

AUGUST TECHNOLOGY CORP  
Form 10-Q  
August 03, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-30637

**AUGUST TECHNOLOGY CORPORATION**

(Exact name of Registrant as specified in its charter)

**Minnesota**  
(State of incorporation)

**41-1729485**  
(I.R.S. Employer  
Identification No.)

**4900 West 78<sup>th</sup> Street**  
**Bloomington, MN**  
(Address of principal executive offices)

**55435**  
(Zip Code)

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**(952) 820-0080**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address, and former fiscal year, if changed since last report.)

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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined by Exchange Act Rule 12b-2). Yes  No

As of July 31, 2004, there were 17,802,646 shares of common stock outstanding.

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**PART I                      FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**AUGUST TECHNOLOGY CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share amounts)  
(Unaudited)

	June 30, 2004	December 31, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,592	\$ 10,027
Short-term marketable debt securities	44,888	43,528
Accounts receivable, net	15,200	4,094
Inventories	18,699	11,651
Inventories at customers under purchase orders	5,072	2,293
Prepaid expenses and other current assets	2,035	1,631
Total current assets	87,486	73,224
Property and equipment, net	4,798	3,141
Long-term marketable debt securities	5,980	10,295
Purchased technology, net	1,013	1,179
Goodwill	498	498
Other assets	648	610
Total assets	\$ 100,423	\$ 88,947
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 7,629	\$ 5,409
Accrued compensation	1,842	1,146
Accrued liabilities	1,368	1,414
Customer deposits and deferred revenue	5,463	2,436
Total current liabilities	16,302	10,405
Other non-current liabilities	118	65
Total liabilities	16,420	10,470
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value, 42,000,000 shares authorized, 17,801,946 and 17,382,538 shares issued and outstanding, respectively	90,076	88,086
Undesignated capital stock, no par value, 3,000,000 shares authorized, no shares issued or outstanding		
Deferred compensation related to stock options	(24)	(49)

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Accumulated deficit		(5,959)		(9,578)
Accumulated other comprehensive income (loss)		(90)		18
Total shareholders' equity		84,003		78,477
Total liabilities and shareholders' equity	\$	100,423	\$	88,947

See accompanying notes to consolidated financial statements.

**AUGUST TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net revenues	\$ 19,855	\$ 7,757	\$ 36,255	\$ 14,320
Cost of revenues	9,059	3,548	16,117	6,503
Gross profit	10,796	4,209	20,138	7,817
Selling, general and administrative expenses	5,390	3,213	10,579	6,420
Research and development expenses	3,322	2,434	6,230	5,202
Operating income (loss)	2,084	(1,438)	3,329	(3,805)
Interest income	189	78	390	176
Income (loss) before provision for income taxes	2,273	(1,360)	3,719	(3,629)
Provision for income taxes	100		100	
Net income (loss)	\$ 2,173	\$ (1,360)	\$ 3,619	\$ (3,629)
Net income (loss) per share:				
Basic	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)
Diluted	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)

See accompanying notes to consolidated financial statements.

**AUGUST TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2004	2003
Cash flows from operating activities:		
Net income (loss)	\$ 3,619	\$ (3,629)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,019	816
Provision for doubtful accounts	79	81
Amortization of deferred compensation related to stock options	27	27
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	(11,185)	2,120
Inventories	(7,048)	1,098
Inventories at customers under purchase orders	(2,779)	(2,383)
Prepaid expenses and other current assets	(402)	(114)
Accounts payable	2,220	1,378
Accrued compensation	696	156
Accrued liabilities	9	94
Customer deposits and deferred revenue	3,027	3,605
Net cash provided by (used in) operating activities	(10,718)	3,249
Cash flows from investing activities:		
Purchases of marketable securities	(91,499)	(18,097)
Maturities of marketable securities	94,356	16,245
Purchases of property and equipment	(2,455)	(588)
Cash paid for acquisitions	(17)	(1,370)
Investments in other assets	(77)	
Net cash provided by (used in) investing activities	308	(3,810)
Cash flows from financing activities:		
Net proceeds from issuances of common stock	1,988	176
Net cash provided by financing activities	1,988	176
Effect of exchange rates on cash and cash equivalents	(13)	2
Net decrease in cash and cash equivalents	(8,435)	(383)
Cash and cash equivalents at beginning of period	10,027	1,895
Cash and cash equivalents at end of period	\$ 1,592	\$ 1,512
Supplemental cash flow information:		
Cash refunds (payments) of income taxes, net	\$ (78)	\$ 250
Common stock issued for acquisition	\$	\$ 756

See accompanying notes to consolidated financial statements.



