SYSCAN IMAGING INC
Form 10QSB
August 15, 2005

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

FORM 10-QSB

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

For the quarter ended June 30, 2005

or

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

Commission file number: 000-27773

SYSCAN IMAGING, INC.
(Exact Name of Small Business Issuer as Specified in Its Charter)

DELAWARE	59-3134518
(State of incorporation)	(I.R.S. Employer Identification No.)

1772 TECHNOLOGY DRIVE
SAN JOSE, CALIFORNIA 95110
(Address of principal executive offices, including zip code)

(408) 436-9888
(Issuer's telephone number, including area code)

(Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days.
Yes |X| No |_|

The number of shares outstanding of the issuer's Common Stock, $.001 Par Value, on August 4, 2005, was 23,110,515 shares

Transitional Small Business Disclosure Format (check one): Yes | | No |X|

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SYSCAN IMAGING, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
JUNE 30, 2005
(UNAUDITED)

ASSETS

Current assets	
Cash and cash equivalents	$
Trade receivables, net	
Inventories	
Prepayments, deposits and other current assets	
Due from related parties	
Total current assets	
Fixed assets, net	
Intangible assets	
Long-term investment	
TOTAL ASSETS	$

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities	
Bank line of credit	$
Trade payables and accruals	
Total current liabilities	
Commitments and contingencies	
Stockholders' equity	
Preferred stock: $0.001 par value; 2,000,000 shares authorized and 18,650 shares outstanding, Series A Convertible (stated value $100)	
Common stock: $0.001 par value; 50,000,000 shares authorized and 23,110,515 shares issued and outstanding	
Additional paid in capital	
Accumulated deficit	(
Total stockholders' equity	
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$

SEE CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

SYSCAN IMAGING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
THREE AND SIX MONTHS ENDED JUNE 30
(UNAUDITED)

	THREE MONTHS ENDED JUNE 30, 2005	THREE MONTHS ENDED JUNE 30, 2004	
NET SALES	$ 1,487,216	$ 974,831	$
COSTS OF SALES	883,262	617,089	
GROSS PROFIT	603,954	357,742	

OPERATING EXPENSES			
Selling and marketing expenses	198,753	172,163	
General and administrative expenses	351,115	193,407	
Stock-based compensation cost	2,812,000	-	
Research and development expenses	162,576	117,352	
Total operating expenses	3,524,444	482,922	
OPERATING LOSS	(2,920,490)	(125,180)	
Other income (expense), net	12,308	1,206	
NET LOSS BEFORE TAXES	(2,908,182)	(123,974)	
PROVISION FOR INCOME TAXES	-	-	
NET LOSS	$ (2,908,182)	$ (123,974)	$
Deemed dividend on preferred stock	(27,600)	-	
NET LOSS AVAILABLE TO COMMON STOCKHOLDERS	$ (2,935,782)	$ (123,974)	$
BASIC AND DILUTED LOSS PER SHARE	$ (0.13)	-	$

SEE CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

SYSCAN IMAGING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
SIX MONTHS ENDED JUNE 30
(UNAUDITED)

	2005
CASH FLOWS FROM OPERATING ACTIVITIES	

Net loss	$ (2,931,347)	$
Adjustments to reconcile net loss to net cash flows provided by operating activities		
Depreciation	10,446	
Stock based compensation cost	2,812,000	
Changes in assets and liabilities		
(Increase) decrease trade receivables	395,850	
(Increase) decrease in inventories	14,199	
(Increase) decrease in other current assets	(954)	
Increase (decrease) in trade payables and accruals	(73,048)	
Net cash flows provided by operating activities	227,146	
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash acquired in reverse acquisition	-	
Capital expenditures	(144,515)	
Net cash flows provided by (used in) investing activities	(144,515)	
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of preferred stock, net of offering costs	1,628,500	
Net advances / repayments - related parties	(231,109)	
Net cash flows provided by (used in) financing activities	1,397,391	
Increase (decrease) in cash and cash equivalents	1,480,022	
Cash and cash equivalents, beginning of period	687,403	
Cash and cash equivalents, end of period	$ 2,167,425	
Cash paid for:		
Interest	$ 26,841	
Income taxes	$ -	

