering service revenue is recognized when services are rendered, or when an identifiable portion of the contract is completed, no significant post-delivery obligations exist and collection of the resulting receivable is considered reasonably assured

### **Inventory Valuation**

We value our inventory at the lower of the actual cost to purchase and/or manufacture the inventory or the current estimated market value of the inventory. We regularly review inventory quantities on hand and may write-down excess and obsolete inventory based primarily on our historical consumption and our estimated forecast of product demand and production requirements. Demand for our products can fluctuate significantly. In addition, our industry is characterized by technological change, new product development, and product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Our estimates of future product demand may differ from actual results, in which case we may adjust the provision required for excess and obsolete inventory. In the future, if our inventory is determined to be overvalued, we would be required to recognize such costs in our cost of goods sold at the time of such determination. Likewise, if our inventory is determined to be undervalued, we may have over-reported our costs of goods sold in previous periods and would be required to recognize such

additional operating income at the time of sale. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

### **Allowance for Doubtful Accounts**

We maintain allowances for estimated losses from the inability of our customers to make required payments. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we had in the past. A significant change in the liquidity or financial position of any one of our customers could have an adverse impact on the collectability of our accounts receivable and our future operating results. An account is written off or written down to its net realizable value, when we determine that and it is in bankruptcy, liquidation or cannot be located or the cost of collection exceeds the realizable value of the account.

### **Valuation of Goodwill and Other Long-Lived Assets**

We review the recoverability of our long-lived assets, such as fixed assets, goodwill, intangible assets and investments, when events or changes in circumstances indicate that the carrying amount of the asset or asset group may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between the estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-termed assets. In addition, we review the valuation of goodwill at least annually. Based on our review of the cash flows relative to the acquisition of MSD, Lundahl Instruments and PSI-Tronix, we believe the goodwill and other long-lived assets are not stated at more than their fair value.

### **Business Factors**

Because of the variety of factors and uncertainties affecting our operating results, past financial performance and historical trends may not be a reliable indicator of future performance. These factors, as well as other factors affecting our operating performance, may result in significant volatility in our common stock price. Among the factors which could affect our future business, financial condition or operating results are the following:

#### **Our operating results may fluctuate.**

We have experienced fluctuations in annual and quarterly operating results and anticipate that these fluctuations will continue, which may cause the trading price of our common stock to decline. These fluctuations are caused by a number of factors described below and elsewhere in this section, including:

- the level and timing of customer orders;
- fluctuations in demand for complementary third party products with which our products are sold;

- changes in the mix of our products sold;
- timing of operating expenditures;
- timing of new product introductions;
- fluctuations in prices charged by our suppliers;
- seasonality of sales within our core markets;
- volatility in supply and demand affecting industrial control products generally, such as increases in the supply of competitive products and declines in selling prices; and
- economic conditions in the U.S. and abroad.

Our sales are dependent on independent distributors.

A majority of our sales are through third party distributors, system integrators and original equipment manufacturers. These resellers are not required to offer our products exclusively. We cannot assure that a reseller will continue to offer our products. In addition many of our resellers are privately owned firms which may not be well capitalized. If our ability to sell products through these third parties is impaired, our results of operations would likely suffer.

The industrial manufacturing equipment industry, and the markets of customers that use our products, are highly cyclical.

Our continued success depends in large part on the vibrancy of various industries that use our products. We operate in a cyclical industry that has been subject to significant economic downturns often in connection with, or in anticipation of, declines in general economic conditions. These types of downturns have occurred numerous times in the past, most recently in 2001. During such downturns, we experience reduced product demand, erosion of average selling prices and gross margins. Our business could be harmed in the future by additional cyclical downturns in the industrial manufacturing equipment industry or by slower growth by any of the markets served by our customers' products.

The markets in which we participate are intensely competitive.

Our core markets are intensely competitive. Many competitors have substantially greater name recognition and technical, marketing, distribution and financial resources than we have, and we may not be able to compete successfully with them in the future. Competitive pressures could also reduce market acceptance of our products and result in price reductions, decreases in revenues and increases in expenses. Competition in our core markets is based primarily on performance, quality, price and availability. If we do not compete successfully on these and other factors, our business, financial condition and operating results would be harmed.

Average sales prices of our products generally decline over time.

