KEY TECHNOLOGY INC
Form 10-Q
August 08, 2008

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

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# FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the quarterly period ended June 30, 2008

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from ____ to ____

Commission File No. 0-21820

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KEY TECHNOLOGY, INC.
(Exact name of registrant as specified in its charter)

| Oregon | 93-0822509 |
|---|---|
| (State or jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

150 Avery Street
Walla Walla, Washington 99362
(Address of principal executive offices and zip code)

(509) 529-2161
(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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 ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

| Large accelerated filer ¨ | Accelerated filer ý |
| --- | --- |
| Non-accelerated filer ¨<br>(Do not check if a smaller reporting company) | Smaller reporting company ¨ |

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

The number of shares outstanding of the registrant's common stock, no par value, on July 31, 2008 was 5,632,911 shares.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED BALANCE SHEETS
JUNE 30, 2008 AND SEPTEMBER 30, 2007

| | June 30, 2008 | September 30, 2007 |
|---|---|---|
| | (in thousands) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 33,132 | $ 27,880 |
| Trade accounts receivable | 16,118 | 14,020 |
| Inventories: | | |
| Raw materials | 11,425 | 7,104 |
| Work-in-process and sub-assemblies | 7,140 | 6,803 |
| Finished goods | 7,454 | 4,846 |
| Total inventories | 26,019 | 18,753 |
| Deferred income taxes | 2,088 | 2,120 |
| Prepaid expenses and other assets | 1,897 | 1,954 |
| Total current assets | 79,254 | 64,727 |
| Property, plant and equipment, net | 6,203 | 4,671 |
| Deferred income taxes | 14 | - |
| Goodwill, net | 2,524 | 2,524 |
| Intangibles and other assets, net | 2,655 | 3,575 |
| Total | $ 90,650 | $ 75,497 |
| | | |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | $ 7,354 | $ 5,692 |
| Accrued payroll liabilities and commissions | 7,978 | 6,663 |
| Customers' deposits | 11,311 | 7,850 |
| Accrued customer support and warranty costs | 2,138 | 1,946 |
| Customer purchase plans | 1,185 | 651 |
| Income taxes payable | 799 | 181 |
| Other accrued liabilities | 695 | 798 |
| Total current liabilities | 31,460 | 23,781 |
| Long-term deferred rent | 604 | 601 |
| Other long-term liabilities | 150 | - |
| Deferred income taxes | 288 | 722 |
| Shareholders' equity: | | |
| Common stock | 18,980 | 17,105 |
| Retained earnings and other shareholders' equity | 39,168 | 33,288 |
| Total shareholders' equity | 58,148 | 50,393 |

| | | | | |
|---|---|---|---|---|
| Total | $ | 90,650 | $ | 75,497 |

See notes to condensed unaudited consolidated financial statements.

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KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED JUNE 30, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| | (in thousands, except per share data) | |
| Net sales | $ 35,831 | $ 31,019 |
| Cost of sales | 20,795 | 18,546 |
| Gross profit | 15,036 | 12,473 |
| Operating expenses: | | |
| Sales and marketing | 5,552 | 4,462 |
| Research and development | 1,984 | 1,175 |
| General and administrative | 3,083 | 2,365 |
| Amortization of intangibles | 327 | 327 |
| Total operating expenses | 10,946 | 8,329 |
| Gain (loss) on sale of assets | 13 | (17) |
| Earnings from operations | 4,103 | 4,127 |
| Other income | 252 | 327 |
| Earnings before income taxes | 4,355 | 4,454 |
| Income tax expense | 1,392 | 1,515 |
| Net earnings | $ 2,963 | $ 2,939 |
| | | |
| Net earnings per share | | |
| - basic | $ 0.54 | $ 0.56 |
| - diluted | $ 0.53 | $ 0.54 |
| | | |
| Shares used in per share calculations - basic | 5,461 | 5,288 |
| | | |
| Shares used in per share calculations - diluted | 5,574 | 5,408 |

See notes to condensed unaudited consolidated financial statements.

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KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE NINE MONTHS ENDED JUNE 30, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| | (in thousands, except per share data) | |
| Net sales | $ 93,884 | $ 75,793 |
| Cost of sales | 56,083 | 46,258 |
| Gross profit | 37,801 | 29,535 |
| Operating expenses: | | |
| Sales and marketing | 15,726 | 12,573 |
| Research and development | 5,958 | 4,018 |
| General and administrative | 8,532 | 6,233 |
| Amortization of intangibles | 981 | 981 |
| Total operating expenses | 31,197 | 23,805 |
| Gain on sale of assets | 44 | 21 |
| Earnings from operations | 6,648 | 5,751 |
| Gain on sale of investment in joint venture | - | 750 |
| Other income | 1,066 | 859 |
| Earnings before income taxes | 7,714 | 7,360 |
| Income tax expense | 2,468 | 2,247 |
| Net earnings | $ 5,246 | $ 5,113 |
| | | |
| Net earnings per share | | |
| - basic | $ 0.97 | $ 0.97 |
| - diluted | $ 0.95 | $ 0.95 |
| | | |
| Shares used in per share calculations - basic | 5,417 | 5,247 |
| | | |
| Shares used in per share calculations - diluted | 5,533 | 5,363 |

See notes to condensed unaudited consolidated financial statements.

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KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED JUNE 30, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| | (in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings | $ 5,246 | $ 5,113 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Gain on sale of joint venture | - | (750) |
| Gain on sale of assets | (44) | (21) |
| Foreign currency exchange (gain) loss | (390) | (421) |
| Depreciation and amortization | 2,064 | 1,920 |
| Share based payments | 1,142 | 721 |
| Excess tax benefits from share based payments | (749) | (320) |
| Deferred income taxes | (188) | 1,023 |
| Deferred rent | 3 | (42) |
| Bad debt expense | 7 | 26 |
| Changes in assets and liabilities: | | |
| Trade accounts receivable | (1,696) | (2,260) |
| Inventories | (6,479) | (2,182) |
| Prepaid expenses and other current assets | 8 | 304 |
| Income taxes receivable | 74 | 181 |
| Accounts payable | 1,506 | 853 |
| Accrued payroll liabilities and commissions | 1,146 | 1,827 |
| Customers' deposits | 3,238 | 1,625 |
| Accrued customer support and warranty costs | 113 | 523 |
| Income taxes payable | 1,372 | 988 |
| Other accrued liabilities | 376 | 562 |
| Other | (38) | - |
| Cash provided by operating activities | 6,711 | 9,670 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of property | 49 | 49 |
| Purchases of property, plant, and equipment | (2,473) | (384) |
| Sale of investment in joint venture | - | 750 |
| Cash provided by (used in) investing activities | (2,424) | 415 |

(Continued)

See notes to condensed unaudited consolidated financial statements.