SEE CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

SYSCAN IMAGING, INC. AND SUBSIDIARIES
CONDENSED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2005
(UNAUDITED)

1 - STATEMENT OF INFORMATION FURNISHED

The accompanying unaudited condensed consolidated financial statements of Syscan Imaging, Inc. ("Syscan", "the Company", "we" or "our") have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-QSB and Article 10 of Regulation S-X. Accordingly, they do not include all information and disclosures necessary for a presentation of our financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results may differ from these estimates. The results of operations for the period ended June 30, 2005 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2005. These financial statements should be read in conjunction with the Management's Discussion and Analysis included in the Company's financial statements and accompanying notes thereto as of and for the year ended December 31, 2004, filed with the Company's Annual Report on Form 10-KSB. Certain amounts from prior periods have been reclassified to conform to the current period's presentation.

The Company does not have any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that is expected to be material.

2 - RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R addresses all forms of share-based payment ("SBP") awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R will require the Company to expense SBP awards with compensation cost for SBP transactions measured at fair value. On March 29, 2005, the SEC issued Staff Accounting Bulletin (SAB) 107 which expresses the views of the SEC regarding the interaction between SFAS No. 123R and certain SEC rules and regulations and provides the SEC's views regarding the valuation of share-based payment arrangements for public companies. In April 2005, the SEC issued a release which amends the compliance dates for SFAS No. 123R. We expect the adoption of SFAS No. 123R and SAB 107 to have a material impact on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections". SFAS No. 154 replaces APB Opinion No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We do not expect the adoption of SFAS No. 154 to have any impact on the Company's financial statements.

3 - SIGNIFICANT ACCOUNTING POLICIES

CONCENTRATION OF CREDIT RISK

Financial instruments that potentially expose the Company to a concentration of credit risk are as follows:

CASH HELD AT BANKS. We maintain cash balances at several banks. Accounts at each institution are insured by the Federal Deposit Insurance Corporation up to $100,000.

DUE TO GEOGRAPHIC SALES AND SIGNIFICANT CUSTOMERS. We operate in a single industry segment - scanner and fax modules. We market our products in the United States, Europe and the Asia Pacific region through our sales personnel and independent sales representatives.

Our geographic sales as a percent of total revenue were as follows for the quarter ended June 30:

	2005	2004
United States	73.0%	96.5%
Asia Pacific	18.4%	0.1%
Europe and others	8.6%	3.4%

Our geographic sales as a percent of total revenue were as follows for the six month period ended June 30:

	2005	2004
United States	86.4%	97.1%
Asia Pacific	8.8%	0.1%
Europe and others	4.8%	2.8%

Sales to major customers as a percentage of total revenues were as follows for the quarters ended June 30:

	2005	2004
Customer A	42%	54%
Customer B	15%	14%
Customer C	7%	10%
Customer D	7%	6%

Sales to major customers as a percentage of total revenues for the six month period ended June 30:

	2005	2004

Customer A	34%	33%
Customer B	15%	20%
Customer C	15%	13%
Customer D	12%	8%

DUE TO ACCOUNTS RECEIVABLE. Financial instruments that potentially subject the Company to a concentration of credit risk consist primarily of trade receivables. Our customers are concentrated in the industrial/consumer electronics channels and with major original equipment manufacturers. As of June 30, 2005, the concentration was approximately 75% (3 customers). The loss of any of these customers could have a material adverse effect on our results of operations, financial position and cash flows.

DUE TO SIGNIFICANT VENDORS. For each of the periods ended June 30, 2005 and 2004, our purchases have primarily been concentrated with the wholly-owned subsidiary of our majority stockholder. If this vendor was unable to provide materials in a timely manner and we were unable to find alternative vendors, our business, operating results and financial condition would be materially adversely affected.

