Part II

Dollar Signs and Decimal Points

Sight Gags **By Shirley U. Geste**

AS A TOKEN OF THEIR **DEPRECIATION**, THE **F&A** DEPARTMENT LETS A RETIRING ACCOUNTANT KEEP HIS ORIGINAL COMPUTER.

Forward-looking Statements

Certain statements made in this report, as well as oral statements made by the Company from time to time, constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Readers can identify these forward-looking statements by the Company's use of the words "expects," "anticipates," "estimates," "believes," "projects," "intends," "plans," "will," "may," "shall," and similar words and other statements of a similar sense. These statements are based upon the Company's current estimates and expectations as to prospective events and circumstances, which may or may not be in the Company's control and as to which there can be no firm assurances given. These forward-looking statements involve known and unknown risks and uncertainties that could cause actual results to differ materially from those projected. Such risks and uncertainties include: (1) global economic conditions that impact the capital spending trends of manufacturers in a variety of industries; (2) the cyclicality of the semiconductor and electronics industries; (3) the inability to achieve significant international revenue; (4) fluctuations in foreign exchange rates; (5) the loss of, or a significant curtailment of purchases by, any one or more principal customers; (6) the reliance upon certain sole-source suppliers to manufacture and deliver critical components for the Company's products; (7) the inability to attract and retain skilled employees; (8) the inability to design and manufacture high-quality products; (9) inaccurate forecasts of customer demand; (10) the technological obsolescence of current products and the inability to develop new products; (11) the inability to protect the Company's proprietary technology and intellectual property; (12) the Company's involvement in time-consuming and costly litigation; (13) the impact of competitive pressures; and (14) the inability to achieve expected results from acquisitions. The foregoing list should not be construed as exhaustive and the Company encourages readers to refer to the detailed discussion of risk factors included in Part I - Item 1 of the Company's Annual Report on Form 10-K. The Company cautions readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made. The Company disclaims any obligation to subsequently revise forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date such statements are made.

Cognex Corporation: Management's Discussion and Analysis of Financial Condition and Results of Operations

Executive Overview

Cognex Corporation (the "Company") designs, develops, manufactures, and markets machine vision systems, or computers that can "see," which are used to automate a wide range of manufacturing processes where vision is required. The Company's Modular Vision Systems Division (MVSD) specializes in machine vision systems that are used to automate the manufacture of discrete items, while the Company's Surface Inspection Systems Division (SISD) specializes in machine vision systems that are used to inspect the surfaces of materials processed in a continuous fashion.

In addition to product revenue derived from the sale of machine vision systems, the Company also generates revenue by providing maintenance and support, education, consulting, and installation services to its customers. The Company's customers can be classified into three categories: semiconductor and electronics capital equipment manufacturers, discrete manufacturing customers, and surface inspection customers. Semiconductor and electronics capital equipment manufacturers purchase Cognex machine vision systems and integrate them into the capital equipment that they manufacture and then sell to their customers in the semiconductor and electronics industries that either make computer chips or make printed circuit boards containing computer chips. Although the Company sells to original equipment manufacturers (OEMs) in a number of industries, these semiconductor and electronics OEMs have historically been large consumers of the Company's products. The discrete manufacturing category includes a wide array of manufacturers who use machine vision for applications in a variety of industries, including the packaging, automotive, consumer electronics, food and beverage, and personal care industries. The majority of these customers are end users who purchase Cognex machine vision systems and install them directly on their production lines. The last category, surface inspection customers, includes manufacturers of materials processed in a continuous fashion, such as paper and steel.

Over the past few years, the Company has been successful in diversifying its customer base beyond semiconductor and electronics capital equipment manufacturers. Demand from these capital equipment manufacturers is highly cyclical, with periods of investment followed by temporary downturns. During the first half of 2004, the Company experienced an increase in orders from these customers, resulting in a 64% increase in sales to this sector for the full year 2004 over the prior year. Despite the rebound in this business, the Company generated 58% of its total revenue in 2004 from customers outside of the semiconductor and electronics capital equipment sector. Sales to customers in the discrete manufacturing category increased from the prior year by 29%, while surface inspection sales were down slightly from the prior year.

The Company's total revenue for 2004 increased 35% from the prior year to $202 million, and because the Company was able to focus increased spending in strategic areas that help drive revenue growth and in employee incentive programs, earnings increased at an even faster rate than revenue. Net income more than doubled from $0.36 per share in 2003 to $0.80 per share in 2004 and grew from 11% of revenue in 2003 to 19% of revenue in 2004.

The following table sets forth certain consolidated financial data as a percentage of revenue:

Year ended December 31,	**2004**	2003	2002
Revenue	**100%**	100%	100%
Cost of revenue	**28**	33	35
Gross margin	**72**	67	65
Research, development, and engineering expenses	**14**	17	23
Selling, general, and administrative expenses	**35**	37	51
Operating income (loss)	**23**	13	(9)
Nonoperating income	**3**	3	2
Income (loss) before taxes	**26**	16	(7)
Income tax provision (benefit)	**7**	5	(2)
Net income (loss)	**19%**	11%	(5)%

Results of Operations

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Revenue

Revenue for the year ended December 31, 2004 increased 35% to $201,957,000 from $150,092,000 for the year ended December 31, 2003. The majority of this growth came from sales to semiconductor and electronics capital equipment manufacturers, which increased $33,001,000, or 64%, from the prior year. While sales to these customers contributed most significantly to the Company's revenue growth in 2004, sales to discrete manufacturing customers also increased by $19,872,000, or 29%, from 2003. Surface inspection sales, however, decreased $1,008,000, or 3%, from the prior year. Although sales to customers outside of the semiconductor and electronics capital equipment sector grew from the prior year and represented the majority of the company's total revenue in 2004, they decreased as a percentage of total revenue to 58% in 2004 from 66% in 2003 due to the significant increase in sales to semiconductor and electronics capital equipment manufacturers. Geographically, revenue increased from the prior year in all of the Company's major regions, but most significantly in Japan, where many of the Company's semiconductor and electronics capital equipment customers are located.

Product revenue for the year ended December 31, 2004 increased 35% to $176,569,000 from $130,670,000 for the year ended December 31, 2003. The increase in product revenue was due to a higher volume of machine vision systems sold to customers in the semiconductor, electronics, automotive, and other industries. Service revenue, which is derived from the sale of maintenance and support, education, consulting, and installation services, increased 31% to $25,388,000 from $19,422,000 due principally to higher revenue generated by maintenance and support programs that are sold bundled with product offerings. Service revenue remained constant as a percentage of total revenue at 13% in both 2003 and 2004.

MVSD revenue for the year ended December 31, 2004 increased 44% to $173,889,000 from $121,016,000 for the year ended December 31, 2003. The increase in MVSD revenue was due to a higher volume of modular vision systems sold to customers in the semiconductor, electronics, automotive, and other industries. Although surface inspection orders increased from the prior year, the timing of shipments and installations resulted in a 3% decline in SISD revenue to $28,068,000 in 2004 from $29,076,000 in 2003. As a result of the increase in MVSD revenue, SISD revenue decreased as a percentage of total revenue to 14% in 2004 compared to 19% in 2003.

Gross Margin

Gross margin as a percentage of revenue was 72% for 2004 compared to 67% for 2003. The increase in gross margin was primarily due to the impact of the higher sales volume without a proportional increase in manufacturing overhead costs, as well as a greater percentage of total revenue from the sale of modular vision systems, which have higher margins than the sale of services and surface inspection systems.

Product gross margin as a percentage of revenue was 76% for 2004 compared to 71% for 2003. The increase in product margin was primarily due to the increased sales volume, as well as the shift in product mix to higher-margin modular vision systems. Service gross margin as a percentage of revenue was 43% for 2004 compared to 37% for 2003. Many of the Company's products are sold with bundled maintenance and support programs for which the revenue is recognized over the program period. The increasing volume of product sales in 2003 and 2004 has resulted in higher service revenue derived from these maintenance and support programs. Although service costs increased to support the additional revenue, the increase in revenue was greater than the increase in costs.

MVSD gross margin as a percentage of revenue was 76% for 2004 compared to 71% for 2003. The increase in MVSD margin was primarily due to the higher sales volume of modular vision systems. SISD gross margin as a percentage of revenue was 45% for 2004 compared to 48% for 2003. The decrease in SISD margin was due principally to the impact of the lower revenue, while costs increased slightly.

Operating Expenses

Research, development, and engineering (R,D&E) expenses for the year ended December 31, 2004 increased 9% to $27,063,000 from $24,719,000 for the year ended December 31, 2003. MVSD R,D&E expenses increased $2,156,000, or 10%, from the prior year primarily due to higher personnel-related costs, including the additional engineering personnel resulting from the acquisition of the machine vision business of Gavitec AG on December 1, 2003 and the accrual of company bonuses for 2004. SISD R,D&E expenses increased $188,000, or 7%, from the prior year due principally to the accrual of company bonuses for 2004.

Selling, general, and administrative (S,G&A) expenses for the year ended December 31, 2004 increased 27% to $70,674,000 from $55,724,000 for the year ended December 31, 2003. MVSD S,G&A expenses increased $11,577,000, or 27%,

from the prior year, while SISD S,G&A expenses increased $1,031,000, or 14%, from 2003. Corporate expenses that are not allocated to a division increased $2,342,000, or 41%, from the prior year. The increase in MVSD expenses was primarily due to the hiring of additional sales personnel and increased marketing spending to grow the Company's base of discrete manufacturing customers, higher commissions related to the increased sales volume, and the accrual of company bonuses for 2004, as well as the unfavorable impact of foreign exchange rates on the Company's international operations. A significant amount of the Company's sales and marketing costs are denominated in currencies other than the U.S. Dollar, primarily the Euro Dollar and Japanese Yen. During 2004, the Euro Dollar and Japanese Yen strengthened versus the U.S. Dollar, resulting in a higher level of expenses when these amounts were translated into U.S. Dollars. The increase in SISD expenses was primarily due to higher personnel-related costs, as well as the accrual of company bonuses for 2004. The increase in corporate expenses was principally due to the accrual of company bonuses for 2004, as well as higher professional fees related to services required to ensure the Company's compliance with the Sarbanes-Oxley Act of 2002.

Nonoperating Income

Investment and other income for the year ended December 31, 2004 decreased 14% to $4,670,000 from $5,450,000 for the year ended December 31, 2003. This decrease was due principally to lower average interest rates on the Company's portfolio of debt securities.