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KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED JUNE 30, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| | (in thousands) | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payments on long-term debt | $ - | $ (1) |
| Repurchases of common stock | - | (1,303) |
| Excess tax benefits from share based payments | 749 | 320 |
| Exchange of shares for statutory withholding | (639) | - |
| Proceeds from issuance of common stock | 661 | 1,267 |
| Cash provided by financing activities | 771 | 283 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 194 | 233 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 5,252 | 10,601 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD | 27,880 | 15,246 |
| CASH AND CASH EQUIVALENTS, END OF THE PERIOD | $ 33,132 | $ 25,847 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for interest | $ 2 | $ 10 |
| Cash paid during the period for income taxes | $ 1,194 | $ 55 |
| | | (Concluded) |

See notes to condensed unaudited consolidated financial statements.

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KEY TECHNOLOGY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED JUNE 30, 2008

1. Condensed unaudited consolidated financial statements

Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been omitted from these condensed unaudited consolidated financial statements. These condensed unaudited consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2007. The results of operations for the three- and nine-month periods ended June 30, 2008 are not necessarily indicative of the operating results for the full year.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

In the opinion of management, all adjustments, consisting only of normal recurring accruals, have been made to present fairly the Company's financial position at June 30, 2008 and the results of its operations and its cash flows for the three and nine-month periods ended June 30, 2008 and 2007.

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

2. Stock compensation

During the nine-month period ended June 30, 2008, the Company granted 60,488 shares of service-based stock awards. The fair value of these grants ranged from $26.80 to $36.25 per share based on the fair market value at the grant date. The restrictions on the grants lapse at the end of the required service periods ranging from September 2008 through May 2011. During the nine-month period ended June 30, 2008, the Company also granted 26,603 shares of performance-based stock awards. The fair value of these grants ranged from $34.74 to $34.97 per share based on the fair market value at the grant date. The restrictions on these grants lapse upon achievement of performance-based objectives for the three-year period ending September 30, 2010 and continuous employment through December 15, 2010. The Company also granted 2,000 shares of non-employee service-based stock awards during the quarter ended December 31, 2007. The shares immediately vested and had a grant date fair value of $33.40 per share.

Stock compensation expense included in the Company's results was as follows (in thousands):

| | Three months ended June 30, | | | | Nine months ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | | 2008 | | 2007 | | 2008 | | 2007 |
| Cost of goods sold | $ | 36 | $ | 61 | $ | 172 | $ | 144 |
| Operating expenses | | 364 | | 208 | | 970 | | 577 |
| Total stock compensation expense | $ | 400 | $ | 269 | $ | 1,142 | $ | 721 |

Stock compensation expense remaining capitalized in inventory at June 30, 2008 and 2007 was $15,000 and $37,000, respectively.

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3. Earnings per share

The calculation of the basic and diluted earnings per share ("EPS") is as follows (in thousands except per share data):

| | For the three months ended June 30, 2008 | | | For the three months ended June 30, 2007 | | |
|---|---|---|---|---|---|---|
| | Earnings | Shares | Per-Share Amount | Earnings | Shares | Per-Share Amount |
| Basic EPS: | | | | | | |
| Net earnings | $ 2,963 | 5,461 | $ 0.54 | $ 2,939 | 5,288 | $ 0.56 |
| Effect of dilutive securities: | | | | | | |
| Common stock options | | 60 | | | 77 | |
| Common stock awards | | 53 | | | 43 | |
| Diluted EPS: | | | | | | |
| Earnings plus assumed conversions | $ 2,963 | 5,574 | $ 0.53 | $ 2,939 | 5,408 | $ 0.54 |

| | For the nine months ended June 30, 2008 | | | For the nine months ended June 30, 2007 | | |
|---|---|---|---|---|---|---|
| | Earnings | Shares | Per-Share Amount | Earnings | Shares | Per-Share Amount |
| Basic EPS: | | | | | | |
| Net earnings | $ 5,246 | 5,417 | $ 0.97 | $ 5,113 | 5,247 | $ 0.97 |
| Effect of dilutive securities: | | | | | | |
| Common stock options | | 72 | | | 86 | |
| Common stock awards | | 44 | | | 30 | |
| Diluted EPS: | | | | | | |
| Earnings plus assumed conversions | $ 5,246 | 5,533 | $ 0.95 | $ 5,113 | 5,363 | $ 0.95 |

The weighted-average number of diluted shares does not include potential common shares which are anti-dilutive or performance-based restricted stock awards if the performance measurement has not been met. The following potential common shares at June 30, 2008 and 2007 were not included in the calculation of diluted EPS as they were anti-dilutive or the performance measurement has not been met:

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Common shares from: | | | | |
| Assumed exercise of stock options | - | - | - | - |
| Assumed lapse of restrictions on: | | | | |
| - Service-based stock grants | 1,650 | - | 2,650 | - |
| - Performance-based stock grants | 35,408 | 58,801 | 35,408 | 58,801 |

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The options expire on dates beginning in February 2009 through February 2015. The restrictions on stock grants may lapse between August 2008 and May 2011.

## 4. Income taxes

The provision (benefit) for income taxes is based on the estimated effective income tax rate for the year.

The Company adopted the provisions of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes, on October 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with Statement of Financial Accounting Standards 5, Accounting for Contingencies. As required by Interpretation 48, which clarifies Statement 109, Accounting for Income Taxes, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied Interpretation 48 to all tax positions for which the statute of limitations remained open. As a result of the implementation of Interpretation 48, the Company recognized a decrease of approximately $250,000 in the liability for unrecognized tax benefits, which was accounted for as an increase to the October 1, 2007 balance of retained earnings.

The amount of unrecognized tax benefits as of October 1, 2007 was approximately $91,000 which, if ultimately recognized, will reduce the Company's annual effective tax rate. There have been no material changes in unrecognized tax benefits since October 1, 2007.

The Company is subject to income taxes in the U.S. federal jurisdiction and various state and foreign jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for the years before 2002.

The Company is not currently under examination by any U.S. federal or state jurisdictions, or foreign jurisdictions, and there are no expected material changes in the unrecognized tax benefit liability within the next twelve months.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in other income and expense for all periods presented. The Company had accrued approximately $37,000 for the payment of interest and penalties at October 1, 2007. Subsequent changes to accrued interest and penalties have not been significant.

## 5. Comprehensive income

The calculation of comprehensive income is as follows (in thousands):

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Components of comprehensive income: | | | | |
| Net earnings | $ 2,963 | $ 2,939 | $ 5,246 | $ 5,113 |
| Other comprehensive income - | | | | |
| Foreign currency translation adjustment, net of tax | (15) | 41 | 386 | 157 |
| Total comprehensive income | $ 2,948 | $ 2,980 | $ 5,632 | $ 5,270 |

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## 6. Contractual guarantees and indemnities

Product warranties

The Company provides a warranty on its products ranging from ninety days to five years following the date of shipment. Management establishes allowances for customer support and warranty costs based upon the types of products shipped, customer support and product warranty experience. The provision of customer support and warranty costs is charged to cost of sales at the point of sale, and it is periodically assessed for adequacy based on changes in these factors.