DUE TO PRODUCT SALES. We had 5 different product categories in the second quarter of 2005 (2004: 5 products) and 3 different products during the six months ended June 30, 2005 (2004: 5 products) that each accounted for more than 10% of sales. We have made positive efforts to mitigate the impact of loss of any single category, however if any of these products were to become obsolete or unmarketable and we were unable to successfully develop and market alternative products, our business, operating results and financial condition could be adversely affected.

RELATED PARTY TRANSACTIONS

A related party is generally defined as (i) any person that holds 10% or more of the Company's securities and their immediate families, (ii) the Company's management, (iii) someone that directly or indirectly controls, is controlled by or is under common control with the Company, or (iv) anyone who can significantly influence the financial and operating decisions of the Company. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties.

The Company purchases significantly all of its finished scanner imaging products from the parent company of its majority stockholder, Syscan Technology Holdings Limited ("STH"). Our Chairman and CEO, Darwin Hu, was formerly the CEO of STH, and beneficially owns approximately 5.33% of the issued and outstanding capital stock of STH.

The following is a summary of significant related party purchases from entities that are wholly-owned subsidiaries of STH. The transactions were carried out in the normal course of our business.

	THREE MONTHS ENDED JUNE 30, 2005	THREE MONTH JUNE 30,
SYSCAN Optoelectronics Technology Co. Ltd., a wholly-owned subsidiary of STH (purchases)		
SYSCAN Intervision Limited, a wholly-owned subsidiary of STH (purchases)	-	
SYSCAN Lab Limited Company Limited, a wholly-owned subsidiary of STH (purchases)	$0.713M	

Amounts due from related parties are unsecured, interest-free and repayable on demand and consisted of the following:

Due from STH	$ 445,998
Due from Majority Stockholder	100,000
Due from various subsidiaries wholly-owned by STH	1,954,531
	$ 2,500,529

EARNINGS PER SHARE

Earnings (loss) per share ("EPS") is computed in accordance with SFAS No. 128 "Earnings Per Share." Basic EPS is computed using weighted average shares outstanding. Diluted EPS is computed using weighted average shares outstanding plus dilutive common stock equivalents. Convertible securities that could potentially dilute basic EPS in the future, such as convertible preferred stock, options and warrants are not included in the computation of diluted EPS because to do so would be antidilutive. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value. Diluted EPS per share does not differ from basic EPS for all periods presented. As of June 30, 2005 and 2004, the total number of outstanding common stock equivalent shares excluded from the loss per share computation was 2,225,833 and 60,000, respectively.

The following table represents the computation of weighted average shares outstanding:

	THREE MONTHS ENDED 6/30/05	THREE MONTHS ENDED 6/30/04	SIX M EN 6/3
Numerator-net loss available to common stockholders	$ 2,935,782	$ 123,974	$ 2,95
Denominator:			
Weighted average shares used in computing basic EPS	23,110,515	23,065,953	23,11
Net effect of dilutive common shares	-	-	
Weighted average shares used in computed diluted EPS	23,110,515	23,065,953	23,11
Basic Earnings Per Share	$0.13	-	
Diluted Earnings Per Share	$0.13	-	

STOCK-BASED COMPENSATION

The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Compensation cost for stock options, if any, is measured as the excess of the quoted market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock. SFAS No.123, "Accounting for Stock-Based Compensation," established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. The Company has elected to remain on its current method of accounting as described above, and has adopted the disclosure requirements of SFAS No. 123. In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, amending FASB No. 123, and "Accounting for Stock-Based Compensation". This statement amends Statement No. 123 to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation.