The foreign currency gain for the year ended December 31, 2004 was $1,641,000 compared to a loss of $1,712,000 for the year ended December 31, 2003. The loss in 2003 was primarily due to the revaluation and settlement of the Company's Irish subsidiary's accounts receivable denominated in U.S. Dollars and Japanese Yen. During 2003, the Euro Dollar strengthened versus the U.S. Dollar and Japanese Yen, resulting in foreign currency losses on the Irish subsidiary's books when these receivables were revalued and collected. Although the Company experienced similar losses in 2004, they were offset by gains on the revaluation and settlement of intercompany balances and gains on forward contracts.

Income Taxes

The Company's effective tax rate for 2004 was 29% compared to 31% for 2003. The decrease in the effective tax rate was primarily due to more of the Company's profits being earned and taxed in lower tax jurisdictions.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Revenue

Revenue for the year ended December 31, 2003 increased 32% to $150,092,000 from $114,107,000 for the year ended December 31, 2002. During the year, the Company experienced an increase in demand as its business rebounded from a slowdown in capital spending by manufacturers worldwide. Sales to OEM customers, most of whom make capital equipment used in the semiconductor and electronics industries,

increased $19,076,000, or 51%, from the prior year. Sales to end-user customers increased from the prior year by $16,909,000, or 22%, due to higher demand from customers across a variety of industries. Sales to end-user customers continued to comprise the majority of the Company's revenue despite the rebound in the OEM business, representing 62% of total revenue in 2003 compared to 67% in 2002. Geographically, revenue increased from the prior year in all of the Company's major regions, but most significantly in Japan, where many of the Company's OEM customers are located.

Product revenue for the year ended December 31, 2003 increased 36% to $130,670,000 from $96,202,000 for the year ended December 31, 2002. The increase in product revenue was due to a higher volume of machine vision systems sold to customers in the semiconductor, electronics, automotive, paper, metals, and other industries. Service revenue, which is derived from the sale of maintenance and support, education, consulting, and installation services, increased 8% to $19,422,000 from $17,905,000. Many of the Company's products that were sold during 2003 included bundled maintenance and support programs for which a portion of the revenue will be recognized in future quarters over the program period. As a result, service revenue did not increase as dramatically as product revenue, and it decreased as a percentage of total revenue from 16% in 2002 to 13% in 2003.

MVSD revenue for the year ended December 31, 2003 increased 34% to $121,016,000 from $90,358,000 for the year ended December 31, 2002. The increase in MVSD revenue was due to a higher volume of modular vision systems sold to customers in the semiconductor, electronics, automotive, and other industries. SISD revenue for the year ended December 31, 2003 increased 22% to $29,076,000 from $23,749,000 for the year ended December 31, 2002. The increase in SISD revenue was due principally to a higher volume of SmartView, systems sold to customers in the paper and metals industries. The markets served by SISD had not been as severely impacted by the worldwide slowdown in capital spending. As a result, SISD revenue did not increase as dramatically as MVSD revenue, and it decreased as a percentage of total revenue to 19% in 2003 compared to 21% in 2002.

Gross Margin

Gross margin as a percentage of revenue was 67% for 2003 compared to 65% for 2002. The increase in gross margin was primarily due to the impact of the higher sales volume with relatively flat manufacturing overhead costs, as well as a greater percentage of revenue from the sale of modular vision systems, which have higher margins than the sale of services and surface inspection systems. This increase was partially offset by a lower amount of benefits recorded to "Cost of product revenue" in 2003 from the sale of previously reserved inventory and the favorable resolution of inventory purchase commitments, both of which had been reserved in 2001. These benefits amounted to $1,290,000 in 2003 compared to $2,684,000 in 2002.

Product gross margin as a percentage of revenue was 71% for 2003 compared to 70% for 2002. The increase in product margin was primarily due to the increased sales volume, as well as the shift in product mix to higher-margin modular vision

systems. This increase was partially offset by the decreased benefit from the sale of previously reserved inventory. Service gross margin as a percentage of revenue remained consistent with the prior year at 37%.

MVSD gross margin as a percentage of revenue was 71% for 2003 compared to 70% for 2002. The increase in MVSD margin was primarily due to the impact of the higher sales volume, as well as a greater percentage of revenue from the sale of products, which carry higher margins than the service business. This increase was partially offset by the decreased benefit from the sale of previously reserved inventory. SISD gross margin as a percentage of revenue was 48% for 2003 compared to 45% for 2002. The increase in SISD margin was due principally to the increased sales volume.

Operating Expenses

Research, development, and engineering (R,D&E) expenses for the year ended December 31, 2003 decreased 4% to $24,719,000 from $25,630,000 for the year ended December 31, 2002. MVSD R,D&E expenses decreased $1,245,000, or 5%, from the prior year primarily due to a headcount reduction in the third quarter of 2002. SISD R,D&E expenses increased $334,000, or 15%, from the prior year due principally to an increase in spending on software translation services and other activities related to the SmartView product line.

Selling, general, and administrative (S,G&A) expenses for the year ended December 31, 2003 decreased 5% to $55,724,000 from $58,376,000 for the year ended December 31, 2002. MVSD S,G&A expenses increased $1,674,000, or 4%, from the prior year, while SISD S,G&A expenses increased $587,000, or 8%, from 2002. Corporate expenses that are not allocated to a division decreased $4,913,000, or 46%, from the prior year. The increase in MVSD and SISD expenses was primarily due to higher spending in sales and marketing undertaken to increase sales opportunities, as well as the unfavorable impact of foreign exchange rate changes on the Company's international operations. A significant amount of the Company's sales and marketing costs are denominated in currencies other than the U.S. Dollar, primarily the Euro Dollar and Japanese Yen. During 2003, the Euro Dollar and Japanese Yen strengthened versus the U.S. Dollar, resulting in a higher level of expenses when these amounts were translated into U.S. Dollars. The decrease in corporate expenses was due principally to lower legal expenses associated with patent infringement lawsuits initiated by the Company to protect its intellectual property.

Nonoperating Income

Investment and other income for the year ended December 31, 2003 decreased 40% to $5,450,000 from $9,156,000 for the year ended December 31, 2002. This decrease was due principally to lower average interest rates on the Company's portfolio of debt securities. In addition, during 2003, the Company reduced the carrying value of its investment in a limited partnership by $1,031,000 compared to $680,000 during 2002, representing realized investment losses and fund expenses that were not offset by realized investment gains.

During the fourth quarter of 2002, based upon the estimated fair value of the Company's investment in a limited partnership, the Company determined that it may be unable to recover its full carrying value. As a result, the Company recorded a charge of $1,768,000, representing an other-than-temporary impairment in the carrying value of this investment. In addition, during 2002, the Company recorded losses from the sale of equity securities totaling $6,184,000.

The foreign currency loss for the year ended December 31, 2003 was $1,712,000 compared to a gain of $350,000 for the year ended December 31, 2002. The loss in 2003 was primarily due to the revaluation and settlement of the Company's Irish subsidiary's accounts receivable denominated in U.S. Dollars and Japanese Yen. During 2003, the Euro Dollar strengthened versus the U.S. Dollar and Japanese Yen, resulting in foreign currency losses on the Irish subsidiary's books when these receivables were revalued and collected. Although the Company experienced similar losses in 2002, they were offset by gains on the revaluation of intercompany balances that were not fully hedged. In addition, a smaller percentage of the Company's Irish subsidiary's accounts receivable were denominated in currencies other than the Euro Dollar in 2002.

Income Taxes

The Company's effective tax rate for 2003 was a provision of 31% compared to a benefit of 27% for 2002. The change in the effective tax rate was primarily due to lower tax-exempt investment income generated from the Company's municipal bond portfolio.

Liquidity and Capital Resources

The Company has historically been able to generate positive cash flow from operations, which has funded the Company's operating activities and other cash requirements and has resulted in an accumulated cash, cash equivalent, and investment balance of $391,076,000 at December 31, 2004, representing 85% of shareholders' equity. The Company has established guidelines relative to credit ratings, diversification, and maturities of its investments that maintain liquidity.

The Company's cash requirements during the year ended December 31, 2004 were met with positive cash flow from operations and the proceeds from the issuance of common stock under stock option and stock purchase plans. Cash requirements primarily consisted of operating activities, capital expenditures, and the payment of dividends. Capital expenditures in 2004 totaled $3,120,000 and consisted primarily of expenditures for computer hardware and software.

The Company believes that its existing cash, cash equivalent, and investment balance, together with continued positive cash flow from operations, will be sufficient to meet its operating, investing, and financing activities in 2005 and the foreseeable future.

The following table summarizes the Company's material contractual obligations, both fixed and contingent (in thousands):

Year Ended December 31,	Limited Partnership Interest	Acquisitions	Leases	Total
2005	$6,625	$2,577	$3,878	$13,080
2006	–	–	977	977
2007	–	–	349	349
2008	–	–	192	192
2009	–	–	190	190
Thereafter	–	–	445	445
	$6,625	$2,577	$6,031	$15,233

Limited Partnership Interest

On June 30, 2000, Cognex Corporation became a Limited Partner in Venrock Associates III L.P. (Venrock), a venture capital fund. A director of the Company is a Managing General Partner of Venrock Associates. In the original agreement with Venrock, the Company committed to a total investment in the limited partnership of up to $25,000,000, with the commitment period expiring on January 1, 2005. In January 2005, the Company signed an amendment to the original agreement with Venrock, which reduces its commitment to $22,500,000 and extends the commitment period through December 31, 2010. The Company does not have the right to withdraw from the partnership prior to December 31, 2010. As of December 31, 2004, the Company had contributed $15,875,000 to the partnership, including $2,250,000 during 2004. The remaining commitment of $6,625,000 can be called by Venrock in any period through 2010.

Acquisitions

On March 31, 2003, the Company acquired the wafer identification business of Siemens Dematic AG for 7,000,000 Euros in cash (or approximately $7,630,000) paid at closing, with the potential for an additional cash payment in 2005 of up to 1,700,000 Euros (or approximately $2,306,000) depending upon the achievement of certain performance criteria.

On December 1, 2003, the Company acquired the machine vision business of Gavitec AG for 3,777,000 Euros in cash (or approximately$4,516,000), including 3,477,000 Euros paid at closing, 100,000 Euros (or approximately $123,000) paid on December 1, 2004, and 200,000 Euros (or approximately $271,000) to be paid on December 1, 2005. There was the potential for two additional cash payments of up to 250,000 Euros (or approximately $339,000) each in the third quarter of 2004 and the first quarter of 2005 depending upon the achievement of certain performance criteria. These criteria were not met, and therefore, these contingent payments were not made.