A reconciliation of the changes in the Company's allowances for warranties for the nine months ended June 30, 2008 and 2007 (in thousands) is as follows:

| | Nine months ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Beginning balance | $ 1,433 | $ 979 |
| Warranty costs incurred | (1,731) | (1,502) |
| Warranty expense accrued | 1,632 | 1,738 |
| Translation adjustments | 42 | 29 |
| Ending balance | $ 1,376 | $ 1,244 |

Intellectual property and general contractual indemnities

The Company, in the normal course of business, provides specific, limited indemnification to its customers for liability and damages related to intellectual property rights. In addition, the Company may enter into contracts with customers where it has agreed to indemnify the customer for personal injury or property damage caused by the Company's products and services. Indemnification is typically limited to replacement of the items or the actual price of the products and services. The Company maintains product liability insurance as well as errors and omissions insurance, which may provide a source of recovery in the event of an indemnification claim, but does not maintain insurance coverage for claims related to intellectual property rights.

Historically, any amounts payable under these indemnifications have not had a material effect on the Company's business, financial condition, results of operations, or cash flows. The Company has not recorded any provision for future obligations under these indemnifications. If the Company determines it is probable that a loss has occurred under these indemnifications, then any such reasonably estimable loss would be recognized.

Director and officer indemnities

The Company has entered into indemnification agreements with its directors and certain executive officers which require the Company to indemnify such individuals against certain expenses, judgments and fines in third-party and derivative proceedings. The Company may recover some of the expenses and liabilities that arise in connection with such indemnifications under the terms of its directors' and officers' insurance policies. The Company has not recorded any provision for future obligations under these indemnification agreements.

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Bank guarantees and letters of credit

At June 30, 2008, the Company had standby letters of credit totaling $4.4 million, which includes secured bank guarantees under the Company's credit facility in Europe and letters of credit securing certain self-insurance contracts and lease commitments. If the Company fails to meet its contractual obligations, these bank guarantees and letters of credit may become liabilities of the Company. This amount is comprised of approximately $4.0 million of outstanding performance guarantees secured by bank guarantees under the Company's European subsidiaries' credit facility in Europe, a standby letter of credit for $150,000 securing certain self-insurance contracts related to workers compensation and a standby letter of credit for $230,000 securing payments under a lease contract for a domestic production facility. Bank guarantees arise when the European subsidiary collects customer deposits prior to order fulfillment. The customer deposits received are recorded as current liabilities on the Company's balance sheet. The bank guarantees repayment of the customer deposit in the event an order is not completed. The bank guarantee is canceled upon shipment and transfer of title. These bank guarantees arise in the normal course of the Company's European business and are not deemed to expose the Company to any significant risks since they are satisfied as part of the design and manufacturing process.

Purchase Obligations

The Company had contractual obligations to purchase certain materials and supplies aggregating $686,000 by December 31, 2008. As of June 30, 2008, the Company had fulfilled its obligations under the contract. The Company has entered into a commitment to acquire capital equipment of approximately $700,000.

7. Future accounting changes

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," which establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather it eliminates inconsistencies in the guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is evaluating the potential effects of this standard, although the Company does not expect the adoption of SFAS No. 157 to have a material effect on its financial position, results of operation, or cash flows.

In February 2007, the FASB issued Statement 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to elect to measure certain financial instruments and other items at fair value. The fair value option may be applied on an instrument by instrument basis, is irrevocable and is applied only to entire instruments. SFAS 159 requires additional financial statement presentation and disclosure requirements for those entities that elect to adopt the standard and is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 159 to have a material effect on its financial position, results of operations or cash flows.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." This position states that unvested share-based payment awards that contain nonforfeitable rights to dividends (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, "Earnings per Share." FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008. All prior period EPS data will be required to be adjusted to conform to the provisions of this pronouncement and early application is prohibited. The Company does have participating securities as described under this pronouncement and is currently evaluating the impact of FSP EITF 03-6-1.

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

From time to time, Key Technology, Inc. ("Key" or the "Company"), through its management, may make forward-looking public statements with respect to the Company regarding, among other things, expected future revenues or earnings, projections, plans, future performance, product development and commercialization, and other estimates relating to the Company's future operations. Forward-looking statements may be included in reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in press releases or in oral statements made with the approval of an authorized executive officer of Key. The words or phrases "will likely result," "are expected to," "intends," "is anticipated," "estimates," "believes," "projects" or similar expressions are intended to identify "forward-looking statements" within the meaning of Section 21E of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are subject to a number of risks and uncertainties. The Company cautions investors not to place undue reliance on its forward-looking statements, which speak only as of the date on which they are made. Key's actual results may differ materially from those described in the forward-looking statements as a result of various factors, including those listed below:

- adverse economic conditions, particularly in the food processing industry, either globally or regionally, may adversely affect the Company's revenues;
- competition and advances in technology may adversely affect sales and prices;
- failure of the Company's new products to compete successfully in either existing or new markets;
- the limited availability and possible cost fluctuations of materials used in the Company's products could adversely affect the Company's gross profits;
- the inability of the Company to protect its intellectual property, especially as the Company expands geographically, may adversely affect the Company's competitive advantage; and
- intellectual property-related litigation expenses and other costs resulting from infringement claims asserted against the Company by third parties may adversely affect the Company's results of operations and its customer relations.

More information may be found in Item 1A, "Risk Factors," in the Company's Annual Report on Form 10-K filed with the SEC on December 14, 2007, which item is hereby incorporated by reference.

Given these uncertainties, readers are cautioned not to place undue reliance on the forward-looking statements. The Company disclaims any obligation subsequently to revise or update forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

### Overview

#### General

The Company and its operating subsidiaries design, manufacture, sell and service process automation systems that process product streams of discrete pieces to improve safety and quality. These systems integrate electro-optical automated inspection and sorting systems with process systems that include specialized conveying and preparation systems. The Company provides parts and service for each of its product lines to customers throughout the world. Industries served include food processing, as well as tobacco, plastics, and pharmaceuticals. The Company maintains two domestic manufacturing facilities and a European manufacturing facility located in the Netherlands. The Company markets its products directly and through independent sales representatives.

In recent years, 40% or more of the Company's sales have been made to customers located outside the United States. In its export and international sales, the Company is subject to the risks of conducting business internationally,

including unexpected changes in regulatory requirements; fluctuations in the value of the U.S. dollar which could increase or decrease the sales prices in local currencies of the Company's products; tariffs and other barriers and restrictions; and the burdens of complying with a variety of international laws.

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Current period – third quarter of fiscal 2008

The results for the third quarter of fiscal 2008 showed continued growth in net sales and backlog compared to the same period in the prior fiscal year. Net sales of $35.8 million in the third fiscal quarter of 2008 were a new quarterly record, and $4.8 million, or 16%, higher than net sales of $31.0 million in the corresponding quarter a year ago. Backlog of $42.2 million at the end of the third fiscal quarter of 2008 was also at a record level for any third fiscal quarter and represented a $5.5 million, or 15%, increase over the ending backlog of $36.7 million in the corresponding quarter a year ago. Net earnings for the third quarter of fiscal 2008 were $3.0 million or $0.53 per diluted share. Net earnings for the same period last year were $2.9 million, or $0.54 per diluted share. Customer orders in the third quarter of fiscal 2008 of $30.7 million were down $2.9 million, or 9%, compared to the record-setting orders of $33.6 million in the third quarter of fiscal 2007. During the third quarter of fiscal 2008, the Company continued to focus on growing market share and revenues in its established markets and geographies, strengthening its presence in the pharmaceutical and nutraceutical market, increasing upgrade system sales, and continuing to establish its global market presence.