Had compensation expense for the Company's stock-based compensation plans been determined under SFAS No. 123, based on the fair market value at the grant dates, the Company's pro forma net earnings and pro forma net earnings per share would have been reflected for the six months ended June 30:

	THREE MONTHS ENDED 6/30/05	THREE MONTHS ENDED 6/30/04	SIX MON ENDED 6/30/0
Net loss available to common stockholders, as reported	$ 2,935,782	$ 123,974	$ 2,958,94

Less: stock-based compensation cost, net of tax	2,847,045	3,824	2,847,04
Pro forma net loss	$ 5,782,827	$ 127,798	$ 5,805,99
Basic and diluted net loss per share			
As reported	$0.13	-	$0.1
Pro forma	$0.25	-	$0.2

The weighted average fair value on the date of grant was $0.7695 for those options granted in 2005. The fair value of each option grant is estimated on the date of grant using the Black-Scholes Option pricing model with the following weighted-average assumptions: dividend yield of 0%, expected volatility of 144%, risk-free interest rate of 5%, and expected life of two years.

4 - STOCK OPTIONS

STOCK OPTIONS OUTSTANDING

The Company has a stock option plan, the objectives of which include attracting and retaining the best personnel, providing for additional performance incentives, and promoting the success of the Company by providing directors, consultants, and key employees the opportunity to acquire common stock. The plan is administrated by the Board of Directors, which determine among other things, those individuals who shall receive options, the time period during which the options may be partially or fully exercised, the number of common stock to be issued upon the exercise of the options and the option exercise price.

The maximum term of the plan is ten years and options may be granted to officers, directors, consultants, employees, and similar parties who provide their skills and expertise to the Company.

Options granted under the plans have a maximum term of ten years and shall be at an exercise price that may not be less than 85% of the fair market value of the common stock on the date of the grant. Options are non-transferable and if a participant ceases affiliation with the company for a reason other than death or permanent and total disability, the participant will have 90 days to exercise the option subject to certain extensions. In the event of death or permanent and total disability, the option holder or their representative may exercise the option within one (1) year. Any unexercised options that expire or that terminate upon an employee's ceasing to be employed by the Company become available again for issuance under the plan, subject to applicable securities regulation. The plan may be terminated or amended at any time by the Board of Directors. No options were forfeited, canceled or exercised during the six months ended June 30, 20005. Information about options outstanding and exercisable at June 30, 2005 is summarized below:

		WEIGHTED-AVERAGE	WEIGHTED-AVERAGE		WEIGHTED

RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	REMAINING CONTRACTUAL LIFE (YEARS)	EXERCISE PRICE	NUMBER EXERCISABLE	REMAIN CONTRAC LIFE (Y
$0.01	3,700,000	1.75	$0.01	1,293,333	1.7
$0.90-$2.50	60,000	1.50	$1.17	60,000	1.5

BOARD OF DIRECTOR APPROVED STOCK OPTIONS SUBJECT TO SHAREHOLDER APPROVAL

On April 2, 2004, the Company's Board of Directors authorized the increase in the number of stock options available under the 2002 Stock Option Plan (the "Plan") from 200,000 to 2,200,000. On July 21, 2004, the Company's Board of Directors further authorized the increase in the number of stock options available under the 2002 Stock Option Plan from 2,200,000 to 3,200,000. The subject increases are subject to stockholder ratification at the next annual or special meeting of stockholders, which has not been obtained as of the date this filing.

On April 13, 2004, the Company's Board of Directors authorized an aggregate of 1,700,000 options under the Plan to certain individuals at $1.50 per share, and expiring through April 2014. These options were canceled by the Board of Directors on May 7, 2004. On July 21, 2004, the Company's Board of Directors further authorized an aggregate of 2,200,000 options under the 2002 Stock Option Plan to be issued to certain individuals at $2.00 per share and expiring through July 2014, of which 165,000 have been canceled as a result of an employment termination subsequent to year end and 55,000 options exercisable through May 4, 2005. The grant of the above options are subject to stockholder ratification of the Company's increase in the number of stock options available for grant under the Plan. The Company plans to obtain stockholder approval at its annual or special meeting of stockholders, which has not yet been scheduled as of the date of this filing.

On April 26, 2005, the Company entered into employment agreements with its executive officers, the terms of which were previously approved by the independent members of the Company's board of directors. The employment agreements extend through 2008 and provide for a base salary, annual bonus to be determined by the Board of Directors, termination payments, stock options, non-competition provisions, and other terms and conditions of employment. In addition, the Company maintains employment agreements with other key employees with similar terms and conditions.