**AUGUST TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2004**

**(In thousands, except per share amounts)**

**(Unaudited)**

**Note 1 Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to such rules and regulations. In the opinion of the management of August Technology Corporation (collectively with its subsidiaries, the Company), all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included in the consolidated balance sheet at June 30, 2004, the consolidated results of operations for the three and six months ended June 30, 2004 and 2003, and the consolidated statements of cash flows for the six months ended June 30, 2004 and 2003. The results of operations of the interim periods are not necessarily indicative of the results of operations that may be expected for any other period or for the year as a whole. These consolidated financial statements and notes hereto should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, filed with the Securities and Exchange Commission on March 1, 2004.

The accompanying consolidated financial statements include the accounts of August Technology Corporation and its wholly owned subsidiaries. All significant intercompany balances and transactions are eliminated in consolidation.

**Note 2 Business Combinations**

On July 27, 2004, the Company purchased certain assets relating to the DMSVision Software business of Inspex, Inc. for a purchase price of \$2.1 million plus future consideration based on DMSVision software revenues resulting from new orders received in the twelve months after the purchase. The purchase was made pursuant to an Asset Purchase Agreement between the Company and Inspex Inc dated June 23, 2004 and was approved by the United States Bankruptcy Court for the District of Massachusetts.

**Note 3 Marketable Securities**

The amortized cost and estimated fair value of available-for-sale marketable debt securities were as follows:

	June 30, 2004					
	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses	Fair Value
Corporate bonds	\$ 13,846	\$	2	\$	(47)	\$ 13,801
Municipal bonds	37,082		1		(16)	37,067
	\$ 50,928	\$	3	\$	(63)	\$ 50,868

	December 31, 2003					
	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses	Fair Value
Corporate bonds	\$ 12,484	\$	35	\$	(2)	\$ 12,517
Municipal bonds	41,301		7		(2)	41,306
	\$ 53,785	\$	42	\$	(4)	\$ 53,823

The maturities of available-for-sale marketable debt securities were as follows:

	June 30, 2004			December 31, 2003		
	Amortized Cost		Fair Value	Amortized Cost		Fair Value
Due within one year	\$ 44,919	\$	44,888	\$ 43,524	\$	43,528
Due after one year through three years	6,009		5,980	10,261		10,295
	\$ 50,928	\$	50,868	\$ 53,785	\$	53,823

Net realized gains and losses were not material for the six months ended June 30, 2004 and the year ended December 31, 2003.

**Note 4 Accounts Receivable**

Accounts receivable consisted of the following:

	June 30, 2004		December 31, 2003
Billed receivables	\$ 13,303	\$	3,837
Unbilled revenue	2,550		812
	15,853		4,649
Allowance for doubtful accounts	(653)		(555)
Accounts receivable, net	\$ 15,200	\$	4,094

**Note 5 Inventories**

Inventories consisted of the following:

	June 30, 2004		December 31, 2003
Raw materials	\$ 6,909	\$	4,645
Work in process	3,017		2,305
Demonstration equipment	2,550		1,603
Finished goods	6,223		3,098
Inventories	\$ 18,699	\$	11,651

**Note 6 Purchased Technology**

As of June 30, 2004, purchased technology was \$1,377 and related accumulated amortization of \$364. Purchased technology is amortized on a straight-line basis over an estimated useful life of four years. Amortization expense for the six months ended June 30, 2004 and 2003 was \$174 and \$18, respectively. Assuming no change in the gross carrying value of purchased technology, the estimated amortization expense for the twelve months ending December 31, 2004 is \$342 and for each of the next four years is \$342, \$342, \$155 and none thereafter.

**Note 7 Accumulated Other Comprehensive Income (Loss)**

The accumulated balances for each classification of accumulated other comprehensive income (loss) are as follows:

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	<b>June 30, 2004</b>		<b>December 31, 2003</b>
Currency translation adjustments	\$	(30)	\$ (20)
Net unrealized gain (loss) on marketable securities		(60)	38
Accumulated other comprehensive income (loss)	\$	(90)	\$ 18

**Note 8 Shareholders Equity**

Changes in shareholders equity during the six months ended June 30, 2004 were as follows:

Shareholders equity balance at December 31, 2003	\$	78,477
Net income		3,619
Accumulated other comprehensive loss:		
Foreign currency translation adjustment		(10)
Net unrealized loss on marketable debt securities		(98)
Comprehensive income		3,511
Issuances of common stock in conjunction with:		
Exercises of employee stock options and warrants		1,851
Employee stock purchase plan		137
Amortization of deferred compensation related to stock options		27
Shareholders equity balance at June 30, 2004	\$	84,003

On September 23, 2003, the Company sold 3,000 shares of its Common Stock at a price of \$13.00 per share in a follow-on public offering (the Offering). In conjunction with the Offering, on October 21, 2003, the underwriters exercised their over-allotment option to acquire an additional 490 shares of Common Stock at the same price to the public and with the same underwriting discount as the Offering. The net proceeds from the Offering, including the exercise of the underwriters over-allotment, after deducting the underwriting discount and offering expenses, was \$42,049.