In addition to the obligations described above, the following items may also result in future material uses of cash:

Derivative Instruments

In certain instances, the Company enters into forward contracts and currency swaps to hedge against foreign currency fluctuations. Because the terms of the derivative instrument and underlying exposure are generally matched at inception, changes in foreign currency exchange rates should not expose the Company to significant net cash outflows.

Standby Letters of Credit

On March 25, 2004, the Company provided standby letters of credit totaling 3,146,280,000 Yen (or approximately $30,722,000) to taxing authorities in Japan that are collateralized by investments on the Consolidated Balance Sheet. The Tokyo Regional Taxation Bureau (TRTB) has asserted that Cognex Corporation has a permanent establishment in Japan that would require certain income, previously reported on U.S. tax returns for the years ended December 31, 1997 through December 31, 2001, to be subject instead to taxation in Japan. The Company disagrees with this position and is contesting the TRTB's assertion. Until this matter is resolved, the Company is required to provide collateral for these tax assessments. Should the TRTB prevail in its assertion, the income in question would be taxable in Japan and the Company would be required to pay approximately $30,722,000 in taxes, interest, and penalties to Japanese taxing authorities. The Company would then be entitled to recoup the majority of this amount from taxing authorities in the U.S.

Stock Repurchase Program

On December 12, 2000, the Company's Board of Directors authorized the repurchase of up to $100,000,000 of the Company's common stock. During 2002, a total of 1,768,452 shares were repurchased at a cost of $26,425,000. There have been no other shares repurchased under this program. The Company may repurchase additional shares under this program in future periods depending upon a variety of factors, including the market value of the Company's common stock and the average return on the Company's invested balances.

Dividends

Beginning in the third quarter of 2003, the Company's Board of Directors has declared and paid a cash dividend in each quarter, including the first quarter of 2005. During the third quarter of 2004, the Company's Board of Directors voted to increase the quarterly cash dividend from $0.06 per share to $0.08 per share. Dividend payments amounted to $12,756,000 during 2004 and $3,698,000 in the first quarter of 2005. Future dividends will be declared at the discretion of the Board of Directors and will depend upon such factors as the Board of Directors deems relevant. The Board of Directors may modify the Company's dividend policy from time to time.

Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and various other assumptions believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates under different assumptions or circumstances resulting in charges that could be material in future reporting periods. The Company believes the following critical accounting policies require the use of significant estimates and judgments in the preparation of its consolidated financial statements.

Revenue Recognition

The Company recognizes revenue from product sales upon delivery if a signed customer contract or purchase order has been received, the fee is fixed or determinable, and collection of the resulting receivable is probable. If the arrangement contains customer-specified acceptance criteria, then revenue is deferred until the Company can demonstrate that the customer's criteria have been met. The Company maintains reserves against revenue for potential product returns. Revenue from maintenance and support programs is deferred and recognized ratably over the program period. Revenue from education and consulting services is recognized over the period the services are provided. Revenue from installation services is recognized when the customer has signed off that the installation is complete.

While the Company applies the guidance of Statement of Position (SOP) No. 97-2, "Software Revenue Recognition," as amended by SOP No. 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions," management exercises judgment in connection with the determination of the amount of revenue to be recognized each period. Such judgments include, but are not limited to, assessing the probability of collecting the receivable, assessing whether the fee is fixed or determinable, and assessing whether customer-specified acceptance criteria are substantive in nature.

Investments

At December 31, 2004, the Company's investment balance totaled $336,806,000, of which $325,094,000 consisted of municipal bonds. Investments in municipal bonds are reported at fair value, with unrealized gains and losses, net of tax, recorded in shareholders' equity as other comprehensive income (loss). The remaining investment balance of $11,712,000 represents a limited partnership interest in Venrock

Associates III, L.P., a venture capital fund. A director of the Company is a Managing General Partner of Venrock Associates. The Company's limited partnership interest is accounted for using the cost method because the Company's investment is less than 5% of the partnership and the Company has no influence over the partnership's operating and financial policies.

The fair value of the Company's limited partnership interest is based upon valuations of the partnership's investments as determined by the General Partner. The Company understands that the General Partner adjusts the investment valuations at least quarterly to reflect both realized and unrealized gains and losses on partnership investments. Securities of public companies are valued at market, subject to appropriate discounts to reflect limitations on liquidity. Securities of private companies are valued at an estimated fair value, which initially is at cost, adjusted for subsequent transactions that indicate a higher or lower value is warranted. The value of private securities may be discounted when, in the General Partner's judgment, the carrying value of such private securities has been impaired by specific events.

The Company monitors the carrying value of its investment compared to its fair value to determine whether an other-than-temporary impairment in its interest in the limited partnership has occurred. In considering whether a decline in fair value is other than temporary, the Company considers many factors, both qualitative and quantitative in nature. Some of these factors include the duration and extent of the fair value decline, the length of the Company's contractual commitment to the partnership, general economic and stock market trends, and specific communications from the General Partner.

In 2002, the Company determined that it may be unable to recover the full carrying value of this investment, and as a result, recorded an other-than-temporary impairment charge of $1,768,000 to reduce the carrying value of this investment to its then estimated fair value. Given the nature of the partnership's portfolio and the difficulty inherent in valuing these investments, there is a great deal of uncertainty surrounding the future value of the Company's interest in the limited partnership and future impairment charges may be required.

Accounts Receivable

The Company maintains reserves against its accounts receivable for potential credit losses. Ongoing credit evaluations of customers are performed and the Company has historically not experienced significant losses related to the collection of its accounts receivable. Allowances for uncollectible accounts are estimated by management taking into account the length of time receivables have been outstanding, specific accounts determined to be at risk for collection, the risks associated with selling to smaller customers, and the economic conditions of the primary regions and industries sold to, as well as general economic conditions. An adverse change in any of these factors may result in the need for additional bad debt provisions.

Inventories

Inventories are stated at the lower of cost or market. The Company estimates excess and obsolescence exposures based upon assumptions about future demand, product transitions, and market conditions and records reserves to reduce the carrying value of inventories to their net realizable value. The failure to accurately forecast demand, in terms of both volume and configuration, and adjust material requirement plans in a timely manner may lead to additional excess and obsolete inventory and future charges.

In 2001, the Company recorded a $16,300,000 charge for excess inventories and purchase commitments resulting from an extended slowdown in the semiconductor and electronics industries, as well as the expected transition to newer Cognex hardware platforms by the Company's OEM customers. The Company has been able to subsequently sell $3,885,000 of this inventory to customers as a result of actual demand being higher than the demand that was forecasted at the time of the charge. In addition, the Company has negotiated the favorable resolution of $894,000 of the inventory purchase commitments. The Company did not record significant excess and obsolete inventory provisions in 2002, 2003, or 2004.

Long-lived Assets

The Company has long-lived assets including property, plant, and equipment, as well as acquired goodwill and other intangible assets. These assets are susceptible to shortened estimated useful lives and changes in fair value due to changes in their use, market or economic changes, or other events or circumstances. In addition, the fair value of goodwill is susceptible to changes in the fair value of the reporting units in which the goodwill resides, which are also reportable segments. The Company evaluates the potential impairment of its long-lived assets annually, as required, or whenever events or circumstances indicate their carrying value may not be recoverable. If events or circumstances occur which would require a significant reduction in the estimated useful lives of these assets or a significant decrease in fair value below their carrying value, an adjustment to the lives or carrying values would result in a charge to income in the period of determination.

Warranty Obligations

The Company records the estimated cost of fulfilling product warranties at the time of sale based upon historical costs to fulfill warranty obligations. Provisions may also be recorded subsequent to the time of sale whenever specific events or circumstances impacting product quality become known that would not have been taken into account using historical data. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers and third-party contract manufacturers, the Company's warranty obligation is affected by product failure rates, material usage, and service delivery costs incurred in correcting a product failure. An adverse change in any of these factors may result in the need for additional warranty provisions.

Contingencies

Estimated losses from contingencies are accrued by management based upon the likelihood of a loss and the ability to reasonably estimate the amount of the loss. Estimating potential losses, or even a range of losses, is difficult and involves a great deal of judgment. The Company relies primarily on assessments made by its internal and external legal counsel to make its determination as to whether a loss contingency arising from litigation should be recorded or disclosed. Should the resolution of a contingency result in a loss that the Company did not accrue because management did not believe that the loss was probable or capable of being reasonably estimated, then this loss would result in a charge to income in the period the contingency was resolved.

Income Taxes

As part of the process of preparing consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating the current tax liability, as well as assessing temporary differences arising from the different treatment of items for financial statement and tax purposes. These differences result in deferred tax assets and liabilities, which are recorded on the Consolidated Balance Sheet.

At December 31, 2004, the Company had net deferred tax assets of $31,020,000, primarily resulting from temporary differences between the financial statement and tax bases of assets and liabilities. Management has evaluated the realizability of these deferred tax assets and has determined that it is more likely than not that these assets will be realized. In reaching this conclusion, management has evaluated relevant criteria, including the Company's historical profitability, current projections of future profitability, and the lives of tax credits, net operating and capital losses, and other carryforwards, certain of which have indefinite lives. Should the Company fail to generate sufficient pre-tax profits in future periods, the Company may be required to record material adjustments to these deferred tax assets, resulting in a charge to income in the period of determination.

Significant judgment is required in determining worldwide income tax expense based upon tax laws in the various jurisdictions in which the Company operates. The Company is subject to audits by various tax authorities, which may result in future charges or credits.

Derivative Instruments

In certain instances, the Company enters into forward contracts and currency swaps to hedge against foreign currency fluctuations. These contracts are used to reduce the Company's risk associated with foreign currency exchange rate changes, as the gains or losses on these contracts are intended to offset the losses or gains on the underlying exposures. The Company does not engage in foreign currency speculation.

The Company recorded foreign currency gains of $1,641,000 in 2004, foreign currency losses of $1,712,000 in 2003, and foreign currency gains of $350,000 in 2002. The Company's exposure to foreign currency gains and losses has increased

in recent years as a greater portion of its revenues, expenses, assets, and liabilities are denominated in currencies other than the functional currencies of the Company or its subsidiaries. In addition, foreign exchange rates have fluctuated more significantly in the past few years.

Administering the Company's foreign currency risk management program requires the use of estimates and the application of judgment, including compiling forecasts of transaction activity denominated in various currencies. The failure to identify foreign currency exposures and construct effective hedges may result in material foreign currency gains or losses.