Additionally, in the third quarter, the Company continued its work toward the implementation of a new global enterprise resource planning (“ERP”) system. Implementation will be spread over a three-year period, with an estimated cost of $5.5 million, including both internal and external resources. A significant portion of these implementation costs will be capitalized. Operating expenses of $291,000 and capital expenditures of approximately $625,000 related to the ERP implementation were incurred during the third quarter of fiscal 2008.

First nine months of fiscal 2008

The results for the first three quarters of fiscal 2008 included records for order volume and net sales. Customer orders for the first three quarters of fiscal 2008 were $105.1 million which represented a $15.8 million, or 18%, increase over customer orders of $89.2 million in the same period in fiscal 2007. This increase in orders is attributable to the increasing global concern regarding food safety and security; the continuing decline of available labor in the food processing industry; the growth of our business in North America, Latin America and Europe; and, finally, the continued confidence of our customers in the Company’s ability to provide high quality processing solutions.

Net sales of $93.9 million for the first nine months of fiscal 2008 were $18.2 million, or 24%, higher than the net sales of $75.8 million in the corresponding period a year ago. Net earnings for the first nine months of fiscal 2008 were $5.2 million, or $0.95 per diluted share. Net earnings for the corresponding nine-month period last year were $5.1 million, or $0.95 per diluted share. Net earnings in the first nine months of fiscal 2007 included a $750,000 gain, or $0.14 per share, from the sale of the Company’s InspX joint venture.

For the first nine months of fiscal 2008, the Company incurred operating expenses of $845,000 and capital expenditures of approximately $1.2 million associated with the implementation of the ERP system. Cumulative ERP-related operating expenses and capital expenditures through June 30, 2008, including amounts incurred in fiscal 2007, are $845,000 and $2.0 million, respectively.

Application of Critical Accounting Policies

The Company has identified its critical accounting policies, the application of which may materially affect the financial statements, either because of the significance of the financial statement item to which they relate, or because they require management judgment to make estimates and assumptions in measuring, at a specific point in time, events which will be settled in the future. The critical accounting policies, judgments and estimates which management believes have the most significant effect on the financial statements are set forth below:

- Revenue recognition

- Allowances for doubtful accounts
- Valuation of inventories
- Long-lived assets
- Allowances for warranties
- Accounting for income taxes

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Management has discussed the development, selection and related disclosures of these critical accounting estimates with the audit committee of the Company's board of directors.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, the Company sells its goods on terms which transfer title and risk of loss at a specified location, typically shipping point, port of loading or port of discharge, depending on the final destination of the goods. Accordingly, revenue recognition from product sales occurs when all criteria are met, including transfer of title and risk of loss, which occurs either upon shipment by the Company or upon receipt by customers at the location specified in the terms of sale. Sales of system upgrades are recognized as revenue upon completion of the conversion of the customer's existing system when this conversion occurs at the customer site. Revenue earned from services (maintenance, installation support, and repairs) is recognized ratably over the contractual period or as the services are performed. If any contract provides for both equipment and services (multiple deliverables), the sales price is allocated to the various elements based on objective evidence of fair value. Each element is then evaluated for revenue recognition based on the previously described criteria. The Company's sales arrangements provide for no other significant post shipment obligations. If all conditions of revenue recognition are not met, the Company defers revenue recognition. In the event of revenue deferral, the sale value is not recorded as revenue to the Company, accounts receivable are reduced by any amounts owed by the customer, and the cost of the goods or services deferred is carried in inventory. In addition, the Company periodically evaluates whether an allowance for sales returns is necessary. Historically, the Company has experienced few sales returns. If the Company believes there are potential sales returns, the Company will provide any necessary provision against sales. In accordance with the Financial Accounting Standard Board's Emerging Issues Task Force Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Product," the Company accounts for cash consideration (such as sales incentives) that are given to customers or resellers as a reduction of revenue rather than as an operating expense unless an identified benefit is received for which fair value can be reasonably estimated. The Company believes that revenue recognition is a "critical accounting estimate" because the Company's terms of sale vary significantly, and management exercises judgment in determining whether to recognize or defer revenue based on those terms. Such judgments may materially affect net sales for any period. Management exercises judgment within the parameters of accounting principles generally accepted in the United States of America (GAAP) in determining when contractual obligations are met, title and risk of loss are transferred, the sales price is fixed or determinable and collectability is reasonably assured. At June 30, 2008, the Company had invoiced $3.4 million compared to $2.3 million at September 30, 2007 for which the Company has not recognized revenue.

Allowances for doubtful accounts. The Company establishes allowances for doubtful accounts for specifically identified, as well as anticipated, doubtful accounts based on credit profiles of customers, current economic trends, contractual terms and conditions, and customers' historical payment patterns. Factors that affect collectability of receivables include general economic or political factors in certain countries that affect the ability of customers to meet current obligations. The Company actively manages its credit risk by utilizing an independent credit rating and reporting service, by requiring certain percentages of down payments, by requiring secured forms of payment for customers with uncertain credit profiles or located in certain countries, and by obtaining credit insurance on specific transactions. Forms of secured payment could include irrevocable letters of credit, bank guarantees, third-party leasing arrangements or EX-IM Bank guarantees, each utilizing Uniform Commercial Code filings, or the like, with governmental entities where possible. The Company believes that the accounting estimate related to allowances for doubtful accounts is a "critical accounting estimate" because it requires management judgment in making assumptions relative to customer or general economic factors that are outside the Company's control. As of June 30, 2008, the balance sheet included allowances for doubtful accounts of $283,000. Amounts charged to bad debt expense for the nine-month period ended June 30, 2008 and 2007 were $7,000 and $26,000, respectively. Actual charges to the allowance for doubtful accounts for the nine-month period ended June 30, 2008 and 2007 were $163,000 and $39,000, respectively. If the Company experiences actual bad debt expense in excess of estimates, or if estimates are

adversely adjusted in future periods, the carrying value of accounts receivable would decrease and charges for bad debts would increase, resulting in decreased net earnings.

Valuation of inventories. Inventories are stated at the lower of cost or market. The Company's inventory includes purchased raw materials, manufactured components, purchased components, service and repair parts, work in process, finished goods and demonstration equipment. Write downs of excess and obsolete inventories are made after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. The factors that contribute to inventory valuation risks are the Company's purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of

new products, product lifecycles and the associated product support. The Company actively manages its exposure to inventory valuation risks by maintaining low safety stocks and minimum purchase lots, utilizing just in time purchasing practices, managing product end-of-life issues brought on by aging components or new product introductions, and by utilizing inventory minimization strategies such as vendor-managed inventories. The Company believes that the accounting estimate related to valuation of inventories is a "critical accounting estimate" because it is susceptible to changes from period to period due to the requirement for management to make estimates relative to each of the underlying factors ranging from purchasing to sales to production to after-sale support. At June 30, 2008, cumulative inventory adjustments to lower of cost or market totaled $1.8 million, approximately the same amount as of September 30, 2007. Amounts charged to expense to record inventory at lower of cost or market for the nine-month period ended June 30, 2008 and 2007 were $312,000 and $241,000, respectively. Actual charges to the cumulative inventory adjustments upon disposition or sale of inventory were $419,000 and $1.0 million for the nine-month period ended June 30, 2008 and 2007, respectively. If actual demand, market conditions or product lifecycles are adversely different from those estimated by management, inventory adjustments to lower market values would result in a reduction to the carrying value of inventory, an increase in inventory write-offs, and a decrease to gross margins.