**Net Income (Loss) Per Share**

The components of basic and diluted net income (loss) per share were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income (loss)	\$ 2,173	\$ (1,360)	\$ 3,619	\$ (3,629)
Weighted average common shares:				
Basic	17,778	13,352	17,700	13,255
Effect of dilutive stock options and warrants	571		721	
Diluted	18,349	13,352	18,421	13,255
Net income (loss) per share:				
Basic	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)
Diluted	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)

The total weighted average number of stock options and warrants excluded from the calculation of potentially dilutive securities either due to the exercise price exceeding the average market price or the inclusion of such securities in a calculation of net income (loss) per share would have been anti-dilutive for the three months ended June 30, 2004 and 2003 were 330 and 1,886, respectively, and for the six months

ended June 30, 2004 and 2003 were 218 and 1,851, respectively.

**Stock-based Compensation**

The Company applies Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock-based compensation. The exercise price of the Company's stock options equals the market price of the underlying stock on the date of grant for all options granted, and thus, under APB 25, no compensation expense is recognized in the consolidated statements of operations.

The estimated per share weighted average fair value of all stock options granted during the three months ended June 30, 2004 and 2003 was \$9.53 and \$2.79, respectively, and for the six months ended June 30, 2004 and 2003 was \$9.91 and \$2.72, respectively. The fair value of each option grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Expected life	5.5 years	5.8 years	4.3 years	5.5 years
Risk free interest rate	3.6%	3.0%	2.8%	2.9%
Volatility	73.7%	75.1%	74.1%	75.2%
Dividend yield				

Had the Company recorded compensation cost based on the estimated fair value on the date of grant, as defined by SFAS 123, the Company's pro forma net income (loss) would have been as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income (loss), as reported	\$ 2,173	\$ (1,360)	\$ 3,619	\$ (3,629)
Stock-based employee compensation expense determined under fair value based method for all awards	(521)	(377)	(1,674)	(675)
Net income (loss), pro forma	\$ 1,652	\$ (1,737)	\$ 1,945	\$ (4,304)
Net income (loss) per share:				
As reported:				
Basic	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)
Diluted	\$ 0.12	\$ (0.10)	\$ 0.20	\$ (0.27)
Pro forma:				
Basic	\$ 0.09	\$ (0.13)	\$ 0.11	\$ (0.32)
Diluted	\$ 0.09	\$ (0.13)	\$ 0.11	\$ (0.32)

**Note 9 Commitments and Contingencies**

*Warranties*

The Company provides warranty coverage for its systems for a period of one year, including parts and labor necessary to repair the systems during the warranty period. The estimated warranty cost is based on our historical experience rate of incurred expenses to corresponding system revenues.

The following table summarizes the activity related to the warranty liability during the six months ended June 30, 2004 and 2003:

	Six Months Ended June 30,			
	2004		2003	
Accrual at beginning of year	\$	239	\$	111
Warranties issued		415		137
Costs incurred		(271)		(79)
Accrual at end of period	\$	383	\$	169

### **Legal Proceedings**

The Company has fully settled the commercial litigation between the Company and Rudolph Technologies, Inc. ( Rudolph ). On September 23, 2003, the Company and its subsidiary, Semiconductor Technologies & Instruments, Inc. ( STI ), filed a complaint against Rudolph and its subsidiary ISOA, Inc. ( ISOA ). In the complaint, the Company and STI sought a declaratory judgment that the Company and STI were not using ISOA technology in their products. STI also asserted a claim for breach of contract to recover amounts STI paid to ISOA in connection with a joint development agreement between STI and ISOA. Rudolph and ISOA filed an answer and counterclaim, denying the allegations set forth in the complaint and claiming that ISOA was entitled to damages for STI s alleged breach of the joint development agreement. ISOA also sought a declaratory judgment that STI and/or the Company were wrongfully using ISOA s technology without compensating ISOA and that ISOA was entitled to royalty payments for use of its technology.

The Company acquired STI from ASTI Holdings, Ltd. ( ASTI ) in April 2003. In connection with the acquisition, ASTI agreed to indemnify the Company for claims relating to STI s dispute with Rudolph and ISOA, up to a maximum value of \$670. To secure ASTI s performance of ASTI s indemnification obligations, ASTI and August created an escrow.

On July 22, 2004, the Company, STI, Rudolph, ISOA agreed to settle all claims between the parties. Under the terms of the confidential settlement, ASTI will make a one-time payment out of the escrow to Rudolph in the amount of \$503. The Company, STI, Rudolph and ISOA agreed to release any and all claims against each other relating to the joint development agreement and to dismiss all claims asserted in the litigation with prejudice.