Total options granted under the agreements with the Company's executive officers were 3,300,000, exercisable at $0.01 per share. One-third of the options vest on the date of execution of the employment agreement, one-third vest on April 3, 2006 and one-third vest on April 2, 2007.

Additionally, the Company issued an aggregate of 400,000 options exercisable at $0.01 per share to two of its key employees in connection with the execution of employment agreements with such individuals. One-third of such options vest on April 26, 2005, one-third vest on April 3, 2006 and one-third vest on April 2, 2007.

5 - PREFERRED STOCK

The Company has authorized 2,000,000 shares of preferred stock, of which an aggregate of 60,000 have been designated Series A Preferred Stock and of which 18,650 shares are outstanding.

On March 15, 2005, the Company sold $1,865,000 of its Series A Convertible Preferred Stock to institutional and accredited retail investors in a private offering pursuant to exemption from registration under Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"). Starboard Capital Markets, LLC, an NASD member firm, acted as placement agent in the sale of the Preferred Stock, for which it received $186,500 in commissions and 186,500 warrants to purchase shares of the Company's common stock at an exercise price equal to $1.00 per share. The net proceeds of this offering to the Company after the payment of commissions, legal fees and other expenses of the offering were approximately $1,628,500.

In connection with the financing, the Company also issued to the purchasers common stock purchase warrants to purchase up to an aggregate of 932,500 shares of the Company's common stock at an exercise price of $2.00 per share. The warrants are exercisable for a period of five years from the date of issuance. Pursuant to a registration rights agreement, the Company has registered the shares of common stock issuable upon conversion of the Preferred Stock and upon exercise of the warrants with the Securities and Exchange Commission on Form SB-2.

The warrants must be exercised by the payment of cash, except if there is no effective registration statement covering the resale of the shares of Common stock underlying the warrants, a holder may exercise their warrants on a cashless basis. Holders of the warrants are entitled to full ratchet anti-dilution protection for issuances of common stock or common stock equivalents, prior to the effective date of the registration statement covering the resale of the shares of common stock underlying the Preferred Stock, at less than the exercise price of such warrants. Holders of warrants also have standard anti-dilution protection for splits, dividends, subdivisions, distributions, reclassifications and combinations of our common stock. None of the individual holders of the Warrants are entitled to exercise any such Warrant held by them, if such exercise would cause such holder to be deemed to beneficially own in excess of 4.999% of the outstanding shares of our Common stock on the date of issuance of such shares.

PREFERRED STOCK CONVERSION RIGHTS. All or any portion of the stated value of Preferred Stock outstanding may be converted into common stock at anytime by the purchasers. The initial fixed conversion price of the preferred stock is $1.00 per share ("Conversion Price"). The Conversion Price is subject to anti-dilution protection adjustments, on a full ratchet basis, at anytime that the preferred stock is outstanding and prior to the effective date of the registration statement required to be filed pursuant to the Registration Rights Agreement, upon our issuance of additional shares of common stock, or securities convertible into common stock, at a price that is less than the then Conversion Price.

DIVIDENDS. The Preferred Stock accrues dividends at a rate of 5% per annum, payable semiannually on July 1 and January 1 in cash, by accretion of the stated value or in shares of common stock. Subject to certain terms and conditions, the decision whether to accrete dividends to the stated value of the Preferred Stock or to pay for dividends in cash or in shares of common stock, shall be at our discretion.

REDEMPTION. On March 15, 2008 (the "Redemption Date"), all of the outstanding Preferred Stock shall be redeemed for a per share redemption price equal to the stated value on the Redemption Date (the "Redemption Price"). The Redemption Price is payable by us in cash or in shares of common stock at our discretion and shall be paid within five trading days after the Redemption Date. In the event we elect to pay all or some of the Redemption Price in shares of common stock, the shares of common stock to be delivered to the purchasers shall be valued at 85% of the fifteen-day volume weighted average price of the common stock on the Redemption Date.