New Pronouncements

On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard (SFAS) No. 123R, "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R requires companies to recognize compensation cost for all share-based payments to employees (including stock option and employee stock purchase plans) at fair value. SFAS 123R will be effective for public companies for interim or annual periods beginning after June 15 , 2005. The Company will adopt SFAS No. 123R beginning in the third quarter of 2005 using the modified prospective method in which compensation cost is recognized beginning on the effective date.

The Company currently recognizes compensation costs using the intrinsic value based method and, as such, generally recognizes no compensation cost. Accordingly, the adoption of SFAS No. 123R's fair value based method will have a significant impact on the Company's results of operations, although it will have no impact on its overall financial position. The impact of adoption of SFAS No. 123R cannot be predicted at this time because it will depend upon levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income (loss) and net income (loss) per share in Note 1 to the Company's consolidated financial statements.

Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Risk

The Company faces exposure to adverse movements in foreign currency exchange rates as a significant portion of its revenues, expenses, assets, and liabilities are denominated in currencies other than the functional currencies of the Company or its subsidiaries. These exposures may change over time as business practices evolve. The Company evaluates its foreign currency exposures on an ongoing basis and makes adjustments to its foreign currency risk management program as circumstances change.

In certain instances, the Company enters into forward contracts and currency swaps to hedge against foreign currency fluctuations. Currency swaps are used to hedge long-term transactions between the Company and its subsidiaries. Forward contracts are used to provide an economic hedge against transactions denominated in currencies other than the functional currencies of the Company or its subsidiaries.

These forward contracts and currency swaps are used to reduce the Company's risk associated with foreign currency exchange rate changes, as the gains or losses on these contracts are intended to offset the losses or gains on the underlying exposures. The Company does not engage in foreign currency speculation.

The success of the Company's foreign currency risk management program depends upon forecasts of transaction activity denominated in various currencies. To the extent that these forecasts are overstated or understated during periods of currency volatility, the Company could experience unanticipated foreign currency gains or losses that could have a material impact on the Company's results of operations. In addition, the failure to identify new exposures and hedge them in a timely manner may result in material foreign currency gains or losses.

The Company enters into currency swaps to hedge the foreign currency exposure of its long-term intercompany loans between the parent and certain of its European subsidiaries. Currency swaps to exchange a total of 48,340,000 Euro Dollars for U.S. Dollars at a weighted-average settlement price of 1.02 USD/Euro, with original terms of two to five years, were outstanding at December 31, 2004. These instruments had a fair value of $68,565,000 at December 31, 2004. The Company also enters into forward contracts to hedge the foreign currency exposure of a portion of its intercompany transactions between its subsidiaries. In addition, the Company enters into forward contracts to hedge the foreign currency exposure of its Irish subsidiary's accounts receivable denominated in U.S. dollars and Japanese Yen. Forward contracts to exchange 1,421,000,000 Japanese Yen for Euro Dollars at a weighted-average settlement price of 135.55 Yen/Euro and contracts to exchange 2,945,000 U.S. dollars for Euro Dollars at a weighted-average settlement price of 1.34 USD/Euro, both with terms of one to four months, were outstanding at December 31, 2004. These instruments had a fair value of $17,112,000 at December 31, 2004.

While the contract amounts of derivative instruments provide one measure of the volume of these transactions, they do not represent the amount of the Company's exposure to changes in foreign currency exchange rates. Because the terms of the derivative instrument and underlying exposure are generally matched at inception, changes in foreign currency exchange rates should not expose the Company to significant losses in earnings or net cash outflows when exposures are properly hedged.

Interest Rate Risk

The Company's investment portfolio includes municipal bonds. Debt securities with original maturities greater than three months are designated as available-for-sale and are reported at fair value. At December 31, 2004, the fair value of the Company's bond portfolio amounted to $325,094,000, with principal amounts totaling $321,120,000, maturities that do not exceed three years, and a yield to maturity of 1.77%. Differences between the fair value and principal amounts of the Company's bond portfolio are primarily attributable to discounts and premiums arising at the acquisition date, as well as unrealized gains and losses at the balance sheet date.

Given the relatively short maturities and investment-grade quality of the Company's bond portfolio at December 31, 2004, a sharp rise in interest rates should not have a material adverse effect on the fair value of these instruments. As a result, the Company does not currently hedge these interest rate exposures.

The following table presents hypothetical changes in the fair value of the Company's bond portfolio at December 31, 2004 arising from selected potential changes in interest rates (in thousands):

Type of security	Valuation of securities given an interest rate decrease		No change in interest rates	Valuation of securities given an interest rate increase	
	(100 BP)	(50 BP)		50 BP	100 BP
Municipal bonds	$327,363	$326,185	$325,094	$324,041	$323,014

A 50 basis point (BP) movement in the Federal Funds Rate has occurred in 15 of the last 56 quarters. There has not been a 100 BP movement in the Federal Funds Rate in any of the last 56 quarters.

Other Market Risks

The Company's investment portfolio also includes a limited partnership interest in Venrock Associates III, L.P., a venture capital fund with an investment focus on Information Technology and Health Care and Life Sciences. The majority of the partnership's portfolio consists of investments in early stage, private companies characterized by a high degree of risk, volatility, and illiquidity. A director of the Company is a Managing General Partner of Venrock Associates.

The fair value of the Company's limited partnership interest is based upon valuations of the partnership's investments as determined by the General Partner. The Company understands that the General Partner adjusts the investment valuations at least quarterly to reflect both realized and unrealized gains and losses on partnership investments. Securities of public companies are valued at market, subject to appropriate discounts to reflect limitations on liquidity. Securities of private companies are valued at an estimated fair value, which initially is at cost, adjusted for subsequent transactions that indicate a higher or lower value is warranted. The value of private securities may be discounted when, in the General Partner's judgment, the carrying value of such private securities has been impaired by specific events.

Given the nature of the partnership's portfolio and the difficulty inherent in valuing these investments, there is a great deal of uncertainty surrounding the future value of the Company's interest in the limited partnership and future impairment charges may be required.

Cognex Corporation: Consolidated Statements of Operations

(in thousands, except per share amounts)

Year Ended December 31,	**2004**	2003	2002
Revenue			
Product	**$176,569**	$130,670	$ 96,202
Service	**25,388**	19,422	17,905
	201,957	150,092	114,107
Cost of revenue			
Product	**42,788**	37,870	28,499
Service	**14,583**	12,269	11,360
	57,371	50,139	39,859
Gross margin			
Product	**133,781**	92,800	67,703
Service	**10,805**	7,153	6,545
	144,586	99,953	74,248
Research, development, and engineering expenses	**27,063**	24,719	25,630
Selling, general, and administrative expenses	**70,674**	55,724	58,376
Operating income (loss)	**46,849**	19,510	(9,758)
Investment and other income	**4,670**	5,450	9,156
Loss on sale of equity securities and impairment of investment in limited partnership	**–**	–	(7,952)
Foreign currency gain (loss)	**1,641**	(1,712)	350
Income (loss) before taxes	**53,160**	23,248	(8,204)
Income tax provision (benefit)	**15,416**	7,297	(2,177)
Net income (loss)	**$ 37,744**	$ 15,951	$ (6,027)
Net income (loss) per common and common equivalent share:			
Basic	**$ 0.83**	$ 0.37	$ (0.14)
Diluted	**$ 0.80**	$ 0.36	$ (0.14)
Weighted-average common and common equivalent shares outstanding:			
Basic	**45,480**	43,173	43,503
Diluted	**47,358**	44,466	43,503
Cash dividends per common share	**$ 0.28**	$ 0.12	$ –

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

(in thousands)

December 31,	2004	2003
Assets		
Current assets:		
Cash and cash equivalents	**$ 54,270**	$ 49,980
Short-term investments	**180,409**	82,653
Accounts receivable, less reserves of $2,596 and $2,613 in 2004 and 2003, respectively	**33,816**	26,697
Inventories, net	**20,091**	15,519
Deferred income taxes	**9,504**	8,223
Prepaid expenses and other current assets	**14,871**	14,526
Total current assets	**312,961**	197,598
Long-term investments	**156,397**	170,869
Property, plant, and equipment, net	**23,995**	24,980
Deferred income taxes	**21,516**	19,428
Intangible assets, net	**7,506**	8,582
Goodwill	**7,033**	7,222
Other assets	**3,900**	3,854
	$533,308	$432,533
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	**$ 5,563**	$ 5,555
Accrued expenses	**55,779**	32,098
Customer deposits	**3,445**	3,932
Deferred revenue	**5,714**	5,702
Total current liabilities	**70,501**	47,287
Other liabilities	**–**	252
Commitments (Notes 4, 9, 10, 11, 12, and 18)		
Shareholders' equity:		
Common stock, $.002 par value – Authorized: 140,000 shares, issued: 46,155 and 48,186 shares in 2004 and 2003, respectively	**92**	96
Additional paid-in capital	**192,860**	209,679
Treasury stock, at cost, 0 and 4,253 shares in 2004 and 2003, respectively	**–**	(72,445)
Retained earnings	**283,712**	258,724
Accumulated other comprehensive loss	**(13,857)**	(11,060)
Total shareholders' equity	**462,807**	384,994
	$533,308	$432,533

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

Cognex Corporation: Consolidated Statements of Shareholders' Equity

(in thousands)

	Common Stock		Additional Paid-in Capital
	Shares	Par Value	
Balance at December 31, 2001	46,289	$93	$173,675
Issuance of common stock under stock option, stock purchase, and other plans	588	1	7,470
Tax benefit from exercise of stock options	–	–	3,450
Repurchase of common stock	–	–	–
Common stock received for payment of stock option exercises	–	–	–
Comprehensive loss:			
Net loss	–	–	–
Recognition of accumulated gains on equity securities in current operations, net of tax of $2,506	–	–	–
Losses on currency swaps, net of gains on long-term intercompany loans, net of tax of $21	–	–	–
Foreign currency translation adjustment	–	–	–
Comprehensive loss			
Balance at December 31, 2002	46,877	$94	$184,595
Issuance of common stock under stock option, stock purchase, and other plans	1,309	2	20,782
Tax benefit from exercise of stock options	–	–	4,302
Payment of dividends	–	–	–
Common stock received for payment of stock option exercises	–	–	–
Comprehensive income:			
Net income	–	–	–
Losses on currency swaps, net of gains on long-term intercompany loans, net of tax of $367	–	–	–
Net unrealized gain on available-for-sale investments, net of tax of $299	–	–	–
Foreign currency translation adjustment	–	–	–
Comprehensive income			
Balance at December 31, 2003	48,186	$96	$209,679
Issuance of common stock under stock option, stock purchase, and other plans	2,232	4	44,213
Tax benefit from exercise of stock options	–	–	11,722
Payment of dividends	–	–	–
Common stock received for payment of stock option exercises	–	–	–
Retirement of treasury stock	(4,263)	(8)	(72,754)
Comprehensive income:			
Net income	–	–	–
Losses on currency swaps, net of gains on long-term intercompany loans, net of tax of $1,016	–	–	–
Net unrealized loss on available-for-sale investments, net of tax of $696	–	–	–
Foreign currency translation adjustment	–	–	–
Comprehensive income			
Balance at December 31, 2004	**46,155**	**$92**	**$192,860**