### **Note 10 Recently Issued Accounting Pronouncements**

In December 2003, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation ( FIN ) No. 46R, *Consolidation of Variable Interest Entities* , which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* , which was issued in January 2003. The Company is required to apply FIN 46R to variable interests in variable interest entities ( VIE ) created after December 31, 2003. For variable interests in VIEs created before January 1, 2004, the Interpretation will be applied beginning on January 1, 2005. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying

amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The Company believes it has no variable interest entities and, therefore, FIN 46R did not have an impact on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. The Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For the Company, the Statement was effective for instruments entered into or modified after May 31, 2003, and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for the Company on January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. The Company currently does not have any financial instruments that are within the scope of the Statement.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Cautionary Factors That May Affect Future Results

Certain statements made in this Quarterly Report on Form 10-Q, as well as oral statements made by us from time to time, which are prefaced with words such as expects, anticipates, believes, projects, intends, plans and similar words and other statements of similar sense, are forward-looking statements. Our forward-looking statements generally relate to our growth strategies, financial results, future financial projections, product development activities and sales efforts. Our actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, including but not limited to market acceptance of our products, our ability to successfully develop new products, our ability to protect our intellectual property, our dependence upon international customers and suppliers, our dependence on a small number of customers that account for a significant portion of revenues, availability of products from our suppliers, cyclicity in the microelectronic manufacturing equipment and other industries, management of growth, integration of acquired businesses, and the other risk factors detailed below and in our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 1, 2004. We disclaim any obligation to revise forward-looking statements, or to update the reasons actual results could differ materially from those anticipated, to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Because many factors are unforeseeable, the foregoing should not be considered an exhaustive list.

### Introduction

The following discussion of our results of operations and financial condition should be read together with the other financial information and consolidated financial statements and related notes included in this Form 10-Q. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of a variety of factors.

### Critical Accounting Policies

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We based these estimates and assumptions on historical experience and evaluate them on an on-going basis to help ensure they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the audit committee of our board of directors on a quarterly basis, and the audit committee has reviewed the Company's critical accounting policies as described in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2003. For the six months ended June 30, 2004, there were no changes to these critical accounting policies.

## Overview

We are a world-class provider of automated defect detection and product characterization systems for microelectronic device manufacturers. Our systems provide manufacturers with information that enables process-enhancing decisions, ultimately lowering manufacturing costs and decreasing time-to-market. We sell our systems to many of the leading microelectronic device manufacturers throughout the world for inspecting semiconductors, advanced packaging applications, optoelectronics devices, MEMS, data storage devices and micro displays. We have traditionally provided systems to address the automated inspection needs of the early stages of the final manufacturing or back-end of the microelectronic device manufacturing process. These needs were met primarily with our NSX Series and 3Di Series of products. We recently introduced the AXi Series, E20 and B20 inspection options for advanced macro detection in the front-end of the wafer manufacturing process. When used in conjunction with one another these systems allow a manufacturer to inspect the top, edge and back of a wafer's surface. We believe we are the first to offer all surface wafer inspection. We complement this broad inspection capability with an expanding suite of software tools designed to enhance the speed and effectiveness of the process by which device manufacturers analyze defects, and make decisions regarding their manufacturing process to reduce or eliminate such defects. We refer to this process as the detection-to-decision process. We believe a key to our success in establishing and maintaining a leadership position in our served markets has been our ability to introduce innovative inspection and defect review solutions that provide microelectronic device manufacturers yield improving information about their increasingly complex manufacturing processes.

In addition to internal development, we look to expand through strategic acquisitions of complementary products and technologies. In April 2003 we completed the acquisition of STI, adding the WAV Series for high speed wafer probe mark inspection and metrology. In July 2003 we acquired the assets of CSI, including the design for the VersaScope, a recently introduced defect review system for advanced microscope-based imaging and analysis. The VersaScope provides us the ability to serve our customers earlier in their device development process and to more quickly analyze defects and understand their manufacturing process once they initiate high volume production. In July 2004 we acquired certain assets of the DMSVision Software business of Inspex, Inc. We plan to use the DMSVision Software to further expand and enhance our current defect analysis software offerings.

Our business is subject to the highly cyclical nature of the microelectronic device manufacturing markets we serve. These cycles are caused by significant fluctuations in the supply and demand of microelectronic devices driven by such factors as changes in technology and global economic conditions. As a result of these fluctuations, our quarterly orders and revenues have fluctuated dramatically. After a three year industry downturn we began to experience signs of an industry recovery during the second half of 2003. The recovery has continued through the first half of 2004. This has resulted in a significant increase in the level of orders and revenues during this period, and a record level of backlog at June 30, 2004. Although we do not believe backlog is always a meaningful or accurate indication of future revenues and performance, since only a portion of our revenues for any quarter represents systems in backlog, we do closely monitor the level of orders both geographically and by product line and in relation to the level of revenues, referred to as the book-to-bill ratio. During the second quarter of 2004 our book-to-bill ratio was above parity for the eighth consecutive quarter. A book-to-bill ratio greater than parity indicates a growing level of backlog.