Long-lived assets. The Company regularly reviews all of its long-lived assets, including property, plant and equipment, and amortizable intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If the total of projected future undiscounted cash flows is less than the carrying amount of these assets, an impairment loss based on the excess of the carrying amount over the fair value of the assets is recorded. In addition, goodwill is reviewed based on its fair value at least annually. As of June 30, 2008, the Company held $11.4 million of property, plant and equipment, goodwill and other intangible assets, net of depreciation and amortization. There were no changes in the Company's long-lived assets that would result in an adjustment of the carrying value for these assets. Estimates of future cash flows arising from the utilization of these long-lived assets and estimated useful lives associated with the assets are critical to the assessment of recoverability and fair values. The Company believes that the accounting estimate related to long-lived assets is a "critical accounting estimate" because: (1) it is susceptible to change from period to period due to the requirement for management to make assumptions about future sales and cost of sales generated throughout the lives of several product lines over extended periods of time; and (2) the potential effect that recognizing an impairment could have on the assets reported on the Company's balance sheet and the potential material adverse effect on reported earnings or loss. Changes in these estimates could result in a determination of asset impairment, which would result in a reduction to the carrying value and a reduction to net earnings in the affected period.

Allowances for warranties. The Company's products are covered by standard warranty plans included in the price of products ranging between 90 days and five years, depending upon the product and contractual terms of sale. The Company establishes allowances for warranties for specifically identified, as well as anticipated, warranty claims based on contractual terms, product conditions and actual warranty experience by product line. Company products include both manufactured and purchased components and, therefore, warranty plans include third-party sourced parts which may not be covered by the third-party manufacturer's warranty. Ultimately, the warranty experience of the Company is directly attributable to the quality of its products. The Company actively manages its quality program by using a structured product introduction plan, process monitoring techniques utilizing statistical process controls, vendor quality metrics, a quality training curriculum for every employee and feedback loops to communicate warranty claims to designers and engineers for remediation in future production. The Company believes that the accounting estimate related to allowances for warranties is a "critical accounting estimate" because: (1) it is susceptible to significant fluctuation period to period due to the requirement for management to make assumptions about future warranty claims relative to potential unknown issues arising in both existing and new products, which assumptions are derived from historical trends of known or resolved issues; and (2) risks associated with third-party supplied components being manufactured using processes that the Company does not control. As of June 30, 2008, the balance sheet included warranty reserves of $1.4 million, while $1.7 million of warranty charges were incurred during the

nine-month period ended June 30, 2008, compared to warranty reserves of $1.2 million as of June 30, 2007 and warranty charges of $1.5 million for the nine-month period then ended. If the Company's actual warranty costs are higher than estimates, future warranty plan coverages are different, or estimates are adversely adjusted in future periods, reserves for warranty expense would need to increase, warranty expense would increase and gross margins would decrease.

Accounting for income taxes. The Company's provision for income taxes and the determination of the resulting deferred tax assets and liabilities involves a significant amount of management judgment. The quarterly provision for income taxes is based partially upon estimates of pre-tax financial accounting income for the full year and is

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affected by various differences between financial accounting income and taxable income. Judgment is also applied in determining whether the deferred tax assets will be realized in full or in part. In management's judgment, when it is more likely than not that all or some portion of specific deferred tax assets, such as foreign tax credit carryovers, will not be realized, a valuation allowance must be established for the amount of the deferred tax assets that are determined not to be realizable. At June 30, 2008, the Company had valuation reserves of approximately $450,000 for deferred tax assets related to the sale of the investment in the InspX joint venture and the valuation reserve for notes receivable and contingent payments; and offsetting amounts for U.S. and Chinese deferred tax assets and liabilities, primarily related to net operating loss carryforwards in the foreign jurisdictions. During the nine-month period ended June 30, 2008, $60,000 of net valuation reserves for combined U.S. and Australian deferred taxes were eliminated due to the final dissolution of the related Australian entity. There were no other valuation allowances at June 30, 2008 due to anticipated utilization of all the deferred tax assets as the Company believes it will have sufficient taxable income to utilize these assets. The Company maintains reserves for estimated tax exposures in jurisdictions of operation. These tax jurisdictions include federal, state and various international tax jurisdictions. Potential income tax exposures include potential challenges of various tax credits, export-related tax benefits, and issues specific to state and local tax jurisdictions. Exposures are typically settled primarily through audits within these tax jurisdictions, but can also be affected by changes in applicable tax law or other factors, which could cause management of the Company to believe a revision of past estimates is appropriate. During fiscal 2007 and thus far in fiscal 2008, there have been no significant changes in these estimates other than the adoption of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes, as discussed further below. Management believes that an appropriate liability has been established for estimated exposures; however, actual results may differ materially from these estimates. The Company believes that the accounting estimate related to income taxes is a "critical accounting estimate" because it relies on significant management judgment in making assumptions relative to temporary and permanent timing differences of tax effects, estimates of future earnings, prospective application of changing tax laws in multiple jurisdictions, and the resulting ability to utilize tax assets at those future dates. If the Company's operating results were to fall short of expectations, thereby affecting the likelihood of realizing the deferred tax assets, judgment would have to be applied to determine the amount of the valuation allowance required to be included in the financial statements established in any given period. Establishing or increasing a valuation allowance would reduce the carrying value of the deferred tax asset, increase tax expense and reduce net earnings.

Adoption of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes

The Company adopted the provisions of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes, on October 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with Statement of Financial Accounting Standards 5, Accounting for Contingencies. As required by Interpretation 48, which clarifies Statement 109, Accounting for Income Taxes, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied Interpretation 48 to all tax positions for which the statute of limitations remained open. As a result of the implementation of Interpretation 48, the Company recognized a decrease of approximately $250,000 in the liability for unrecognized tax benefits, which was accounted for as an increase to the October 1, 2007 balance of retained earnings.

The amount of unrecognized tax benefits as of October 1, 2007 was approximately $91,000 which, if ultimately recognized, will reduce the Company's annual effective tax rate. There have been no material changes in unrecognized tax benefits since October 1, 2007.

The Company is subject to income taxes in the U.S. federal jurisdiction and various state and foreign jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and

require significant judgment to apply. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for the years before 2002.