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

Treasury Stock Shares	Treasury Stock Cost	Retained Earnings	Accumulated Other Comprehensive Loss	Comprehensive Income (Loss)	Total Shareholders' Equity
2,390	$(43,419)	$254,037	$ (6,342)		$378,044
–	–	–	–	–	7,471
–	–	–	–	–	3,450
1,768	(26,425)	–	–	–	(26,425)
91	(2,467)	–	–	–	(2,467)
–	–	(6,027)	–	(6,027)	(6,027)
–	–	–	4,269	4,269	4,269
–	–	–	(35)	(35)	(35)
–	–	–	(3,760)	(3,760)	(3,760)
				$ (5,553)	
4,249	$(72,311)	$248,010	$ (5,868)		$354,520
–	–	–	–	–	20,784
–	–	–	–	–	4,302
–	–	(5,237)	–	–	(5,237)
4	(134)	–	–	–	(134)
–	–	15,951	–	15,951	15,951
–	–	–	(625)	(625)	(625)
–	–	–	509	509	509
–	–	–	(5,076)	(5,076)	(5,076)
				$10,759	
4,253	$(72,445)	$258,724	$(11,060)		$384,994
–	–	–	–	–	44,217
–	–	–	–	–	11,722
–	–	(12,756)	–	–	(12,756)
10	(317)	–	–	–	(317)
(4,263)	72,762	–	–	–	–
–	–	37,744	–	37,744	37,744
–	–	–	(1,730)	(1,730)	(1,730)
–	–	–	(1,185)	(1,185)	(1,185)
–	–	–	118	118	118
				$34,947	
–	**$ –**	**$283,712**	**$(13,857)**		**$462,807**

Cognex Corporation: Consolidated Statements of Cash Flows

(in thousands)

Year Ended December 31,	**2004**	2003	2002
Cash flows from operating activities:			
Net income (loss)	**$ 37,744**	$ 15,951	$ (6,027)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation of property, plant, and equipment	**4,548**	5,422	6,534
Amortization of intangible assets	**1,526**	1,012	543
Amortization of investments	**3,896**	3,728	2,447
Tax benefit from exercise of stock options	**11,722**	4,302	3,450
Deferred income tax benefit	**(2,568)**	(432)	(2,196)
Net loss (gain) on investment in limited partnership	**(154)**	1,031	680
Impairment on investment in limited partnership	**–**	–	1,768
Loss on sale of equity securities	**–**	–	6,184
Changes in current assets and current liabilities:			
Accounts receivable	**(5,417)**	(4,775)	(348)
Inventories	**(3,642)**	5,833	5,010
Accounts payable	**(290)**	1,482	(2,569)
Accrued expenses	**15,785**	148	(1,411)
Other current assets and current liabilities	**(49)**	(2,783)	1,979
Other operating activities	**75**	45	402
Net cash provided by operating activities	**63,176**	30,964	16,446
Cash flows from investing activities:			
Purchase of investments	**(805,621)**	(316,481)	(137,922)
Maturity and sale of investments	**716,714**	276,529	184,453
Purchase of property, plant, and equipment	**(3,120)**	(2,462)	(2,227)
Cash paid for business acquisitions	**(123)**	(11,787)	(349)
Net cash provided by (used in) investing activities	**(92,150)**	(54,201)	43,955
Cash flows from financing activities:			
Issuance of common stock under stock option, stock purchase, and other plans	**43,900**	20,650	5,004
Repurchase of common stock	**–**	–	(26,425)
Payment of dividends	**(12,756)**	(5,237)	–
Net cash provided by (used in) financing activities	**31,144**	15,413	(21,421)
Effect of exchange rate changes on cash	**2,120**	(660)	(4,875)
Net increase (decrease) in cash and cash equivalents	**4,290**	(8,484)	34,105
Cash and cash equivalents at beginning of year	**49,980**	58,464	24,359
Cash and cash equivalents at end of year	**$ 54,270**	$ 49,980	$ 58,464

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

Note 1: Summary of Significant Accounting Policies

The accompanying consolidated financial statements reflect the application of the significant accounting policies described below.

Nature of Operations

Cognex Corporation (the "Company") designs, develops, manufactures, and markets machine vision systems, or computers that can "see." The Company's products are used to automate a wide range of manufacturing processes where vision is required.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and judgments that affect the reported amounts of assets and liabilities at the balance sheet date and the reported amounts of revenue and expenses during the year. Actual results could differ from those estimates.

Basis of Consolidation

The consolidated financial statements include the accounts of Cognex Corporation and its subsidiaries, all of which are wholly-owned. All intercompany accounts and transactions have been eliminated. Certain amounts reported in prior years have been reclassified to be consistent with the current year presentation.

Foreign Currency

The financial statements of the Company's foreign subsidiaries, where the local currency is the functional currency, are translated using exchange rates in effect at the end of the year for assets and liabilities and average exchange rates during the year for results of operations. The resulting foreign currency translation adjustment is recorded in shareholders' equity as other comprehensive income (loss).

Cash, Cash Equivalents, and Investments

Debt securities purchased with original maturities of three months or less are classified as cash equivalents and are stated at amortized cost. Debt securities with original maturities greater than three months and remaining maturities of one year or less, as well as auction rate securities for which interest rates reset in less than 90 days but for which the maturity date is greater than 90 days, are classified as short-term investments. Despite the long-term nature of their contractual maturities, the Company has the ability to quickly liquidate auction rate securities. Debt securities with remaining maturities greater than one year, as well as a limited partnership interest, are classified as long-term investments. It is the Company's policy to invest in debt securities with contractual maturities that do not exceed three years.

Debt securities with original maturities greater than three months are designated as available-for-sale and are reported at fair value, with unrealized gains and losses, net of tax, recorded in shareholders' equity as other comprehensive income (loss). Realized gains and losses are included in current operations, along with the amortization of the discount or premium arising at acquisition and are calculated using the specific identification method.

The Company's limited partnership interest is accounted for using the cost method because the Company's investment is less than 5% of the partnership and the Company has no influence over the partnership's operating and financial policies. The Company monitors the carrying value of its investment compared to its fair value to determine whether an other-than-temporary impairment in its interest in the limited partnership has occurred. If the decline in fair value is determined to be other-than-temporary, an impairment charge is recorded in current operations.

Accounts Receivable

The Company establishes reserves against its accounts receivable for potential credit losses when it determines receivables are at risk for collection based upon the length of time receivables have been outstanding, as well as various other factors. Receivables are written off against these reserves in the period they are determined to be uncollectible.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using standard costs, which approximate the first in, first out (FIFO) method. The Company estimates excess and obsolescence exposures based upon assumptions about future demand, product transitions, and market conditions and records reserves to reduce the carrying value of inventories to their net realizable value.

The Company generally disposes of obsolete inventory upon determination of obsolescence. The Company does not dispose of excess inventory immediately, due to the possibility that some of this inventory could be sold to customers as a result of differences between actual and forecasted demand.

When inventory has been written down below cost, such reduced amount is considered the new cost basis for subsequent accounting purposes. As a result, the Company would recognize a higher than normal gross margin if the reserved inventory were subsequently sold.

Property, Plant, and Equipment

Property, plant, and equipment are stated at cost and depreciated using the straight-line method over the assets' estimated useful lives. Buildings' useful lives are 39 years, building improvements' useful lives are 10 years, and the useful lives of computer hardware, computer software, and furniture and fixtures range from two to five years. Leasehold improvements are depreciated over the shorter of the estimated useful lives or the remaining terms of the leases. Maintenance and repairs are expensed when incurred; additions and improvements are capitalized. Upon retirement or disposition, the cost and related accumulated depreciation of the assets disposed of are removed from the accounts, with any resulting gain or loss included in current operations.

Intangible Assets

Intangible assets are stated at cost and amortized using the straight-line method over the assets' estimated useful lives, which range from two to ten years. The Company evaluates the possible impairment of long-lived assets, including intangible assets, whenever events or circumstances indicate the carrying value of the assets may not be recoverable. At the occurrence of a certain event or change in circumstances, the

Company evaluates the potential impairment of an asset based upon the estimated future undiscounted cash flows. If an impairment exists, the Company determines the amount of such impairment based upon the present value of the estimated future cash flows using a discount rate commensurate with the risks involved.

Goodwill

Goodwill is stated at cost. The Company evaluates the possible impairment of goodwill annually each fourth quarter, and whenever events or circumstances indicate the carrying value of the goodwill may not be recoverable. The Company evaluates the potential impairment of goodwill by comparing the fair value of the reporting unit to its carrying value, including goodwill. If the fair value is less than the carrying value, the Company determines the amount of such impairment by comparing the implied fair value of the goodwill to its carrying value.

Warranty Obligations

The Company warrants its hardware products to be free from defects in material and workmanship for periods ranging from six months to two years from the time of sale based upon the product being purchased and the terms of the customer arrangement. Warranty obligations are accounted for in accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," since it is probable that customers will make claims under warranties related to products that have been sold and the amount of these claims can be reasonably estimated based upon experience. Estimated warranty obligations are evaluated and recorded at the time of sale based upon historical costs to fulfill warranty obligations. Provisions may also be recorded subsequent to the time of sale whenever specific events or circumstances impacting product quality become known that would not have been taken into account using historical data.

Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position (SOP) No. 97-2, "Software Revenue Recognition," as amended by SOP No. 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions," since the software is not incidental to the arrangement and the services in the arrangement do not involve significant production, modification, or customization of the software. The Company recognizes revenue from product sales upon delivery if a signed customer contract or purchase order has been received, the fee is fixed or determinable, and collection of the resulting receivable is probable. If the arrangement contains customer-specified acceptance criteria, then revenue is deferred until the Company can demonstrate that the customer's criteria have been met.