In addition to monitoring our level of orders and backlog, we focus on several key financial metrics in evaluating our financial condition and operating performance, most importantly revenues by product family compared to prior-period and current-year plans, year-over-year revenue growth compared to the overall semiconductor equipment industry, operating profit or loss performance compared with prior-period and current-year plans and the level of operating cash flow.

In response to the current increase in activity we have added and continue to recruit additional staff in all functional areas and increased our manufacturing levels to meet the increased demand. However, we cannot predict the sustainability of the current recovery, and/or the industry's rate of growth. If we are unable to effectively manage our resources and production capacity during an industry cycle, there could be a material adverse effect on our business, financial condition and results of operations.

We anticipate that future quarterly and annual results will continue to be impacted by fluctuations in supply and demand of microelectronic devices, the timing of new product announcements and releases by us or our competitors, market acceptance of new or enhanced versions of our products, changes in the pricing of our products and the timing and level of our research and development expenditures.

## Results of Operations

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	45.6	45.7	44.5	45.4
Gross profit	54.4	54.3	55.5	54.6
Selling, general and administrative expenses	27.2	41.4	29.2	44.9
Research and development expenses	16.7	31.4	17.1	36.3
Operating income (loss)	10.5	(18.5)	9.2	(26.6)
Interest income	0.9	1.0	1.1	1.2
Net income (loss) before provision for income taxes	11.4	(17.5)	10.3	(25.4)
Provision for income taxes	0.5		0.3	
Net income (loss)	10.9%	(17.5)%	10.0%	(25.4)%

*Three and six months ended June 30, 2004 compared to the three and six months ended June 30, 2003*

*Net Revenues.* Net revenues increased \$12.1 million, or 156.0%, to \$19.9 million for the three months ended June 30, 2004, from \$7.8 million for the same period in 2003. Net revenues increased \$21.9 million, or 153.2%, to \$36.3 million for the six months ended June 30, 2004, from \$14.3 million for the same period in 2003. The increase in net revenues was primarily due to increased sales of higher throughput NSX Series systems installed in a broader array of wafer and device fabrication processes and sales related to the AXi Series, for which we began to recognize revenue during the third quarter of 2003. Net revenues also increased as a result of the recognition revenues from the sale of the first VersaScope systems. Sales of these product lines increased primarily as a result of higher sales of systems

into the front end of the wafer fabrication process and an overall increase in demand due to the industry recovery that began in the second half of 2003. Revenues are expected to continue to increase during the second half of 2004 due to the

recognition of revenues currently in backlog as of June 30, 2004 and anticipated continued strength of the overall microelectronic industry.

Net revenues from international sales represented 71% and 69% of total net revenues for the three months ended June 30, 2004 and 2003. International revenues during the three months ended June 30, 2004 consisted entirely of sales to customers in Asia. The increase in the percentage of net revenues from Asia was partially offset by a decrease in net revenues from Europe, which comprised 11% of net revenues in the prior year. Net revenues from international sales represented 71% and 68% of net revenues for the six months ended June 30, 2004 and 2003, and were primarily the result of sales to Asia, which comprised 69% and 57% of total net revenues.

*Gross Margin.* Gross margin increased slightly to 54.4% for the three months ended June 30, 2004, from 54.3% for the same period in 2003. Gross margin increased to 55.5% for the six months ended June 30, 2004, from 54.6% for the same period in 2003. Gross margins increased due to an increase in the number of systems manufactured, which resulted in higher manufacturing utilization and decreased labor and overhead per system sold, and increased revenue from our YieldPilot product line. This increase was offset by lower gross margins on sales of our AXi Series and NSX Series product lines due to an increase in the number of systems sold that included automated material handling subsystem options, which have lower gross margins than our core inspection systems, and lower margins on revenues from the first VersaScope systems due to the higher costs of the initial systems manufactured. In addition, we have experienced pricing pressure primarily related to our inspection systems sold into final manufacturing applications as competitors have continued to enter this market.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses consist primarily of employee salaries and related benefits, travel expenses and occupancy related costs. Selling, general and administrative expenses were \$5.4 million and \$10.6 million for the three and six months ended June 30, 2004, compared to \$3.2 million and \$6.4 million for the same periods in 2003. Selling, general and administrative expenses as a percentage of net revenues were 27.2% and 29.2% for the three and six months ended June 30, 2004, compared to 41.4% and 44.9% of net revenues for the same periods in 2003. The increase in expense dollars was primarily the result of increased variable costs associated with the increased level of revenues, employee compensation costs, including salaries related to the hiring of additional field service and sales personnel to support the increased revenues and our direct sales and service office in Korea, which opened in February 2004, and expenses associated with the ongoing operations of two acquisitions completed during the second and third quarters of 2003. The quarterly selling, general and administrative expense dollars are expected to increase in the third quarter of 2004, as compared to the first quarter, primarily as a result of variable expenses associated with the expected higher level of revenues, and increased headcount to support the increased revenues and further develop our organization to meet increased customer demands. However, selling, general and administrative expenses as a percentage of revenues are expected to decrease, as revenues are expected to increase at a higher rate than the increase in selling, general and administrative expenses.