The Company is not currently under examination by any U.S. federal or state jurisdictions, or foreign jurisdictions, and there are no expected material changes in the unrecognized tax benefit liability within the next twelve months.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in other income and expense for all periods presented. The Company had accrued approximately $37,000 for the

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payment of interest and penalties at October 1, 2007. Subsequent changes to accrued interest and penalties have not been significant.

Results of Operations

For the three months ended June 30, 2008 and 2007

Net sales increased $4.8 million, or 16%, to $35.8 million in the third quarter of fiscal 2008 over the $31.0 million in net sales recorded in the same quarter a year ago. This was a new record net sales level for any quarter, up from the previous record of $31.7 million in the fourth quarter of fiscal 2007. International sales for the three-month period were 55% of net sales compared to 42% in the corresponding prior year period. Increases in net sales occurred in automated inspection systems sales, up $1.6 million, or 12%; process systems sales, up $2.9 million, or 24%; and parts and service sales, up $318,000, or 6%. The increases in automated inspection systems sales and process system sales related to significantly increased shipments in upgrade systems and vibratory products, respectively. Automated inspection systems sales, including upgrade systems, represented 42% of net sales in the third quarter of fiscal 2008 compared to 44% of net sales in the third quarter of fiscal 2007. Process systems sales represented 42% of net sales in the third quarter of fiscal 2008 compared to 39% during the third quarter of fiscal 2007, while parts and service sales accounted for 16% of the more recent quarter's net sales, down from 17% in the same quarter a year ago.

Total backlog was $42.2 million at the end of the third quarter of fiscal 2008 and was $5.5 million higher than the $36.7 million backlog at the end of the third quarter in the prior fiscal year. Backlog for automated inspection systems was up $3.4 million, or 17%, to $23.4 million at June 30, 2008 compared to $20.1 million at June 30, 2007. The increased automated inspection systems backlog included increases in pharmaceutical systems, the Optyx and Raptor products, and the new Manta product. Process systems backlog increased by $1.9 million, or 12%, to $17.4 million at the end of the third quarter of fiscal 2008 compared to $15.5 million at the same time a year ago. The backlog increase for process systems was primarily related to vibratory products and pharmaceutical systems. Backlog by product line at June 30, 2008 was 56% automated inspection systems, 41% process systems, and 3% parts and service, compared to 55% automated inspection systems, 42% process systems, and 3% parts and service on June 30, 2007.

Orders decreased by $2.9 million, or 9%, to $30.7 million in the third quarter of fiscal 2008 compared to the third quarter record for new orders of $33.6 million during the same period a year ago. Orders for automated inspection systems remained strong during the third quarter of fiscal 2008, increasing $1.5 million, or 11%, to $15.1 million from $13.6 million in the comparable quarter of fiscal 2007. The increase was driven by orders in North America and Latin America. Process system orders decreased $4.9 million, or nearly 35%, during the third quarter of fiscal 2008 to $9.2 million compared to $14.1 million in the third quarter of fiscal 2007. The decrease in process systems orders from the third quarter of fiscal 2007 was due significantly to decreased orders for vibratory products in both North America and Europe. Orders for parts and service were $6.4 million, up $468,000, or 8%, from $5.9 million for the same period in the prior year.

Gross profit for the third quarter of fiscal 2008 was $15.0 million compared to $12.5 million in the corresponding period last year. Gross profit in the third quarter of fiscal 2008, as a percentage of net sales, increased to 42.0% compared to the 40.2% reported the same quarter of fiscal 2007. The margin improvement from the same quarter a year ago was primarily a result of increased efficiency of manufacturing operations due to higher product shipment volumes, slightly offset by the mix of increased sales of lower margin process systems.

Operating expenses of $10.9 million for the third quarter of fiscal 2008 were 30.5% of net sales compared with $8.3 million, or 26.9%, of net sales for the third quarter of fiscal 2007. Spending increased $2.6 million as a result of higher research and development spending, increased sales activity, additional general and administrative expenses, and higher stock-based and incentive compensation expenses. As previously announced, the Company has increased

spending throughout fiscal 2008 on research and development to continue to expand capabilities and to provide new and innovative solutions. The Company also continues to invest in sales and marketing efforts, which contributed to record year-to-date orders in fiscal 2008. The Company also experienced increased sales commissions in the third quarter of fiscal 2008 due to a higher mix of sales through our outside sales representatives. General and administrative expenses during the third quarter of fiscal 2008 were up compared to the prior year third quarter, a result of work to implement a new global enterprise resource planning system and increases in staffing driven by the Company's growth.

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Other income for the third quarter of fiscal 2008 was $252,000 compared to $327,000 for the same period in fiscal 2007. Other income consisted of interest income and foreign exchange gains.

Net earnings for the quarter ending June 30, 2008 were $3.0 million, or $0.53 per diluted share. Net earnings for the same period last year were $2.9 million, or $0.54 per diluted share. In the third quarter of fiscal 2008, higher revenues and stronger gross margins were also partially offset by higher operating expenses. Operating expenses are anticipated to remain higher in the fourth quarter of fiscal 2008 than in the prior year fourth quarter due to expenditures to support the higher sales levels and the Company's investments in research and development, as well as the new ERP system.

For the nine months ended June 30, 2008 and 2007

Net sales in the first nine months of fiscal 2008 increased by $18.2 million, or 24%, to $93.9 million compared to $75.8 million for the same period in fiscal 2007. International sales for the more recent nine-month period were 53% of net sales compared to 43% for the first nine months of fiscal 2007. Increases in total net sales for the first nine months of fiscal 2008 compared to the same period in the prior year occurred in process systems sales, up $11.1 million, or 37%; automated inspection systems sales, up $5.8 million, or 18%; and parts and service sales, up $1.2 million, or 8%. The increase in process system sales was primarily the result of increased shipments of vibratory products in North America, Europe and Latin America. The increase in automated inspection systems sales resulted significantly from upgrade sales, which increased $3.7 million to $13.0 million in the first nine months of fiscal 2008 compared to the same period in the prior year. Automated inspection systems net sales, including upgrade systems, represented 40% of net sales in the first three quarters of fiscal 2008 compared to 42% of net sales for the same period of fiscal 2007. Process systems represented 44% of net sales in the first nine months of fiscal 2008 compared to 39% of net sales in the first nine months of fiscal 2007. Parts and service accounted for 17% of net sales in the first three quarters of fiscal 2008, down from 19% for the same period in fiscal 2007.

New orders for the first nine months of fiscal 2008 increased $15.8 million, or 18%, to $105.1 million compared to orders of $89.2 million for the first nine months of fiscal 2007. Orders for automated inspection systems increased approximately $7.8 million, or 20%, to $46.6 million compared to $38.9 million in fiscal 2007. This increase occurred primarily in North American, Europe and Latin American and was driven by system upgrades, the Optyx and Raptor products, and the new Manta product. Orders for process systems increased $6.8 million, or 19%, to over $42.3 million compared to $35.5 million in fiscal 2007. The increase in process systems orders in the first nine months of fiscal 2008 over the first three quarters of fiscal 2007 was due to increased orders for vibratory products in North America and Latin America. New orders for system upgrades were $13.1 million, up $1.8 million, or 16%, from $11.2 million in the prior year. Orders for parts and service were $16.1 million, up $1.2 million, or 8%, from $14.9 million in the prior year.

