KEY TECHNOLOGY INC
Form 10-Q
May 12, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549-1004

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 March 31, 2006

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

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)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ý

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 April 28, 2006 was 5,351,269 shares.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED UNAUDITED CONSOLIDATED BALANCE SHEETS
MARCH 31, 2006 AND SEPTEMBER 30, 2005

	March 31, 2006	September 30, 2005
	(in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 10,842	$ 13,181
Trade accounts receivable and notes receivable, net	10,850	10,828
Inventories:		
Raw materials	6,845	6,170
Work-in-process and sub-assemblies	6,530	5,700
Finished goods	2,465	2,990
Total inventories	15,840	14,860
Deferred income taxes	2,241	2,382
Other current assets	2,211	1,490
Total current assets	41,984	42,741
Property, plant and equipment, net	4,537	4,264
Deferred income taxes	22	10
Investment in joint venture	1,087	1,254
Goodwill, net	2,524	2,524
Intangibles and other assets, net	5,534	6,734
Total	$ 55,688	$ 57,527
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 3,301	$ 2,280
Accrued payroll liabilities and commissions	3,843	3,957
Accrued customer support and warranty costs	1,445	1,775
Customer purchase plans	644	1,316
Other accrued liabilities	1,718	1,767
Customers' deposits	3,723	3,015
Current portion of long-term debt and capital lease obligations	3	1,121
Total current liabilities	14,677	15,231
Long-term debt and capital lease obligations	-	1,199
Deferred income taxes	276	626
Shareholders' equity:		
Common stock	14,092	15,301
Deferred stock-based compensation	-	(2,057)
Retained earnings and other shareholders' equity	26,643	27,227
Total shareholders' equity	40,735	40,471

Total	$	55,688	$	57,527

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 MARCH 31, 2006 AND 2005

	2006		2005	
	(in thousands, except per share data)			
Net sales	$	19,956	$	18,269
Cost of sales		12,389		11,405
Gross profit		7,567		6,864
Operating expenses:				
Sales and marketing		3,643		3,106
Research and development		1,483		1,176
General and administrative		2,326		2,003
Amortization of intangibles		334		333
Total operating expenses		7,786		6,618
Gain on sale of assets		51		8
Earnings (loss) from operations		(168)		254
Other income (expense)		75		(201)
Earnings (loss) before income taxes		(93)		53
Income tax benefit		(32)		(9)
Net earnings (loss)		(61)		62
Assumed dividends on mandatorily redeemable preferred stock		-		(1)
Net earnings (loss) available to common shareholders	$	(61)	$	61
Net earnings (loss) per share				
- basic	$	(0.01)	$	0.01
- diluted	$	(0.01)	$	0.01
Shares used in per share calculations - basic		5,201		5,009
Shares used in per share calculations - diluted		5,201		5,191

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 SIX MONTHS ENDED MARCH 31, 2006 AND 2005

	2006	2005
	(in thousands, except per share data)	
Net sales	$ 39,152	$ 32,840
Cost of sales	24,507	20,671
Gross profit	14,645	12,169
Operating expenses:		
Sales and marketing	7,264	6,137
Research and development	2,973	2,516
General and administrative	4,776	3,769
Amortization of intangibles	669	664
Total operating expenses	15,682	13,086
Gain on sale of assets	110	13
Loss from operations	(927)	(904)
Other income	61	226
Loss before income taxes	(866)	(678)
Income tax benefit	(295)	(298)
Net loss	$ (571)	$ (380)
Net loss per share		
- basic	$ (0.11)	$ (0.08)
- diluted	$ (0.11)	$ (0.08)
Shares used in per share calculations - basic	5,194	5,001
Shares used in per share calculations - diluted	5,194	5,001

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 SIX MONTHS ENDED MARCH 31, 2006 AND 2005