*Research and Development Expenses.* Research and development expenses consist primarily of employee salaries and related benefits and consulting fees for individuals engaged in the research, design and development of new products. Research and development expenses were \$3.3 million and \$6.2 million for the three and six months ended June 30, 2004, compared to \$2.4 million and \$5.2 million for the same periods in 2003. Research and development expenses as a percentage of net revenues were 16.7% and 17.1% for the three and six months ended June 30, 2004, compared to

31.4% and 36.3% for the same periods in 2003. The increase in expense dollars was primarily due

to employee compensation and related benefits associated with the hiring of additional staff and an increase in the use of outside contractors to complete certain stages of development of the B20 back-side inspection option and VersaScope, and further enhancements to both the NSX Series and AXi Series. In addition, expenses increased due to two acquisitions completed during the second and third quarters of 2003. We anticipate that research and development expenses, both in dollars and as a percentage of revenues, will increase in the third quarter of 2004, as compared to the second quarter of 2004 due to development projects related to the continued expansion of our business in the front-end of the wafer manufacturing process and expansion of our suite of software solutions.

*Interest Income.* Interest income was \$189,000 and \$390,000 for the three and six months ended June 30, 2004, compared to \$78,000 and \$176,000 for the same periods in 2003. The increase in interest income was primarily due to an increase in overall investment balances, as a result of the proceeds received from a follow-on public offering of our Common Stock that was completed on September 23, 2003 and the underwriters' exercise of the over-allotment option on October 21, 2003 (the "Offering").

*Income Taxes.* As a result of historical operating losses and uncertainty as to the extent of profitability in future periods, we began to record a valuation allowance against our deferred tax assets in the second quarter of 2002 and continue to do so at June 30, 2004. As a result, we did not reflect a provision for income taxes during the three and six months ended June 30, 2003, and have recorded a provision for income taxes of \$100,000 during the three and six months ended June 30, 2004, primarily to reflect alternative minimum tax owed on our pretax income. Statement of Financial Accounting Standards (SFAS) No. 109 "Accounting for Income Taxes," requires the establishment of a valuation allowance to reflect the likelihood of the realization of deferred tax assets. We expect to record a similar provision for income taxes during the second half of 2004. As of December 31, 2003 the valuation allowance was \$7.5 million.

### **Liquidity and Capital Resources**

During the six months ended June 30, 2004, working capital increased to \$71.2 million as compared to \$62.8 million at December 31, 2003. The increase was primarily due to an increase in both accounts receivable and inventories. At June 30, 2004 our principal sources of liquidity consisted of cash, cash equivalents and marketable debt securities of \$52.5 million. We have no outstanding debt at June 30, 2004. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of our business, the most significant of which includes the timing of the collection of receivables, the level of inventories, capital expenditures and acquisitions.

*Accounts Receivable.* Our accounts receivable increased \$11.1 million from December 31, 2003 to June 30, 2004. Our days sales outstanding (DSO) during the three months ended June 30, 2004 was 59 days. This compares to a DSO of 41 days in the first quarter of 2004. Due to the high mix of international revenues during a given quarter, which generally require a longer time for collection, we believe our DSO will be between 60 and 70 days in future quarters.

*Inventories.* Inventories increased \$7.0 million from December 31, 2003 to June 30, 2004. The increase is primarily due to the need to support new product introductions, increased backlog and increased demonstration equipment at customers under evaluation.



*Inventories at Customers under Purchase Orders.* Inventories at customers under purchase orders increased \$2.8 million from December 31, 2003 to June 30, 2004, primarily due to shipments of newer models of our NSX Series that have not yet qualified for revenue recognition. We anticipate that a portion of this inventory will be recognized as revenue during the third quarter of 2004. We anticipate that this inventory will increase as shipments of newly introduced products increase.

*Capital Expenditures.* Our capital expenditures during the first six months of 2004 were \$2.5 million, consisting primarily of the capitalization of finished goods used to support our engineering, sales and service efforts. Our total capital expenditures are expected to be between \$4.0 million and \$5.0 million in 2004 as we expand the use of internal test and development equipment and facilities to meet increased customer demand.