RIGHT TO COMPEL CONVERSION. If, on any date after March 15, 2006, (A) the closing market price per share of our common stock for ten (10) consecutive trading days equals at least $4.00 (subject to adjustment for certain events), and (B) the average reported daily trading volume during such ten-day period equals or exceeds 100,000 shares, then we shall have the right, at our option, to convert, all, but not less than all, of the outstanding shares of Preferred Stock at the Conversion Price; provided that there shall be an effective registration statement covering the resale of the shares of common stock underlying the preferred stock at all times during such 10-day period and during the 30-day notice period to the holders thereof.

RESTRICTIONS ON CONVERSION OF PREFERRED STOCK. No holder of our Preferred Stock is entitled to receive shares upon payment of dividends on the Preferred Stock, or upon conversion of the Preferred Stock held by such holder if such receipt would cause such holder to be deemed to beneficially own in excess of 4.999% of the outstanding shares of our common stock on the date of issuance of such shares (such provision may be waived by such holder upon 61 days prior written notice to us). In addition, no individual holder is entitled to receive shares upon payment of dividends on the Preferred Stock, or upon conversion of the Preferred Stock held by such holder if such receipt would cause such holder to be deemed to beneficially own in excess of 9.999% of the outstanding shares of our common stock on the date of issuance of such shares (such provision may be waived by such holder upon 61 days prior written notice to us).

REGISTRATION RIGHTS. Pursuant to the terms of a Registration Rights Agreement between us and the holders of the preferred stock, we are obligated to file a registration statement on Form SB-2 registering the resale of shares of our common stock issuable upon conversion of the preferred stock and exercise of the warrants. We are required to file the registration statement on or before April 24, 2005 and have the registration statement declared effective on or before July 13, 2005. If the registration statement is not declared effective within the timeframe described, or if the registration is suspended other than as permitted in the Registration Rights Agreement, we will be obligated to pay each holder a fee equal to 1.0% of such holders purchase price of the Preferred Stock during the first 90 days, and 2.0% for each 30 day period thereafter (pro rated for partial periods), that such registration conditions are not satisfied.

RIGHT OF FIRST REFUSAL. Subject to certain conditions, we have granted the holders a right of first refusal, for a period until one (1) year from the effective date of the registration statement required to be filed in connection with the purchase of the Preferred Stock, to participate in any subsequent financing that we conduct.

VOTING RIGHTS. Holders of the Preferred Stock shall have no voting rights. However, so long as any shares of Preferred Stock are outstanding, we shall not, without the affirmative vote of the holders of a majority of the shares of the Preferred Stock then outstanding, (a) alter or change adversely the powers, preferences or rights given to the Preferred Stock or alter or amend the Series A Certificate of Designation, (b) authorize or create any class of stock ranking as to dividends or distribution of assets upon a liquidation senior to or otherwise pari passu with the Preferred Stock, (c) amend our certificate or articles of incorporation or other charter documents so as to affect adversely any rights of the holders of the Preferred Stock, (d) increase the authorized number of shares of Preferred Stock, or (e) enter into any agreement with respect to the foregoing.

LIQUIDATION PREFERENCE. Upon our liquidation, dissolution or winding up, whether voluntary or involuntary (a "Liquidation"), the holders of the Preferred Stock shall be entitled to receive out of our assets, whether such assets are capital or surplus, for each share of Preferred Stock an amount equal to the stated value per share before any distribution or payment shall be made to the holders of any of our securities with rights junior to the Preferred Stock, and if our assets shall be insufficient to pay in full such amounts, then the entire assets to be distributed to the holders of the Preferred Stock shall be distributed among such holders ratably in accordance with the respective amounts that would be payable on such shares if all amounts payable thereon were paid in full.