	2006	2005
	(in thousands)	
Net cash provided by operating activities	$ 606	$ 3,267
Cash flows from investing activities:		
Proceeds from sale of property	143	4
Additions to property, plant and equipment	(1,109)	(482)
Cash paid for acquired company, net of cash acquired	-	(332)
Net cash used in investing activities	(966)	(810)
Cash flows from financing activities:		
Repayment of long-term debt	(2,308)	(698)
Excess tax benefits from stock-based payments	262	-
Redemption of preferred stock	-	(126)
Redemption of warrants	-	(12)
Proceeds from issuance of common stock	158	324
Net cash used in financing activities	(1,888)	(512)
Effect of exchange rates on cash	(91)	98
Net increase (decrease) in cash and cash equivalents	(2,339)	2,043
Cash and cash equivalents, beginning of the period	13,181	8,817
Cash and cash equivalents, end of the period	$ 10,842	$ 10,860
Supplemental information:		
Cash paid during the period for interest	$ 52	$ 91
Cash paid (refunded) during the period for income taxes	$ 63	$ (50)
Depreciation and amortization	$ 1,515	$ 1,581

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 AND SIX-MONTH PERIODS ENDED MARCH 31, 2006

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, 2005. The results of operations for the three and six-month periods ended March 31, 2006 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 March 31, 2006 and the results of its operations and its cash flows for the three and six-month periods ended March 31, 2006 and 2005.

2. Stock compensation

At March 31, 2006, the Company has two stock-based employee compensation plans, which are described more fully in Note 3. Prior to October 1, 2005, the company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. No stock-based employee compensation cost was recognized in the Statement of Operations for the three and six-month periods ended March 31, 2005, as all outstanding unvested options granted under those plans at that time had an exercise price equal to the market value of the underlying common stock on the date of grant and no restricted stock grants were outstanding during that period. Effective October 1, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment*, using the modified-prospective-transition method. Under that transition method, compensation cost recognized in fiscal 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of October 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to October 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated. The adoption of Statement 123(R) had the following effect on the Company’s results:

	Three months ended March 31, 2006		Six months ended March 31, 2006	
	As reported	Without FASB 123(R)	As reported	Without FASB 123(R)
Net earnings (loss) before income taxes	$ (93)	$ 160	$ (866)	$ (452)
Net earnings (loss)	(61)	$ 115	(571)	$ (279)

Net earnings (loss) per share:								
- basic	$	(0.01)	$	0.02	$	(0.11)	$	(0.05)
- diluted	$	(0.01)	$	0.02	$	(0.11)	$	(0.05)

Upon adoption of Statement 123(R), the $2.1 million increase in common stock and the offsetting amount in deferred stock-based compensation, that are both reflected in shareholders' equity at September 30, 2005, have

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been reversed as required by Statement 123(R). The net effect has no change in total shareholders' equity. Prior to the adoption of Statement 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. Statement 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The $262,000 excess tax benefit classified as a financing cash inflow would have been classified as an operating cash inflow if the Company had not adopted Statement 123(R).

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement 123 to options granted under the Company's stock option plans in periods presented prior to the adoption of Statement 123(R). For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' vesting periods.

	Three months ended March 31, 2005	Six months ended March 31, 2005
Net earnings (loss), as reported	$ 62	$ (380)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	$ (80)	$ (154)
Pro forma net loss	$ (18)	$ (534)
Loss per share:		
Basic - as reported	$ 0.01	$ (0.08)
Basic - pro forma	$ 0.00	$ (0.11)
Diluted - as reported	$ 0.01	$ (0.08)
Diluted - pro forma	$ 0.00	$ (0.11)

3. Stock compensation plans

At March 31, 2006, the Company has two stock-based compensation plans, which are shareholder-approved, as described below. The Company has also awarded shares to non-employees. The Company issues new shares of common stock for exercises and awards under these plans and non-employee awards. Effective October 1, 2005, the Company began accounting for stock-based compensation under SFAS No. 123(R) (see Note 2). The stock-based compensation cost has been reflected in the financial statements as follows:

	Three months ended March 31, 2006	Three months ended March 31, 2005	Six months ended March 31, 2006	Six months ended March 31, 2005
Charged to operating expenses	$ 220	$ -	$ 368	$ -
Capitalized into inventory	33	-	60	-
Capitalized inventory expensed to cost of goods sold	33	-	45	-
Income tax benefit	77	-	121	-