Gross profit for the first nine months of fiscal 2008 was $37.8 million compared to $29.5 million in the corresponding period last year. Gross profit as a percentage of sales in the first nine of fiscal 2008 increased to 40.3%, compared to the 39.0% reported for the same period of fiscal 2007. The margin improvement for the first nine months of fiscal 2008 compared to the same period in fiscal 2007 was primarily a result of increased efficiency of manufacturing operations and favorable material pricing, partially offset by the mix of increased sales of lower margin process systems.

Operating expenses of $31.2 million for the first nine months of fiscal 2008 were 33.2% of net sales compared with $23.8 million, or 31.4%, of net sales for the first nine months of fiscal 2007. Spending increased by $7.4 million as a result of higher research and development spending, increased sales activity, additional general and administrative expenditures, and higher stock-based and incentive compensation expenses. The Company has increased spending throughout fiscal 2008 on research and development to continue to expand capabilities and to provide new and

innovative solutions. The Company continues to invest in sales and marketing efforts. These efforts have contributed to record year-to-date orders in fiscal year 2008. The Company also experienced increased sales commissions due to a higher mix of sales through our outside sales representatives. General and administrative expenses during the first nine months of fiscal 2008 increased compared to the prior year as a result of work to implement the global ERP system, increased recruiting expenses and increased staffing driven by the Company’s growth.

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Other income for the first three quarters of fiscal 2008 was $1.1 million compared to $859,000 for the same period in fiscal 2007. Other income consisted primarily of interest income, foreign exchange gains and gains from reductions in other liabilities. The first nine months of fiscal 2007 also included a $750,000 gain from the sale of the Company's 50% interest in the InspX joint venture.

Net earnings for the first nine months of fiscal 2008 were $5.2 million, or $0.95 per diluted share. The net earnings for the same period in fiscal 2007 were $5.1 million, or $0.95 per diluted share, which included a $750,000 gain, or $0.14 per share, from the sale of the Company's 50% interest in its InspX joint venture. In the first nine months of fiscal 2008, higher revenues and better gross margins were also significantly offset by the higher operating expenses. Operating expenses are anticipated to remain higher in the last three months of fiscal 2008 than in the prior year due to expenditures to support the higher sales levels and the Company's investments in research and development, as well as the new ERP system.

Liquidity and Capital Resources

For the nine months ended June 30, 2008, net cash increased by $5.3 million to $33.1 million on June 30, 2008 from $27.9 million on September 30, 2007. Cash provided by operating activities was $6.7 million during the nine-month period ended June 30, 2008. Investing activities consumed $2.4 million of cash, a result of $2.5 million in capital expenditures, while financing activities generated $771,000 of cash. The effect of exchange rate changes on cash was a positive $194,000 during the first nine months of fiscal 2008.

Cash provided by operating activities during the nine-month period ended June 30, 2008 was $6.7 million compared to $9.7 million of cash provided by operating activities for the comparable period in fiscal 2007. The primary contributor was the change in non-cash working capital. In the first nine months of fiscal 2007, changes in non-cash working capital provided $2.4 million of cash from operating activities. During the first nine months of fiscal 2008, changes in non-cash working capital used $380,000 of cash from operating activities. The major changes in current assets and current liabilities during the first nine months of fiscal 2008 were increased trade receivables of $1.7 million as a result of increase sales volumes, and increased inventories of $6.5 million related to higher production levels and new product introductions. These were offset by an increase in accounts payable of $1.5 million and customer deposits of $3.2 million. In addition, there were increases in accrued payroll liabilities and commissions of $1.1 million.

The net cash used in investing activities of $2.4 million for the first nine months of fiscal 2008 represents a $2.8 million change from the $415,000 of net cash generated from investing activities in the corresponding period a year ago. The major change in investing activities resulted from the $750,000 in proceeds from the sale of the Company's interest in the InspX joint venture during the first quarter of fiscal 2007. In addition, the Company's investments in property, plant and equipment increased by $2.1 million in the first nine months of fiscal 2008 from the corresponding period a year ago, the largest component of which related to investment in a new ERP system.

Net cash provided by financing activities during the first nine months of fiscal 2008 was $771,000, compared with net cash provided of $283,000 during the corresponding period in fiscal 2007. The net cash provided by financing activities during the first nine months of fiscal 2008 resulted from excess tax benefits from share-based payments and proceeds from issuance of common stock for employee stock option exercises, offset by the exchange of shares for statutory tax withholding. Financing activities during the first nine months of the prior fiscal year included $1.3 million used in the stock repurchase program offset by $1.3 million generated from the issuance of common stock relating to employee stock option exercises and $320,000 from excess tax benefits from share-based payments. No stock was purchased under the Company's stock repurchase program in the first nine months of fiscal 2008.

The Company's domestic credit facility provides for a revolving credit line of up to $10 million and credit sub-facilities of $3.0 million each for sight commercial letters of credit and standby letters of credit. The credit facility matures on June 30, 2009. The credit facility bears interest, at the Company's option, of either the bank prime rate minus 1.75% or LIBOR plus 1.0% per annum. At June 30, 2008, the interest rate would have been 3.25%. The credit facility is secured by all U.S. accounts receivable, inventory and fixed assets. The credit facility contains covenants which require the maintenance of a defined net worth ratio, a liquidity ratio and an EBITDA coverage ratio. The credit facility also restricts mergers and acquisitions, incurrence of additional indebtedness, and transactions, including purchases and retirements, in the Company's own common stock, without the prior consent of the lender. At June 30, 2008, the Company had no borrowings outstanding under the credit facility and $380,000 in

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standby letters of credit. At June 30, 2008, the Company was in compliance with its loan covenants and had received the consent of the lender for its stock repurchase program.

The Company's credit accommodation with a commercial bank in the Netherlands provides a credit facility for its European subsidiary. This credit accommodation totals $4.0 million and includes an operating line of the lesser of $2.4 million or the available borrowing base, which is based on varying percentages of eligible accounts receivable and inventories, and a bank guarantee facility of $1.6 million. The operating line and bank guarantee facility are secured by all of the subsidiary's personal property. The credit facility bears interest at the bank's prime rate, with a minimum of 3.00%, plus 1.75%. At June 30, 2008, the interest rate was 7.40%. At June 30, 2008, the Company had no borrowings under this facility and had received bank guarantees of $4.0 million under the bank guarantee facility. The credit facility allows overages on the bank guarantee facility. Any overages reduce the available borrowings from the operating line.

The Company's continuing contractual obligations and commercial commitments existing on June 30, 2008 are as follows:

| | Payments due by period (in thousands) | | | | |
|---|---|---|---|---|---|
| Contractual Obligations (1) | Total | Less than 1 year | 1 – 3 years | 4 – 5 years | After 5 years |
| Operating leases | $ 13,462 | $ 1,499 | $ 2,756 | $ 2,555 | $ 6,652 |
| Purchase obligations | 700 | 700 | - | - | - |
| Total contractual cash obligations | $ 14,162 | $ 2,199 | $ 2,756 | $ 2,555 | $ 6,652 |

(1) The Company also has $105,000 of contractual obligations related to uncertain tax positions for which the timing and amount of payment can not be reasonably estimated due to the nature of the uncertainties and the unpredictability of jurisdictional examinations in relation to the statute of limitations.