ANTI-DILUTION. Holders of the Preferred Stock are entitled to full ratchet anti-dilution protection for issuances of common stock or common stock equivalents, prior to the effective date of the registration statement covering the resale of the shares of common stock underlying the Preferred Stock, at less than the Conversion Price. Holders of Preferred Stock also have standard anti-dilution protection for splits, dividends, subdivisions, distributions, reclassifications and combinations of our common stock.

6 - COMMITMENTS AND CONTINGENCIES

OPERATING LEASES - The Company is committed under various non-cancelable operating leases which expire through November 2006. Future minimum rental commitments are as follows: 2005-$53,000 and 2006-$101,000. Rent expense charged to operations was approximately $61,000 for the six months ended June 30, 2005 (2004: $59,000).

LINE OF CREDIT - The Company has a line of credit to borrow up to $1,000,000, bearing interest at the rate of prime plus 1% and secured by all of the assets of the Company. Interest payments are due monthly and all unpaid interest and principal is due in full on August 24, 2005. Upon certain events of default as more fully described in the agreement, the default variable interest rate increases to prime plus 3%. The Company had $66,964 available for use at June 30, 2005.

LETTERS OF CREDIT - The Company issues letters of credit in the normal course of business. Syscan had no outstanding letters of credit as of June 30, 2005.

EMPLOYMENT AGREEMENTS - The Company maintains employment agreements with its executive officers which extend through 2008. The agreements provide for a base salary, annual bonus to be determined by the Board of Directors, termination payments, stock options, non-competition provisions, and other terms and conditions of employment. In addition, the Company maintains employment agreements with other key employees with similar terms and conditions.

LITIGATION, CLAIMS AND ASSESSMENTS - On May 20, 2003, Syscan, Inc., the Company's wholly-owned subsidiary, filed a lawsuit named SYSCAN, INC. V. PORTABLE PERIPHERAL CO., LTD. ("PPL"), IMAGING RECOGNITION INTEGRATED SYSTEMS, INC., CARDREADER INC. AND TARGUS INC. (Case No. C03-02367 VRW) in United States District Court, Northern District of California. Syscan alleges claims against the above-mentioned parties for patent infringement of patent nos. 6,054,707, 6,275,309 and 6,459,506, and unfair competition. Syscan expects to continue the case unless a reasonable settlement amount from the defendants or a licensing agreement to the satisfaction of Syscan is entered.

Syscan is seeking: (1) a temporary restraining order, preliminary injunction and permanent injunction against defendants, restraining defendants from patent infringement and unfair competition; (2) treble damages due to defendants' willful infringement; (3) punitive damages; (4) accounting of unjust enrichment by defendants, resulting from defendants' unfair competition; and (5) attorney's fees and costs.

The defendants are jointly represented by PPL's counsel. PPL has initiated counterclaims against Syscan for patent invalidity. Syscan has not yet been able to quantify its damage claim against PPL. Syscan intends to vigorously pursue this claim and denies PPL's counterclaim of patent invalidity.

The Company experiences routine litigation in the normal course of its business and does not believe that any pending litigation will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

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

Management's discussion and analysis of financial condition and results of operations (MD&A) is provided as a supplement to the accompanying consolidated financial statements and footnotes to help provide an understanding of our financial condition, changes in financial condition and results of operations.

The MD&A is organized as follows:

- OVERVIEW. This section provides a general description of our business, as well as recent developments that we believe are important in understanding the results of operations and to anticipate future trends in those operations.

- CRITICAL ACCOUNTING POLICIES. This section provides an analysis of the significant estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

- RECENT ACCOUNTING PRONOUNCEMENTS. This section provides an overview of recent accounting pronouncements and their expected impact on our financial condition and results of operations.

- RESULTS OF OPERATIONS. This section provides an analysis of our results of operations for the periods ended June 30, 2005 compared to the same periods in 2004. A brief description is provided of transactions and events, including related party transactions that impact the comparability of the results being analyzed.

- LIQUIDITY AND CAPITAL RESOURCES. This section provides an analysis of our financial condition and cash flows as of and for the quarter ended June 30, 2005.