Average sales prices in the industrial manufacturing equipment market tend to decline over time as a result of competition, technological advances, manufacturing efficiencies and other factors. Declines in average sales prices for our products, if not offset by reductions in the cost of producing those products or by sales of new products with higher gross margins, would decrease our gross margins, could cause a negative adjustment to the value of our inventories and could materially and adversely affect our operating results.

We do not have long term contracts with our customers.

Our customers generally purchase our products on a purchase-order basis and do not have long-term contracts with us. As a result, we cannot be certain that our customers will continue to order products from us at the same or higher levels as in the past. The loss of one or more significant

customers, or a decline in overall orders from our customers, would harm our business and operating results.

In addition, the lack of long-term sales contracts and significant order backlog makes it difficult for us to forecast future sales with certainty or to accurately forecast component and product requirements. These factors expose us to a number of risks:

- if we overestimate our requirements we may be obligated to purchase more components or third-party products than are required;
- if we underestimate our requirements, our suppliers may have an inadequate product or product component inventory, which could interrupt manufacturing of our products and result in delays in shipments and revenues;
- we may also experience shortages of product components from time to time, which also could delay the manufacturing of our products; and
- over or under production can lead to higher expenses, lower than anticipated revenues, and reduced margins.

We may be unable to increase our international sales.

We are attempting to develop, integrate and expand our international distribution networks in an effort to increase international sales of our products. We may not be successful in developing or expanding our international distribution network or in marketing and selling products in foreign markets. If the revenues generated by our international sales are not adequate to recover the expense of establishing, expanding, and maintaining an international distribution network, our business, financial condition, and results of operations could be materially adversely affected. If international sales become a more significant component of net sales, our business would be more vulnerable to risks inherent in doing business internationally, including:

- difficulties in managing foreign resellers;
- longer payment cycles and problems in collecting accounts receivable;
- the effects of seasonal customer demand;
- changes in regulatory requirements;
- difficulties in meeting the requirements of different international product regulations;
- risks relating to intellectual property rights;
- increased expenses due to efforts to localize our product offerings;
- export restrictions, tariffs and other trade barriers;
- fluctuations in currency exchange rates; and
- potentially adverse tax consequences and political instability.

The existence or occurrence of any one of these factors could have a material adverse effect on our business, financial condition, and results of operations.

We depend upon suppliers and outsourced manufacturers, several of which are located outside of the U.S. Disruption of our access to these supplies and services, or problems with the quality of supplies or services, could prevent us from filling customer orders and harm our business.

The principal components of our products are purchased from outside vendors. We generally buy components under purchase orders, do not have long-term agreements with our suppliers, and we

generally do not maintain large inventories of components. Any termination of, or significant disruption of, our relationships with the suppliers of our product components may prevent us from filling customer orders in a timely manner which could result in customer dissatisfaction and lost sales.

For some of our products, including private label products, we rely on third party manufacturers for subassembly of products and for final assembly, quality assurance, and testing of some of our products. These outsourcing arrangements and any future outsourcing arrangements involve numerous risks, including reduced control over product quality, delivery schedules, manufacturing yields, and costs.

For certain products that we private label, we are dependent on third party suppliers.

We rely on third party suppliers for several finished products that we sell under the STI brand name. If we do not manage the relationship with the supplier properly or if the supplier stops providing us with these products, we may not be able to find replacement products in a timely manner or at all. This may prevent us from fulfilling customer orders and have an adverse impact on our financial results.

Our business could suffer if we do not respond to technological change and new product development demands of our customers.

The market for our products is characterized by changing technology, evolving industry standards, changes in customer needs and new product introductions. Our future success will depend on our ability to respond to emerging industry standards, enhance current products, develop new products, and achieve market acceptance of those products, all on a timely and cost-effective basis. The introduction of new products also requires that we manage the transition from older products in order to minimize disruption of customer orders, avoid excessive levels of older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demands.

Product errors or defects could result in product recalls and claims against us.

We manufacture machine safety and automation sensing products, many of which are used in manufacturing, construction and other industrial environments. Errors or defects in our products could contribute to injuries, and could subject us to product liability claims. Any such claims would divert management's attention from our core business, would be expensive to defend, and could result in sizeable damage awards against us. Our existing product liability insurance coverage may be inadequate to protect us from any liabilities we might incur, and we may not be able to maintain this insurance or do so at a reasonable cost or on reasonable terms. Any product liability claim brought against us, with or without merit, could also increase our product liability insurance rates or prevent us from securing any coverage in the future. If a product liability claim or series of claims is brought against us for uninsured liabilities or is in excess of our insurance coverage, our business would suffer. In addition, such claims may require us to recall some of our products, which could result in significant costs to us.