Employees' Stock Incentive Plan—Under the Restated Employees' Stock Incentive Plan (the "Incentive Plan"), eligible employees may receive either incentive stock options or nonqualified stock options and such options may be exercised only after an employee has remained in continuous employment for one year after the date of grant. Thereafter, the options become exercisable as stipulated by the individual option agreements,

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generally 25% per year on the anniversary date of the grant for incentive stock options and 100% on the one year anniversary for non-qualified stock options. The contractual term for these options varies from 5-10 years. The option exercise price is the fair market value of the underlying stock at the date of grant. In addition, under the Incentive Plan, eligible employees may be granted restricted stock awards which vest either on employment-based or performance-based measures. At March 31, 2006, the total number of shares reserved for issuance under the Incentive Plan was 869,670, of which 263,906 were available for grant. The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model. Expected volatilities are based on historical volatility of the Company’s stock, and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model: separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury Note five-year rate in effect at the time of grant.

Incentive Stock Options

A summary of option activity under the Incentive Plan as of March 31, 2006 and the six-month period then ended is presented below:

Options	Number of Shares	Weighted-Average Exercise Price		Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)	
Outstanding at October 1, 2005	531,289	$	11.67			
Granted	0		-	-		-
Exercised	(27,900)	$	5.28			
Forfeited or expired	(35,250)	$	11.18			
Outstanding at March 31, 2006	468,139	$	12.09	2.66	$	1,166
Exercisable at March 31, 2006	415,639	$	12.43	2.62	$	1,018

The total intrinsic value of options exercised during the six-month period ended March 31, 2006 was $214,000.

A summary of the status of the Company’s non-vested options as of March 31, 2006 and changes during the six-month period then ended is as follows:

Non-vested Options	Number of Shares	Weighted-Average Grant-date Fair Value	
Non-vested at October 1, 2005	125,090	$	4.68
Granted	0		-
Vested	(57,340)	$	3.67
Forfeited or expired	(15,250)	$	5.07
Non-vested at March 31, 2006	52,500	$	5.69

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As of March 31, 2006, there was $216,000 of total unrecognized compensation cost related to stock options granted under the Incentive Plan. That cost is expected to be recognized over a weighted-average period of eleven months.

Service-Based Stock Awards—Under the Incentive Plan, the Company may award shares of service-based stock grants to selected executives and other key employees whose vesting is contingent upon meeting the required service period, generally three years, or in the case of members of the Board of Directors, one year. The fair value of these grants is based on the average fair market value at the grant date. The restrictions on the grants lapse at the end of the required service period. Stock compensation expense is recognized based on the grant date fair value of the stock over the vesting period.

The summary of activity for service-based stock awards as of March 31, 2006, and changes during the six- month period then ended is presented below:

Service-Based Stock Awards	Number of Shares	Weighted-Average Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at October 1, 2005	52,500	$ 0		
Granted	22,625	$ 0		
Exercised	0			
Forfeited	(15,000)			
Outstanding at March 31, 2006	60,125	$ 0	1.81	$ 736

The weighted-average grant date fair value of these awards was $13.22. The weighted average grant date fair value of awards during fiscal 2006 was $12.28. The number of shares granted during the period that vest in one year is 15,625 and 7,000 vest in three years. As of March 31, 2006, there was $641,000 of total unrecognized compensation cost related to service-based stock awards that is expected to be recognized over a weighted-average period of 1.8 years.

Employee Performance-Based Stock Awards—Under the Incentive Plan, the Company awarded shares of performance-based stock grants to selected executive and other key employees, the lapse of the restrictions on which is contingent upon the increase in the Company’s net earnings over a three-year period beginning with fiscal 2005. If the Company’s net income from continuing operations has a compound annual growth rate of 7.5%, the restrictions on 50% of the shares lapse; at 10%, the restrictions on 80% of the shares lapse; and at 25%, the restrictions on 100% of the shares lapse. The lapse of the restrictions on the shares is linear between the stated levels. No restrictions lapse if the compound annual growth rate is less than 7.5%, and 10% of the shares may be forfeited if net income in any one year does not equal at least 90% of the prior year’s net income from continuing operations, although up to 25% of the forfeited shares may be reinstated at the discretion of the Board of Directors. In addition, recipients must be in continued employment with the Company through December 2007 for the restrictions on the awards to lapse. Compensation expense is recognized over the period the employee performs related services based on the estimated number of shares expected to vest at the grant date fair value and assumes that 77% of the performance goal will be achieved. If the performance goals are not met, no compensation cost is recognized and any recognized compensation cost will be reversed.