Our liquidity is also affected by factors beyond our control related to the uncertainties of global economies and the cyclical nature of the semiconductor and microelectronic industries. Although liquidity requirements will fluctuate based on the timing and extent of all of these factors and others, management believes that existing cash and investment balances will be adequate to satisfy our existing liquidity requirements for at least the next twelve months.

#### *Cash Flows*

Net cash used in operating activities for the six months ended June 30, 2004 was \$10.7 million, which resulted primarily from increased accounts receivable and inventories partially offset by our net income and increased accounts payable and customer deposits. Net cash provided by investing activities was \$308,000, primarily due to \$2.9 million of net proceeds from sales of marketable securities and partially offset by \$2.5 million for purchases of property and equipment. Net cash provided by financing activities was \$2.0 million from the proceeds received from issuances of common stock. We currently expect to generate cash flow from operating activities during the second half of 2004. Cash flows used in investing activities will include the \$2.1 million purchase price for the DMSVision software acquisition and capital expenditures to be between \$1.5 million and \$2.5 million during the second half 2004.

Net cash provided by operating activities for the six months ended June 30, 2003 was \$3.2 million, which resulted primarily from decreased accounts receivable and increased customer deposits and accounts payable partially offset by our net loss and increased inventory during the period. Net cash used in investing activities was \$3.8 million, primarily due to \$1.8 million of net purchases of marketable securities, \$1.4 million of cash paid to acquire STI and \$588,000 for purchases of property and equipment. Net cash provided by financing activities was \$176,000 proceeds received from issuances of common stock.

#### **New Accounting Pronouncements**

In December 2003, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation ( FIN ) No. 46R, *Consolidation of Variable Interest Entities* , which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* , which was issued in January 2003. We are required to apply FIN 46R to variable interests in variable interest entities

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( VIE ) created after December 31, 2003. For variable interests in VIEs created before January 1, 2004, the Interpretation will be applied beginning on January 1, 2005. For any VIEs that

must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. We believe that we have no variable interest entities and, therefore, FIN 46R did not have an impact on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. The Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For us, the Statement was effective for instruments entered into or modified after May 31, 2003, and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for us on January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. We currently do not have any financial instruments that are within the scope of the Statement and, therefore, SFAS 150 did not have an effect on our consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

#### *Market Risk*

We are exposed to market risk primarily from changes in interest rates and credit risk. We do not have material exposure to market risk from fluctuations in foreign currency exchange rates because all sales are made in U.S. dollars.

#### *Interest Rate Risk*

We are exposed to interest rate risk primarily from investments in cash equivalents and short-term and long-term marketable debt securities (the Investment Portfolio). The entire Investment Portfolio, classified as available-for-sale, is recorded on the balance sheet at fair market value with unrealized gains or losses excluded from earnings and included in Accumulated other comprehensive income (loss) until realized. The entire Investment Portfolio is denominated in U.S. dollars. We do not use derivative financial instruments in the Investment Portfolio. Due to the short duration of our Investment Portfolio, an immediate 100 percent change in interest rates is not expected to have a material adverse effect on our near-term financial condition or results of operations.

#### *Credit Risk*

Financial instruments which potentially subject us to credit risk consist principally of securities in the Investment Portfolio and trade receivables. We limit credit risk related to the Investment Portfolio by placing all investments with high quality credit issuers and limit the amount of investments with any one issuer. As of June 30, 2004, 88.2% of the Investment Portfolio consisted of government securities and corporate commercial paper and bonds with maturities of one year or less. We limit credit risk associated with trade receivables by performing ongoing credit evaluations and believe that there is no additional risk beyond amounts provided for collection losses to be inherent in trade

receivables.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

As of the end of the period covered by this report, the Company conducted an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, regarding the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rules 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information that is required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission.

*Changes in Internal Controls*

There were no changes in the Company's internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company has fully settled the commercial litigation between the Company and Rudolph Technologies, Inc. (Rudolph). On September 23, 2003, the Company and its subsidiary, Semiconductor Technologies & Instruments, Inc. (STI), filed a complaint against Rudolph and its subsidiary ISOA, Inc. (ISOA). In the complaint, the Company and STI sought a declaratory judgment that the Company and STI were not using ISOA technology in their products. STI also asserted a claim for breach of contract to recover amounts STI paid to ISOA in connection with a joint development agreement between STI and ISOA. Rudolph and ISOA filed an answer and counterclaim, denying the allegations set forth in the complaint and claiming that ISOA was entitled to damages for STI's alleged breach of the joint development agreement. ISOA also sought a declaratory judgment that STI and/or the Company were wrongfully using ISOA's technology without compensating ISOA and that ISOA was entitled to royalty payments for use of its technology.