Certain of the Company's products are sold with multiple elements, such as maintenance and support programs, education services, and installation services. The Company accounts for each element separately. The amount allocated to each undelivered element is the price charged when the item is sold separately, with the residual value from the arrangement allocated to the delivered element. In addition, the Company also provides consulting services. Revenue from maintenance and support programs is deferred and recognized ratably over the program period.

Revenue from education and consulting services are recognized over the period the services are provided. Revenue from installation services is recognized when the customer has signed off that the installation is complete.

The Company's products are sold directly to end users, as well as to resellers including original equipment manufacturers (OEMs), system integrators, and distributors. Revenue is recognized upon delivery of the product to the reseller, assuming all other revenue recognition criteria have been met. The Company establishes reserves against revenue for potential product returns in accordance with Statement of Financial Accounting Standards No. 48, "Revenue Recognition When Right of Return Exists," since the amount of future returns can be reasonably estimated based upon experience.

Amounts billed to customers related to shipping and handling, as well as reimbursements received from customers for out-of-pocket expenses, are classified as revenue, with the associated costs included in cost of revenue.

Research and Development

Research and development costs for internally-developed products are expensed when incurred until technological feasibility has been established for the product. Thereafter, all software costs are capitalized until the product is available for general release to customers. The Company determines technological feasibility at the time the product reaches beta in its stage of development. Historically, the time incurred between beta and general release to customers has been short, and therefore, the costs have been insignificant. As a result, the Company has not capitalized software costs associated with internally-developed products.

The cost of acquired software for products determined to have reached technological feasibility is capitalized; otherwise the cost is expensed. Capitalized software costs are amortized using the straight-line method over the economic life of the product, which is typically two to five years.

Income Taxes

The Company accounts for income taxes under the liability method. Under this method, a deferred tax asset or liability is determined based upon the differences between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates that will be in effect when these differences reverse. Tax credits are recorded as a reduction in income taxes. Valuation allowances are provided if, based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted-average number of common shares outstanding for the period plus potential dilutive common shares. All potential dilutive common shares are excluded from the computation of net loss per share because they are antidilutive. Dilutive common equivalent shares consist of stock options and are calculated using the treasury stock method.

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. Other comprehensive income (loss) consists of foreign currency translation adjustments, unrealized gains and losses on available-for-sale investments, net of tax, and gains and losses on long-term intercompany loans and their associated currency swaps, net of tax.

Concentrations of Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, cash equivalents, investments, and trade receivables. The Company primarily invests in municipal obligations of state and local government entities. The Company has established guidelines relative to credit ratings, diversification, and maturities of its debt securities that maintain safety and liquidity. The Company has not experienced any significant realized losses on its debt securities.

A significant portion of the Company's sales and receivables are from customers who are either in or who serve the semiconductor and electronics industries. The Company performs ongoing credit evaluations of its customers and maintains allowances for potential credit losses. The Company has not experienced any significant losses related to the collection of its accounts receivable.

A significant portion of the Company's MVSD inventory is manufactured by a third-party contractor. The Company is dependent upon this contractor to provide quality product and meet delivery schedules. The Company engages in extensive product quality programs and processes, including actively monitoring the performance of its third-party manufacturers.

Derivative Instruments

The Company has adopted the accounting and disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current operations or in shareholders' equity as other comprehensive income (loss), depending upon whether the derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. Hedges of underlying exposures are designated and documented at the inception of the hedge and are evaluated for effectiveness at least quarterly. As the terms of the derivative are generally matched at inception with the underlying exposure, hedging effectiveness is calculated by comparing the change in fair value of the derivative to the change in fair value of the underlying exposure.

In certain instances, the Company enters into forward contracts and currency swaps to hedge against foreign currency fluctuations. Currency swaps are used to hedge long-term transactions between the Company and its subsidiaries. Forward contracts are used to provide an economic hedge against transactions denominated in currencies other than the functional currencies of the Company or its subsidiaries.

These forward contracts and currency swaps are used to reduce the Company's risk associated with exchange rate changes, as the gains or losses on these contracts are intended to offset the losses or gains on the underlying exposures. The Company does not engage in foreign currency speculation.

Stock-Based Compensation Plans

The Company has adopted the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," and SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123." The Company continues to recognize compensation costs using the intrinsic value based method described in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." No compensation costs were recognized in 2004, 2003, or 2002.

Net income (loss) and net income (loss) per share as reported in these consolidated financial statements and on a pro forma basis, as if the fair value based method described in SFAS No. 123 had been adopted, are as follows (in thousands, except per share amounts):

Year Ended December 31,	**2004**	2003	2002
Net income (loss), as reported	**$ 37,744**	$ 15,951	$ (6,027)
Less: Total stock-based compensation costs determined under fair value based method, net of tax	**(13,183)**	(14,092)	(17,235)
Net income (loss), pro forma	**$ 24,561**	$ 1,859	$(23,262)
Basic net income (loss) per share, as reported	**$ 0.83**	$ 0.37	$ (0.14)
Basic net income (loss) per share, pro forma	**$ 0.54**	$ 0.04	$ (0.53)
Diluted net income (loss) per share, as reported	**$ 0.80**	$ 0.36	$ (0.14)
Diluted net income (loss) per share, pro forma	**$ 0.49**	$ 0.04	$ (0.53)

For the purpose of providing pro forma disclosures, the fair values of stock options granted were estimated using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants:

Year Ended December 31,	**2004**	2003	2002
Risk-free interest rate	**2.5%**	2.1%	3.5%
Expected life (in years)	**3.1**	2.9	2.9
Expected volatility	**45%**	58%	57%
Expected annualized dividend yield	**.73%**	.85%	–

Treasury Stock

Effective July 1, 2004, the Massachusetts Business Corporation Act (the "Act") eliminated the concept of treasury shares. Under the Act, shares previously classified as treasury shares are to be treated as authorized but unissued shares of common stock. As a result of this change, the Company reclassified its treasury shares to authorized but unissued shares of common stock on the Consolidated Balance Sheet.

Note 2: New Pronouncements

On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard (SFAS) No. 123R, "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R requires companies to recognize compensation cost for all share-based payments to employees (including stock option and employee stock purchase plans) at fair value. SFAS 123R will be effective for public companies for interim or annual periods beginning after June 15 , 2005. The Company will adopt SFAS No. 123R beginning in the third quarter of 2005 using the modified prospective method in which compensation cost is recognized beginning on the effective date.

The Company currently recognizes compensation costs using the intrinsic value based method and, as such, generally recognizes no compensation cost. Accordingly, the adoption of SFAS No. 123R's fair value based method will have a significant impact on the Company's results of operations, although it will have no impact on its overall financial position. The impact of adoption of SFAS No. 123R cannot be predicted at this time because it will depend upon levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income (loss) and net income (loss) per share in Note 1 to the Company's consolidated financial statements.

Note 3: Foreign Currency Risk Management

The Company enters into currency swaps to hedge the foreign currency exposure of its long-term intercompany loans between the parent and certain of its European subsidiaries. These contracts, which relate to the Euro Dollar, have original terms of two to five years. These hedges have been designated for hedge accounting. They are classified as net investment hedges, with the gains or losses on the currency swaps, along with the associated losses or gains on the intercompany loans, net of tax, recorded in shareholders' equity as other comprehensive income (loss) to the extent they are effective as a hedge. The Company recorded net foreign currency losses of $1,730,000, $625,000, and $35,000 in other comprehensive income (loss) on the intercompany loans and associated currency swaps in 2004, 2003, and 2002, respectively.

The Company enters into forward contracts to hedge the foreign currency exposure of a portion of its intercompany transactions between its subsidiaries and to hedge the foreign currency exposure of its Irish subsidiary's accounts receivable denominated in U.S. Dollars and Japanese Yen. These contracts, which relate to the Euro Dollar and Japanese Yen, generally have terms of one to four months. These hedges have been deemed economic hedges and have not been designated for hedge accounting. They are classified as fair value hedges, with the gains or losses on the forward contracts, along with the associated losses or gains on the revaluation and

settlement of the intercompany balances and accounts receivable, recorded in current operations. In addition to the transactions described above that are included in the Company's hedging program, the Company enters into other transactions denominated in foreign currencies for which the exchange rate gains or losses are included in current operations. The Company recorded net foreign currency gains of $1,641,000 in 2004, net foreign currency losses of $1,712,000 in 2003, and net foreign currency gains of $350,000 in 2002, representing the total net exchange rate gains or losses that are recognized in current operations.

Note 4: Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and investments consist of the following (in thousands):

December 31,	**2004**	2003
Cash	**$ 54,270**	$ 49,980
Total cash and cash equivalents	**54,270**	49,980
Municipal bonds	**180,409**	82,653
Total short-term investments	**180,409**	82,653
Municipal bonds	**144,685**	156,511
Corporate bonds	–	4,212
Limited partnership interest	**11,712**	10,146
Total long-term investments	**156,397**	170,869
	$391,076	$303,502

In connection with the preparation of the accompanying consolidated financial statements, the Company concluded that it was appropriate to classify its auction rate securities as short-term investments. Previously, such securities were classified as cash and cash equivalents. Accordingly, the Company revised the classification to exclude from cash and cash equivalents $26,247,000 at December 31, 2003 and to include such amounts in short-term investments on the Consolidated Balance Sheets. This revised classification was also reflected in the Consolidated Statements of Cash Flows for all periods presented to reflect gross purchases and sales of these investments, which had the impact of increasing net cash used in investing activities by $23,847,000 in 2003 and increasing net cash provided by investing activities by $4,901,000 in 2002. This change in classification did not affect previously reported cash flows from operations or financing activities, or the results of operations and statements of shareholders' equity for the periods presented.

The following is a summary of the Company's available-for-sale investments at December 31, 2004 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term municipal bonds	$180,627	$14	$ (232)	$180,409
Long-term municipal bonds	145,540	5	(860)	144,685
	$326,167	$19	$(1,092)	$325,094

The Company recorded gross realized gains on the sale of debt securities totaling $392,000 in 2004, $1,222,000 in 2003, and $1,112,000 in 2002. The Company recorded gross realized losses on the sale of debt securities totaling $90,000 in 2004, $24,000 in 2003, and $25,000 in 2002.