A summary of the activity for performance-based stock awards as of March 31, 2006 and changes during the six-month period then ended is presented below:

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Performance-Based Stock Awards	Number of Shares	Weighted-Average Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at October 1, 2005	115,000	$ 0		
Granted	0			
Exercised	0			
Forfeited	(37,500)			
Outstanding at March 31, 2006	77,500	$ 0	1.76	$ 949

The weighted-average grant date fair value of these awards was $13.785. As of March 31, 2006, there was $617,000 of total unrecognized compensation cost related to performance-based stock awards that is expected to be recognized over a period of 1.76 years.

Employee Stock Purchase Plan—Most employees are eligible to participate in the Company's Employee Stock Purchase Plan (the "Purchase Plan"). Shares are not available to employees who already own 5% or more of the Company's stock. Employees can withhold, by payroll deductions, up to 5% of their regular compensation to purchase shares at a purchase price of 85% of the fair market value of the common stock on the purchase date. There were 500,000 shares reserved for purchase under the Purchase Plan of which 411,319 remained available at March 31, 2006.

During the six-month period ended March 31, 2006, the Company issued 2,335 shares under the Purchase Plan and recorded compensation cost based on the 15% discount from market price paid by the employees.

Non-Employee Service-Based Stock Awards—The Company may award shares of service-based stock grants to non-employees. At March 31, 2006, there were 2,000 shares outstanding that had been awarded to non-employees. There were no grants, exercises or forfeitures during the six-month period ending March 31, 2006. Under the terms of the award, 50% of the shares vest if the non-employees perform services through May 31, 2006 and the remaining 50% vest if the services are performed through May 31, 2007. The grants have a weighted-average remaining contractual life of 1.17 years. In accordance with EITF 96-18, the value of the instrument is amortized to expense over the vesting period with final valuation measured on the vesting date. The weighted-average fair value of these shares was $13.785 at the grant date, and at March 31, 2006, the aggregate intrinsic value of these shares was $24,000. At March 31, 2006, there was $18,000 of total unrecognized compensation cost related to these awards that is expected to be recognized over a period of 1.17 years.

Cash received from option and employee stock purchase plan exercises was $158,000 and $324,000 for the six-month periods ended March 31, 2006 and 2005, respectively. The tax benefit to be realized for the tax deductions from option exercises under the share-based payment arrangements was $49,000 and $35,000 for the six-month periods ended March 31, 2006 and 2005, respectively.

4. Earnings per share

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

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	For the three months ended March 31, 2006			For the three months ended March 31, 2005		
	Earnings	Shares	Per-Share Amount	Earnings	Shares	Per-Share Amount
Net earnings (loss) from continuing operations	$ (61)			$ 62		
Less: Assumed dividends on mandatorily redeemable preferred stock	-			(1)		
Basic EPS:						
Net earnings (loss)available to common shareholders	(61)	5,201	$ (0.01)	61	5,009	$ 0.01
Effect of dilutive securities:						
Common stock options		-			101	
Mandatorily redeemable preferred stock	-	-		1	81	
Diluted EPS:						
Earnings (loss) available to common shareholders plus assumed conversions	$ (61)	5,201	$ (0.01)	$ 62	5,191	$ 0.01

	For the six months ended March 31, 2006			For the six months ended March 31, 2005		
	Earnings	Shares	Per-Share Amount	Earnings	Shares	Per-Share Amount
Basic EPS:						
Net earnings (loss)	$ (571)	5,194	$ (0.11)	$ (380)	5,001	$