The Company acquired STI from ASTI Holdings, Ltd. (ASTI) in April 2003. In connection with the acquisition, ASTI agreed to indemnify the Company for claims relating to STI's dispute with Rudolph and ISOA, up to a maximum value of \$670,000. To secure ASTI's performance of ASTI's indemnification obligations, ASTI and August created an escrow.

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On July 22, 2004, the Company, STI, Rudolph, ISOA agreed to settle all claims between the parties. Under the terms of the confidential settlement, ASTI will make a one-time payment out of the escrow to Rudolph in the amount of \$502,500. The Company, STI, Rudolph and ISOA agreed to release any and all claims against each other relating to the joint development agreement and to dismiss all claims asserted in the litigation with prejudice.

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

On April 29, 2004 and May 19, 2004, the Company sold an aggregate of 9,375 shares of common stock at \$1.20 per share upon the exercise of warrants by two holders. The issuances were exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, which provides an exemption for transactions not involving a public offering.

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

The Company held its Annual Meeting of Shareholders on April 28, 2004 at the Company's world headquarters at 4900 West 78 Street, Bloomington, Minnesota. Of the 17,695,930 shares of Common Stock outstanding as of March 4, 2004 (the record date), 16,105,956 shares (91%) were present or represented by proxy at the meeting.

1. The shareholders approved the Board of Director's recommendation for setting the number of directorships at five. This proposal received 15,998,581 votes for and 82,186 votes against, with 25,189 votes abstaining.

2. The shareholders elected Jeff L. O Dell and Michael W. Wright as Class I Directors, pursuant to the following votes:

	Votes For	Votes Withheld
Jeff L. O Dell	15,404,397	701,559
Michael W. Wright	15,644,174	461,782

The terms of Linda Whitman, as a Class II director and James A. Bernards and Roger E. Gower as Class III directors of the Company, were not subject to reelection at this meeting and thus their terms continued after the meeting.

3. The shareholders approved an amendment to the Company's Restated 1997 Stock Incentive Plan (the Plan) to increase the number of shares of Common Stock reserved for issuance from 3,050,000 to 4,250,000 shares. In addition, the amendment added restricted stock awards, performance awards, and stock appreciation rights to the incentives offered under the Plan. This proposal received 9,888,302 votes for and 2,611,455 votes against, with 3,606,199 votes abstaining.

4. The shareholders ratified the appointment of KPMG LLP as the Company's independent auditors for the 2004 fiscal year. This proposal received 16,015,829 votes for and 61,539 votes against, with 28,588 votes abstaining.

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits:

The exhibits listed on the Exhibit Index are filed herewith.

(b) Reports on Form 8-K:

Current Report on Form 8-K dated April 28, 2004 and furnished April 28, 2004, was furnished pursuant to Item 9 (Regulation FD Disclosure) in satisfaction of Item 12 (Disclosure of Results of Operations and Financial Condition) to report the press release announcing the Company's first quarter 2004 financial results.

Current Report on Form 8-K dated May 12, 2004 and filed May 13, 2004, was filed pursuant to Item 5 (Other Events) and Item 7 (Financial Statements and Exhibits) to report the adoption of a trading plan under Rule 10b5-1 by a director of the Company.

Current Report on Form 8-K dated June 23, 2004 and filed June 24, 2004, was filed pursuant to Item 5 (Other Events) to report the entering of a purchase agreement with Inspex Inc. for the purchase of certain assets used by Inspex Inc. in connection with its DMSVision software.

**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.

AUGUST TECHNOLOGY CORPORATION

Date: August 3, 2004

By: /s/ JEFF L. O DELL  
Jeff L. O Dell  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 3, 2004

By: /s/ STANLEY D. PIEKOS  
Stanley D. Piekos  
Chief Financial Officer  
(Principal Financial Officer)

Date: August 3, 2004

By: /s/ SCOTT A. GABBARD  
Scott A. Gabbard  
Chief Accounting Officer and  
Vice President, Finance  
(Principal Accounting Officer)

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

EXHIBIT INDEX TO FORM 10-Q

For the quarter ended:  
June 30, 2004

Commission File No.: 000-30637

**AUGUST TECHNOLOGY CORPORATION**

<b>Exhibit Number</b>	<b>Description</b>
10.1	Fifth Amendment to Lease Agreement between the Company and 4900 West 78th Street Bloomington Associates, LLC dated May 27, 2004
31.1	Certification pursuant to Exchange Act Rules 13a-14(a) of the Chief Executive Officer
31.2	Certification pursuant to Exchange Act Rules 13a-14(a) of the Chief Financial Officer
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to the Sarbanes-Oxley Act of 2002