On June 30, 2000, Cognex Corporation became a Limited Partner in Venrock Associates III, L.P. (Venrock), a venture capital fund. A director of the Company is a Managing General Partner of Venrock Associates. In the original agreement with Venrock, the Company committed to a total investment in the limited partnership of up to $25,000,000 with an expiration date of January 1, 2005. In January 2005, the Company signed an amendment to the original agreement with Venrock, which reduces its total commitment to $22,500,000 and extends the commitment period through December 31, 2010. The Company does not have the right to withdraw from the partnership prior to December 31, 2010. As of December 31, 2004, the Company had contributed $15,875,000 to the partnership, including $2,250,000 during 2004. Venrock returned $838,000 to the Company during 2004 representing realized gains on the sale of certain investments in the portfolio.

At December 31, 2004, the carrying value of this investment was $11,712,000 compared to an estimated fair value, as determined by the General Partner, of $10,730,000. The unrealized loss of $982,000 was determined to be temporary.

Note 5: Inventories

Inventories consist of the following (in thousands):

December 31,	**2004**	2003
Raw materials	**$ 6,311**	$ 7,831
Work-in-process	**6,285**	3,323
Finished goods	**7,495**	4,365
	$20,091	$15,519

In the fourth quarter of 2001, the Company recorded a $16,300,000 charge in "Cost of product revenue" on the Consolidated Statement of Operations for excess inventories and purchase commitments resulting from an extended slowdown in the semiconductor and electronics industries, as well as the expected transition to newer Cognex hardware platforms by the Company's OEM customers. A total of $12,500,000 of this charge represented reserves against existing inventories and was accordingly included in "Inventories" on the Consolidated Balance Sheet at December 31, 2001. The remaining $3,800,000 of the charge represented commitments to purchase excess components and systems from various suppliers and accordingly was included in "Accrued Expenses" on the Consolidated Balance Sheet at December 31, 2001.

The following table summarizes the change in the inventory-related reserve established in the fourth quarter of 2001 (in thousands):

	Balance Sheet		Statement of Operations
	Inventories	Accrued Expenses	Benefits
Initial charge in the fourth quarter of 2001	$12,500	$ 3,800	–
Inventory sold to customers	(1,790)	–	$1,790
Settlement of purchase commitments	1,506	(2,400)	894
Reserve balance at December 31, 2002	$12,216	$ 1,400	
Benefits to cost of product revenue recorded in 2002			$2,684
Inventory sold to customers	(1,290)	–	1,290
Inventory sold to brokers	(667)	–	–
Write-off and scrap of inventory	(876)	–	–
Reserve balance at December 31, 2003	$ 9,383	$ 1,400	
Benefits to cost of product revenue recorded in 2003			$1,290
Inventory sold to customers	(805)	–	805
Inventory sold to brokers	(387)	–	–
Write-off and scrap of inventory	(743)	–	–
Reserve balance at December 31, 2004	$ 7,448	$ 1,400	
Benefits to cost of product revenue recorded in 2004			$ 805

A favorable settlement of the remaining purchase commitments may result in a recovery of a portion of the remaining $1,400,000 accrued at December 31, 2004.

Note 6: Property, Plant, and Equipment

Property, plant, and equipment consist of the following (in thousands):

December 31,	**2004**	2003
Land	**$ 3,051**	$ 3,051
Buildings	**17,571**	17,571
Building improvements	**4,622**	4,156
Computer hardware and software	**33,826**	32,100
Furniture and fixtures	**4,183**	3,919
Leasehold improvements	**2,197**	2,308
	65,450	63,105
Less: accumulated depreciation	**(41,455)**	(38,125)
	$ 23,995	$ 24,980

Buildings include property held for lease with a cost basis of $4,950,000 at December 31, 2004 and 2003 and accumulated depreciation of $1,206,000 and $1,079,000 at December 31, 2004 and 2003, respectively.

Note 7: Intangible Assets

Intangible assets consist of the following (in thousands):

	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
December 31, 2004			
Customer contracts and relationships	**$ 8,349**	**$1,522**	**$6,827**
Complete technology	**5,440**	**4,864**	**576**
Patents	**122**	**42**	**80**
Noncompete agreements	**54**	**31**	**23**
	$13,965	**$6,459**	**$7,506**
December 31, 2003			
Customer contracts and relationships	$ 7,832	$ 492	$ 7,340
Complete technology	5,388	4,280	1,108
Patents	113	17	96
Noncompete agreements	50	12	38
	$ 13,383	$ 4,801	$ 8,582

Aggregate amortization expense was $1,526,000 in 2004, $1,012,000 in 2003, and $543,000 in 2002. Estimated amortization expense for each of the five succeeding fiscal years and thereafter is as follows (in thousands):

Year ended December 31,	Amount
2005	$1,315
2006	1,195
2007	1,136
2008	1,035
2009	1,001
Thereafter	1,824
	$7,506

Note 8: Goodwill

The Company has two reporting units with goodwill, the Modular Vision Systems Division (MVSD) and the Surface Inspection Systems Division (SISD), which are also reportable segments.

The changes in the carrying value of goodwill are as follows (in thousands):

	MVSD	SISD	Consolidated
Balance at December 31, 2002	$1,488	$2,254	$3,742
Business acquisitions (Note 18)	2,753	–	2,753
Foreign exchange rate changes	281	446	727
Balance at December 31, 2003	$4,522	$2,700	$7,222
Purchase price adjustment (Note 18)	(514)	–	(514)
Foreign exchange rate changes	113	212	325
Balance at December 31, 2004	$4,121	$2,912	$7,033

Note 9: Accrued Expenses

Accrued expenses consist of the following (in thousands):

December 31,	**2004**	2003
Forward contracts and currency swaps	**$19,527**	$12,971
Income taxes	**9,165**	3,017
Company bonuses	**5,979**	423
Consumption taxes	**4,900**	2,368
Salaries, commissions, and payroll taxes	**3,452**	2,340
Vacation	**2,775**	2,348
Warranty obligations	**1,758**	2,119
Professional fees	**1,698**	1,780
Purchase commitments	**1,400**	1,400
Other	**5,125**	3,332
	$55,779	$32,098

The changes in the warranty obligation are as follows (in thousands):

Balance at December 31, 2002	$ 1,523
Provisions for warranties issued during the period	1,591
Provisions related to pre-existing warranties	550
Fulfillment of warranty obligations	(1,771)
Foreign exchange rate changes	226
Balance at December 31, 2003	$ 2,119
Provisions for warranties	797
Fulfillment of warranty obligations	(1,298)
Foreign exchange rate changes	140
Balance at December 31, 2004	$ 1,758

Note 10: Commitments

At December 31, 2004, the Company had purchase orders totaling $4,960,000 to purchase inventory from various vendors. These purchase commitments relate to expected sales in 2005.

The Company conducts certain of its operations in leased facilities. These lease agreements expire at various dates through 2014 and are accounted for as operating leases. Annual rental expense totaled $4,662,000 in 2004, $4,427,000 in 2003, and $4,536,000 in 2002. Future minimum rental payments under these agreements are as follows (in thousands):

Year ended December 31,	Amount
2005	$ 3,878
2006	977
2007	349
2008	192
2009	190
Thereafter	445
	$ 6,031

The Company owns an 83,000 square-foot office building adjacent to its corporate headquarters. The building is currently occupied with tenants who have lease agreements that expire at various dates through 2007. Annual rental income totaled $818,000 in 2004, $1,137,000 in 2003, and $1,224,000 in 2002. Rental income and related expenses are included in "Investment and other income" on the Consolidated Statement of Operations. Future minimum rental receipts under non-cancelable lease agreements are $891,000 in 2005 and 2006, $294,000 in 2007, $95,000 in 2008, and $40,000 in 2009.

Note 11: Indemnification Provisions

Except as limited by Massachusetts law, the by-laws of the Company require it to indemnify certain current or former directors, officers, and employees of the Company against expenses incurred by them in connection with each proceeding in which he or she is involved as a result of serving or having served in certain capacities. Indemnification is not available with respect to a proceeding as to which it has been adjudicated that the person did not act in good faith in the reasonable belief that the action was in the best interests of the Company. The maximum potential amount of future payments the Company could be required to make under these provisions is unlimited. The Company has never incurred significant costs related to these indemnification provisions. As a result, the Company believes the estimated fair value of these provisions is minimal.

The Company accepts standard limited indemnification provisions in the ordinary course of business, whereby it indemnifies its customers for certain direct damages incurred in connection with third-party patent or other intellectual property infringement claims with respect to the use of the Company's products. The term of these indemnification provisions generally coincides with the customer's use of the Company's products. The maximum potential amount of future payments the Company could be required to make under these provisions is always subject to fixed monetary limits. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification provisions. As a result, the Company believes the estimated fair value of these provisions is minimal.

The Company also accepts limited indemnification provisions from time to time, whereby it indemnifies customers for certain direct damages incurred in connection with bodily injury and property damage arising from the installation of the Company's products. The term of these indemnification provisions generally coincides with the period of installation. The maximum potential amount of future payments the Company could be required to make under these provisions is limited and is likely recoverable under the Company's insurance policies. As a result of this coverage, and the fact that the Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification provisions, the Company believes the estimated fair value of these provisions is minimal.

Note 12: Standby Letters of Credit

On March 25, 2004, the Company provided standby letters of credit totaling 3,146,280,000 Yen (or approximately $30,722,000) to taxing authorities in Japan that are collateralized by investments on the Consolidated Balance Sheet. The Tokyo Regional Taxation Bureau (TRTB) has asserted that Cognex Corporation has a permanent establishment in Japan that would require certain income, previously reported on U.S. tax returns for the years ended December 31, 1997 through December 31, 2001, to be subject instead to taxation in Japan. The Company disagrees with this position and believes that this assertion is inconsistent with principles under the U.S. – Japan income tax treaty. The Company has filed a notice of objection and request for deferral of tax payment and intends to contest

this assessment vigorously, although no assurances can be made that the Company will prevail in this matter. In September 2003, the Company also filed a request with the Internal Revenue Service Tax Treaty Division for competent authority assistance. Until this matter is resolved, the Company is required to provide collateral for these tax assessments. These letters of credit expire in approximately one year. Should the TRTB prevail in its assertion, the income in question would be taxable in Japan and the Company would be required to pay approximately $30,722,000 in taxes, interest, and penalties to Japanese taxing authorities. The Company would then be entitled to recoup the majority of this amount from taxing authorities in the U.S.

Note 13: Shareholders' Equity

Preferred Stock

The Company has 400,000 shares of authorized but unissued $.01 par value preferred stock.

Stock Repurchase Program

On December 12, 2000, the Company's Board of Directors authorized the repurchase of up to $100,000,000 of the Company's common stock. During 2002, a total of 1,768,452 shares were repurchased at a cost of $26,425,000. There have been no other shares repurchased under this program.