As of June 30, 2008, the Company has entered into a commitment to acquire capital equipment of approximately $700,000.

The Company anticipates that current cash balances and ongoing cash flows from operations will be sufficient to fund the Company's operating needs in the near term. At June 30, 2008, the Company had standby letters of credit totaling $4.4 million, which includes secured bank guarantees under the Company's credit facility in Europe and letters of credit securing certain self-insurance contracts and lease commitments. If the Company fails to meet its contractual obligations, these bank guarantees and letters of credit may become liabilities of the Company. The Company has no off-balance sheet arrangements or transactions, or arrangements or relationships with "special purpose entities."

Future Accounting Changes

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," which establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather it eliminates inconsistencies in the guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is evaluating the potential effects of this standard, although the Company does not expect the adoption of SFAS No. 157 to have a material effect on its financial position, results of operation, or cash flows.

In February 2007, the FASB issued Statement 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to elect to measure certain financial instruments and other items at fair

value. The fair value option may be applied on an instrument by instrument basis, is irrevocable and is applied only to entire instruments. SFAS 159 requires additional financial statement presentation and disclosure requirements for those entities that elect to adopt the standard and is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 159 to have a material effect on its financial position, results of operations or cash flows.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." This position states that unvested share-based

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payment awards that contain nonforfeitable rights to dividends (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, "Earnings per Share." FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008. All prior period EPS data will be required to be adjusted to conform to the provisions of this pronouncement and early application is prohibited. The Company does have participating securities as described under this pronouncement but has not yet determined the effect of FSP EITF 03-6-1.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company has assessed its exposure to market risks for its financial instruments and has determined that its exposures to such risks are generally limited to those affected by the value of the U.S. dollar compared to the Euro and to a lesser extent the Australian dollar, Mexican Peso and Chinese Renminbi (RMB).

The terms of sales to European customers are typically denominated in either Euros or U.S. dollars. The terms of sales to customers in Australia are typically denominated in their local currency. The Company expects that its standard terms of sale to international customers, other than those in Europe and Australia, will continue to be denominated in U.S. dollars, although as the Company expands its operations in Latin America and China, transactions denominated in those countries' local currencies may increase. For sales transactions between international customers, including European customers, and the Company's domestic operations, which are denominated in currencies other than U.S. dollars, the Company assesses its currency exchange risk and may enter into forward contracts to minimize such risk. At June 30, 2008, the Company was not a party to any currency hedging transaction. As of June 30, 2008, management estimates that a 10% change in foreign exchange rates would affect net earnings before taxes by approximately $630,000 on an annual basis as a result of converted cash, accounts receivable, loans to foreign subsidiaries, and sales or other contracts denominated in foreign currencies.

As of June 30, 2008, the Euro gained a net of 9.4% in value against the U.S. dollar compared to its value at September 30, 2007. During the nine-month period ended June 30, 2008, changes in the value of the Euro against the U.S. dollar ranged between a 2.3% gain and a 9.7% gain for the period. Other currencies also gained in value against the U.S. dollar. The effect of these fluctuations on the operations and financial results of the Company were:

- Translation adjustments of $386,000, net of income tax, were recognized as a component of comprehensive income for the first nine months of fiscal 2008 as a result of converting the Euro denominated balance sheet of Key Technology B.V. and Suplusco Holding B.V. into U.S. dollars and, to a lesser extent, the conversion of the Australian dollar balance sheet of Key Technology Australia Pty. Ltd., the RMB balance sheet of Key Technology (Shanghai) Trading Co. Ltd., the Singapore dollar balance sheet of Key Technology Asia-Pacific Pte Ltd., and the Peso balance sheet of Productos Key Mexicana into U.S. dollars.

- Foreign exchange gains of $390,000 for the first nine months of fiscal 2008 were recognized in the other income and expense section of the consolidated statement of operations as a result of conversion of Euro and other foreign currency denominated receivables, intercompany loans and cash carried on the balance sheet of the U.S. operations, as well as the result of the conversion of other non-functional currency receivables, payables, and cash carried on the balance sheet of the European, Australian, Chinese, Singapore, and Mexican operations.

The U.S. dollar weakened during the nine-month period ended June 30, 2008 and the U.S. dollar is still in a relatively weak position on the world markets. A relatively weaker U.S. dollar on the world markets makes the Company's U.S.-manufactured goods relatively less expensive to international customers when denominated in U.S. dollars or potentially more profitable to the Company when denominated in a foreign currency. In addition, the Company's

products may be relatively less expensive to domestic customers compared to products imported to the U.S. On the other hand, materials or components imported into the U.S. by the Company may be more expensive. A relatively weaker U.S. dollar on the world markets, especially as measured against the Euro, may favorably affect the Company's market and economic outlook for international sales. The Company's Netherlands-based subsidiary transacts business primarily in Euros and does not have significant exports to the U.S.

Under the Company's credit facilities, the Company may borrow at the lender's prime rate minus 175 basis points or LIBOR plus 100 basis points on its domestic credit facility and at the lender's prime rate plus 175 basis points on its European credit facility. At June 30, 2008, the Company had no borrowings which had variable interest



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rates. During the nine-month period then ended, interest rates applicable to its variable rate credit facilities ranged from 3.25% to 7.4%. At June 30, 2008, the rate was 3.25% on its domestic credit facility and 7.4% on its European credit facility. As of June 30, 2008 management estimates that a 100 basis point change in these interest rates would not affect net income before taxes because the Company had no borrowings outstanding under its variable interest rate facilities.

## ITEM 4. CONTROLS AND PROCEDURES

The Company's management, with the participation of its Chief Executive Officer and Chief Financial Officer, have evaluated the disclosure controls and procedures relating to the Company at June 30, 2008 and concluded that such controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in reports filed or submitted by the Company under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. There were no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2008 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

# PART II. OTHER INFORMATION

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information about purchases made by or on behalf of the Company during the quarter ended June 30, 2008 of equity securities registered by the Company under Section 12 of the Securities Exchange Act of 1934.

Issuer Purchases of Equity Securities

Stock Repurchase Program (1)

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| April - 30, 2008 | 0 | | 0 | |
| May 1 - 31, 2008 | 0 | | 0 | |
| June 1 - 30, 2008 | 0 | | 0 | |
| Total | 0 | | 0 | 411,748 |

(1) The Company initiated a stock repurchase program effective November 27, 2006. The Company may purchase up to 500,000 shares of its own common stock under the program.

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ITEM 6. EXHIBITS

31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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## 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.

KEY TECHNOLOGY, INC.
(Registrant)

Date: August 8, 2008

By /s/ David M. Camp
David M. Camp
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 8, 2008

By /s/ John J. Ehren
John J. Ehren
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

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EXHIBIT INDEX

| Exhibit | |
|---|---|
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
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