The following management's discussion and analysis should be read in conjunction with our consolidated unaudited financial statements for the three and six month periods ended June 30, 2005 and 2004 and related condensed notes to those financial statements.

OVERVIEW

Management's Discussion and Analysis (MD&A) contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in our Form 10-KSB as filed with the Securities and Exchange Commission on March 31, 2005, as well as other factors which we cannot predict and that are not within our control. We undertake no duty to update any forward-looking statement to conform the statement to actual results or changes in our expectations.

We are in the business of developing, designing and delivering imaging technology solutions. Our approach to research and development (R&D) is focused on creating new deliverable and marketable technologies. We sell our products to clients' throughout the world, including the United States, Canada, Europe, South America, Australia and Asia. We intend to expand our business and product offerings into the much larger image display market where we intend to leverage our experience and expertise. We also believe that we may benefit from a level of transfer of technologies from image capture to image display.

We design and manufacture imaging technology solutions for a worldwide customer base. Our core business is currently focused on the manufacturing and worldwide delivery of 20 plus mobile image-scanning products, which has allowed us to become the largest OEM - private label manufacturer of USB driven mobile scanning systems for a large number of major brands. Our strong intellectual property portfolio in the imaging area consists of 19 patents with an additional 3 patents pending. We have 3 patent applications currently pending with the US Patent & Trademark Office, 2 of which relate to image display technology and one of which relates to image scanning.

In 2003, we began developing new technologies targeted towards the flat panel LCD display market. A natural extension of their patented image scanning technologies multiple products are in development with the first expected to reach the marketplace in the second half of 2006. The products are designed to significantly enhance picture quality, decrease power consumption, extend product life and greatly reduce the manufacturing costs associated with flat-panel televisions.

Our strategy continues to be to expand our image capture product line and technology while leveraging our assets in other areas of the imaging industry. We are actively shipping five categories of image capture products under the Travel Scan marquee or their OEM counterparts. These categories include A4 format document scanners which represented approximately 23% of our sales during the three month period ended June 30, 2005 and 28% of our sales during the six month period ended June 30, 2005. The A6 format scanners that are ideal for ID cards & checks, is our best selling product and represented approximately 40% and 46%, respectively, of our sales during each of the three and six month periods ended June 30, 2005. The A8 format that is primarily sold for use as a business card reader represented approximately 17% and 12%, respectively, of our sales during each of the three and six month periods ended June 30, 2005. The A5 format scanner also used for ID cards and security documents represented approximately 11% and 7%, respectively, of our sales during each of the three and six month periods ended June 30, 2005. We also manufacture and sell the Contact Image Sensor (CIS) Modules that we use in our products and separately as a component to other manufacturers which represented 11% of our three month sales and 5% of our six month sales for the period ended June 30, 2005.

For the remainder of this year, we will expand our image capture product line with three new products. The first product is a true-duplex high-speed A4 scanner in which we have strong market interest. The second product is an A6 scanner that follows in the footsteps of the current 662 but is high speed and will have the expanded ability of duplex scanning. The third product is a specialized security document scanner that utilizes infrared light sources to help in the process of identifying fraudulent or tampered with documents.

While we continue to grow our presence in image capture technology, we have begun creating, through research and development, new technology solutions for the substantially larger, image display market. More specifically we are creating products and technologies to accent and enhance the Liquid Crystal Display (LCD) and Plasma Display Panel (PDP) television market. Our first image display products are expected to be available for delivery during the second half of 2006 under the SysView brand name. These SysView display products will include highly integrated, high performance video processors that combine state-of-the-art scaling and video processing techniques for displaying analog and digital video/graphics on our LCD-PDP TV products. We believe that these products will provide advanced image processing, including High-Definition (HD) products, that will greatly enhance display quality. The next product/technology that we are developing is a Light Emitting Diode (LED) backlighting solution to replace the industries current standard Cold Cathode Fluorescent Lamp (CCFL). The principal behind this technology is related to the proprietary technology used in our image capture products. The benefits are substantial, including longer life, higher dimming ratio, sharper contrast, and near high definition resolution without