Fluctuations in currency exchange rates would have an adverse effect on our operating results and financial condition.

While substantially all of our sales are denominated in U.S. dollars, we purchase material for resale denominated in British pounds and Euros, and, in the future, we may transact business in other foreign currencies. Increases in value of the U.S. dollar relative to foreign currencies have the effect of increasing the prices of our products in foreign markets and, as a result, could harm sales of our products in those markets. Conversely, declines in value of the U.S. dollar relative to foreign currencies, as we have recently experienced, has the effect of increasing our operating expenses by increasing the cost of materials we purchase for resale in British pounds and Euros.



As a result, future volatility in currency exchange rates would have an adverse effect on our operating results.

An adverse evaluation of our internal controls over financial reporting could damage public perception of our financial statements and cause our stock price to decline.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404), beginning with our Annual Report on Form 10-K for the fiscal year ending December 31, 2006, we will be required to furnish a report by our management on our internal control over financial reporting. The report must contain a statement as to whether or not our internal controls over financial reporting are effective. In addition, our independent auditors must attest to and report on management's assessment of such internal controls.

We have begun to expend significant resources to perform the system and process documentation and evaluation needed to comply with Section 404. However, if we and our auditors are unable to adequately test our internal controls, or if during this process we identify one or more significant deficiencies or material weaknesses in our internal controls over financial reporting which we are unable to remedy prior to December 31, 2006, we may be unable to assert that our internal controls over financial reporting are effective or our auditors may be unable to attest that our management's report is fairly stated. In such case, we could lose investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on our stock price.

Our business could suffer if we are unable to protect and enforce our intellectual property rights.

We rely on a combination of patent, trademark, trade secret laws and contractual restrictions to establish and protect proprietary rights in our products and services. There can be no assurance that our patents, trademarks, or contractual arrangements or other steps taken by us to protect our intellectual property will prove sufficient to prevent misappropriation of our technology or defer independent third party development of similar technologies. Moreover, there can be no assurance that the technology licenses granted to us from our parent company will continue to be available. The loss of any of our proprietary technology could require us to obtain technology of lower quality or performance standards or at greater cost, which could materially adversely affect our business, results of operations and financial condition. Also, competitors may develop their own intellectual property or technologies, obtain their own patents, or challenge the validity of, or be able to design around, our patents. The laws of certain foreign countries may not protect our products, services or intellectual property rights to the same extent as do the laws of the United States.

We may initiate claims or litigation against other third parties for infringement of proprietary rights or to establish the validity of proprietary rights. Similarly, our competitors may initiate claims or litigation against us alleging infringement of their proprietary rights or improper use of their intellectual property. Litigation relating to intellectual property to which we may become a party is subject to numerous risks and uncertainties, including the risk of counterclaims or other litigation against us, and we may not be successful in any such litigation.

Our ability to develop and market our products is dependent upon our retention of certain executive officers and other key personnel.

We are greatly dependent on the ability to retain key management and technical personnel, and our future success is highly dependent upon the personal efforts of our management and technical personnel. The loss of services of any one of them could have a material adverse effect on our business, financial condition, and results of operations. Our success will also be dependent in part upon our ability to attract, retain, and motivate highly skilled employees. We may need to offer additional compensation or incentives to attract and retain these and other employees.

#### We may need to raise additional capital

It is possible we may need to raise additional funds in the future, and this additional financing may not be available to us in favorable terms, if at all. We may also require additional capital to acquire or invest in complementary businesses or products or obtain the right to use complementary technologies. If we issue additional equity securities to raise funds, the ownership percentage of our existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock. If we issue debt securities to raise funds, we may incur significant interest expense, which would harm our profitability. The issuance of debt securities may also require us to agree to various restrictions typical of debt securities, including limitations on further borrowing and our right to pay dividends.

#### Our operations have been and may continue to be negatively impacted by uncertain global economic and political conditions

Our business may suffer as a result of general economic and political conditions in the U.S. and abroad. In 2003 and 2002, there was a rapid and severe downturn in the U.S. market and global economy. This downturn has been compounded by recent terrorist activity, such as the attacks in the U.S. on September 11, 2001, and the recent military activity in Afghanistan, Iraq and the Middle East. Additional terrorist acts or acts of war could cause damage or disruption to us or to our suppliers and our customers. Fears of global recession, war, and terrorism may continue to have seriously detrimental effects on the U.S. and global economies. Such conditions could further dampen consumer confidence and cause our customers to slow or cease spending on our products. If these events continue, our operations may be negatively impacted.

#### The seasonality inherent in our business could cause our operating results to fluctuate.

The industrial manufacturing equipment industry in which we compete has historically been subject to seasonality. This is also true with respect to European markets in which we compete where business activity declines due to vacations taken in the summer months. This seasonality, combined with other factors such as the variability in our operating results described above, renders quarter-to-quarter comparisons of our results of operations unreliable as indicia of our overall performance.

#### Our parent company has voting control over us.

Approximately eighty-six percent (86%) of our capital stock is currently held by our parent corporation, Scientific Technology Incorporated, a California corporation. As a result, our parent has control over matters requiring approval by our shareholders, including the election of directors and the approval of mergers or similar transactions, even if other shareholders disagree. This control, along with provisions of Oregon law affecting acquisitions and business combinations, may delay, deter or prevent a third party from acquiring or merging with us and prevent shareholders from realizing a premium price for their shares associated with an acquisition. This voting control and provisions of Oregon law may also have a negative effect on the market price of our common stock.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The market risk inherent in our investments represents the potential loss arising from adverse changes in interest rates. We are exposed to market risk in the area of interest rate changes impacting the fair value of our investment securities. Our policy is to invest primarily in money market accounts and short-term investments held at financial institutions. We do not have any derivative instruments in our investment portfolio. Due to their highly liquid nature, our investments are subject to minimal credit and market risk.

Item 4. CONTROLS AND PROCEDURES.

(a) Based on their evaluation as of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are ineffective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. However, we undertook corrective actions, including the implementation of certain reporting tools and independent internal reviews of key account reconciliations, to ensure that the financial statements and other financial information included in this quarterly report are complete and accurate in all material respects.

(b) In response to the material weaknesses in our internal controls identified by our auditors in connection with the audit of our consolidated financial statements for the year ended December 31, 2004, and in preparation for our compliance with Section 404 of the Sarbanes-Oxley Act of 2002, which will be required as of the end of our fiscal year 2006, we commenced during the first quarter of fiscal 2005 the following corrective actions to remediate the material weaknesses:

- (1) We have implemented additional general ledger close and account analysis procedures including procedures to analyze consolidated fluctuations and reporting. These procedures also include analysis of inventory and accounts receivable aging and valuation.
- (2) We are working with advisors to help establish policies and procedures related to changes and updates in our accounting system; and
- (3) We have begun a process to address our need for additional experienced finance personnel in order to improve our controls over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS.**

On January 19, 2005, we agreed to the terms of a settlement with Paul Davis Automation, Inc. one of our former manufacturer's representatives, relating to a lawsuit filed by Paul Davis Automation in the United States District Court, Eastern Division. In the lawsuit, Paul Davis Automation had alleged unpaid commission fees upon termination of a contract between the parties. Pursuant to the terms of the settlement agreement, on February 14, 2005, we made a cash payment of approximately \$600,000 to Paul Davis Automation, in complete and final settlement of all claims.

Items 2 through 5 are not applicable for this reporting period.

### **Item 6. EXHIBITS.**

The following documents are filed as a part of this Report:

Exhibit 10.4 - Incentive Bonus Plan dated April 29, 2005

Exhibit 24.1 - Power of Attorney is incorporated by reference to the Registrant's Form 10-K for the year ended December 31, 2004, Exhibit 24.1.

Exhibit 31 - Section 302 Certification of Chief Executive and Chief Financial Officers

Exhibit 32 - Section 906 Certification of Chief Executive and Chief Financial Officers

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

### SCIENTIFIC TECHNOLOGIES INCORPORATED

Registrant

Date: May 13, 2005

/s/Joseph J. Lazzara  
Joseph J. Lazzara  
President and Chief Executive  
Officer  
(Principal Executive Officer)

Date: May 13, 2005

/s/ Ralph S. Marimon  
Ralph S. Marimon  
Vice-President and Chief Financial  
Officer  
(Principal Financial Officer)