Stock Option Plans

At December 31, 2004, the Company had 9,311,319 shares available for grant under the following stock option plans: the 1998 Director Plan, 4,000; the 1998 Stock Incentive Plan, 1,807,319; no shares under the 2001 Interim General Stock Incentive Plan; and the 2001 General Stock Option Plan, 7,500,000.

The 2001 General Stock Option Plan was adopted by the Board of Directors on December 11, 2001 without shareholder approval. This plan provides for the granting of nonqualified stock options to any employee who is actively employed by the Company and is not an officer or director of the Company. The maximum number of shares of common stock available for grant under the plan is 7,500,000 shares. All option grants must have an exercise price per share that is no less than the fair market value per share of the Company's common stock on the grant date and must have a term that is no longer than fifteen years from the grant date. No stock options have been granted under the 2001 General Stock Option Plan.

The 2001 Interim General Stock Incentive Plan was adopted by the Board of Directors on July 17, 2001 without shareholder approval. This plan provides for the granting of nonqualified stock options to any employee who is actively employed by the Company and is not an officer or director of the Company. The maximum number of shares of common stock available for grant under the plan is 400,000 shares. All option grants have an exercise price per share that is no less than the fair market value per share of the Company's common stock on the grant date and must have a term that is no longer than fifteen years from the grant date. All 400,000 stock options have been granted under the 2001 Interim General Stock Incentive Plan.

On April 21, 1998, the shareholders approved the 1998 Stock Incentive Plan, under which the Company initially was able to grant stock options and stock awards to purchase up to 1,700,000 shares of common stock. Effective January 1, 1999 and each January 1st thereafter during the term of the 1998 Stock Incentive Plan, the number of shares of common stock available for grants of stock options and stock awards is increased automatically by an amount equal to 4.5% of the total number of issued shares of common stock as of the close of business on December 31st of the preceding year.

Stock options generally vest over four years and generally expire no later than ten years from the date of grant.

The following table summarizes the status of the Company's stock option plans at December 31, 2004, 2003, and 2002, and changes during the years then ended (shares in thousands):

	2004		2003		2002	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	**10,986**	**$22.85**	10,381	$22.40	9,529	$ 22.31
Granted at fair market value	**2,253**	**29.31**	2,402	21.54	2,211	21.38
Exercised	**(2,210)**	**19.78**	(1,279)	15.84	(550)	12.56
Forfeited	**(409)**	**26.06**	(518)	25.75	(809)	25.26
Outstanding at end of year	**10,620**	**24.74**	10,986	22.85	10,381	22.40
Options exercisable at year-end	**5,074**	**24.52**	5,182	22.37	4,156	19.01
Weighted-average grant-date fair value of options granted during the year at fair market value	**$ 9.22**		$ 8.32		$ 8.39	

No stock options were granted above fair market value in 2004, 2003, or 2002.

The following table summarizes information about stock options outstanding at December 31, 2004 (shares in thousands):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$ 1.00 – 18.13	1,981	5.2	$ 14.00	1,461	$ 12.79
18.19 – 21.73	1,847	8.3	21.05	353	20.62
21.74 – 24.45	1,568	6.8	22.34	864	22.45
24.49 – 28.51	1,165	7.3	25.67	700	25.53
28.67 – 28.90	1,913	8.8	28.69	316	28.77
28.95 – 59.69	2,146	7.6	35.56	1,380	37.76
	10,620	7.3	24.74	5,074	24.52

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan (ESPP), employees who have completed six months of continuous employment with the Company may purchase common stock semi-annually at the lower of 85% of the fair market value of the stock at the beginning or end of the six-month payment period through accumulation of payroll deductions. Employees are required to hold common stock purchased under the ESPP for a period of one year from the date of purchase. The maximum number of shares of common stock available for issuance under the ESPP is 250,000 shares. Effective January 1, 2001 and each January 1st thereafter during the term of the ESPP, 250,000 shares of common stock will always be available for issuance. Shares purchased under the ESPP totaled 21,031 in 2004, 31,667 in 2003, and 38,105 in 2002. The weighted-average fair value of shares purchased under the ESPP was $10.61 in 2004, $9.89 in 2003, and $5.73 in 2002.

For the purpose of providing pro forma disclosures, the fair values of shares purchased were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

Year Ended December 31,	**2004**	2003	2002
Risk-free interest rate	**2.3%**	2.0%	1.5%
Expected life (in months)	**12**	12	6
Expected volatility	**39%**	58%	57%
Expected annualized dividend yield	**1.00%**	.85%	–

Note 14: Employee Savings Plan

Under the Company's Employee Savings Plan, a defined contribution plan, employees who have attained age 21 may contribute up to 25% of their salary on a pre-tax basis subject to the annual dollar limitations established by the Internal Revenue Service. The Company contributes fifty cents for each dollar an employee contributes, with a maximum contribution of 3% of an employee's pre-tax salary. Company contributions vest 20%, 40%, 60%, and 100% after two, three, four, and five years of continuous employment with the Company, respectively. Company contributions totaled $967,000 in 2004, $917,000 in 2003, and $869,000 in 2002. Cognex stock is not an investment alternative, nor are Company contributions made in the form of Cognex stock.

Note 15: Income Taxes

Domestic income before taxes was $22,507,000, $24,852,000, and $3,422,000 and foreign income (loss) before taxes was $30,653,000, $(1,604,000), and $(11,626,000) in 2004, 2003, and 2002, respectively.

The provision (benefit) for income taxes consists of the following (in thousands):

Year Ended December 31,	**2004**	2003	2002
Current:			
Federal	**$ 9,662**	$ 6,330	$(1,930)
State	**758**	431	48
Foreign	**983**	2,181	1,040
	11,403	8,942	(842)
Deferred:			
Federal	**(177)**	(616)	524
State	**306**	48	(51)
Foreign	**3,884**	(1,077)	(1,808)
	4,013	(1,645)	(1,335)
	$15,416	$ 7,297	$(2,177)

A reconciliation of the United States federal statutory corporate tax to the Company's effective tax is as follows (in thousands):

Year Ended December 31,	**2004**	2003	2002
Income tax provision (benefit) at federal statutory rate	**$ 18,606**	$ 8,137	$(2,871)
State income taxes, net of federal benefit	**1,070**	325	67
Tax-exempt investment income	**(1,463)**	(1,901)	(2,992)
Foreign tax rate differential	**(3,138)**	1,023	2,934
Goodwill amortization and impairment charges	–	–	846
Other	**341**	(287)	(161)
Provision (benefit) for income taxes	**$15,416**	$ 7,297	$(2,177)

Deferred tax assets consist of the following (in thousands):

December 31,	2004	2003
Current deferred tax assets:		
Inventory and revenue related	**$ 6,321**	$ 6,494
Bonus, commission, and other compensation	**937**	500
Other	**2,246**	1,229
Total net current deferred tax asset	**$ 9,504**	$ 8,223
Noncurrent deferred tax assets (liabilities):		
Federal and state tax credit carryforwards	**$ 8,138**	$ 6,638
Net operating loss carryforwards	**3,989**	5,519
Acquired complete technology and other intangibles	**3,180**	3,353
Federal and state capital loss carryforwards	**1,640**	1,694
Unrealized investment gains (losses)	**1,573**	(462)
Depreciation	**1,339**	1,308
Acquired in-process technology	**972**	1,021
Other	**685**	357
Total net noncurrent deferred tax asset	**$21,516**	$19,428

At December 31, 2004, the Company had federal research and experimentation tax credit carryforwards of approximately $4,424,000, which may be available to offset future federal income tax liabilities and will begin to expire in 2015. The Company also had approximately $2,290,000 of alternative minimum tax credits and approximately $991,000 of foreign tax credits, which may be available to offset future regular income tax liabilities. The alternative minimum tax credits have an unlimited life and the foreign tax credits will begin to expire in 2007. In addition, the Company had approximately $433,000 of state research and experimentation tax credit carryforwards, which will begin to expire in 2015.

At December 31, 2004, the Company's subsidiaries had net operating loss carryforwards of approximately $15,688,000, of which $9,011,000, representing a tax benefit of $3,154,000, will expire in 2009. The remaining balance of $6,677,000, representing a tax benefit of $835,000, has an unlimited life.

The Company did not establish valuation allowances against its deferred tax assets at December 31, 2004 and 2003. While these assets are not assured of realization, the Company has evaluated the realizability of these deferred tax assets and has determined that it is more likely than not that these assets will be realized. In reaching this conclusion, the Company has evaluated certain relevant criteria including the Company's historical profitability, current projections of future profitability, and the lives of tax credits, net operating and capital losses, and other carryforwards. Should the Company fail to generate sufficient pre-tax profits in future periods, the Company may be required to establish valuation allowances against these deferred tax assets, resulting in a charge to income in the period of determination.

The Company files income tax returns in all jurisdictions in which it operates. The Company has established reserves to provide for additional income taxes that may be due in future years as these previously filed tax returns are audited. These

reserves have been established based upon management's assessment as to the potential exposure attributable to permanent differences and interest applicable to both permanent and temporary differences. All tax reserves are analyzed periodically and adjustments are made as events occur that warrant modification.

The Company does not provide U.S. taxes on its foreign subsidiaries' undistributed earnings, as they are deemed to be permanently reinvested outside the U.S. Non-U.S. income taxes are, however, provided on those foreign subsidiaries' undistributed earnings. Upon repatriation, the Company would provide the appropriate U.S. income taxes on these earnings.

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned outside the U.S. at an effective tax rate of 5.25%. On November 15, 2004, the Financial Accounting Standards Board issued proposed Statement of Financial Accounting Standard (SFAS) No. 109-2, "Accounting and Disclosure for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004." SFAS No. 109-2 would allow companies additional time to evaluate the effect of the law on whether unrepatriated foreign earnings continue to qualify for SFAS No. 109's exception to recognizing deferred tax liabilities and would require explanatory disclosures from those companies who need the additional time. Through December 31, 2004, the Company had not provided deferred taxes on foreign earnings because such earnings were intended to be indefinitely reinvested outside the U.S. Whether the Company will ultimately take advantage of this provision depends upon a number of factors, including reviewing future Congressional guidance, before a decision can be made. Until that time, the Company will not change its current intention to indefinitely reinvest accumulated earnings of its foreign subsidiaries.

Note 16: Net Income (Loss) Per Share

Net income (loss) per share is calculated as follows (in thousands, except per share amounts):

Year Ended December 31,	**2004**	2003	2002
Net income (loss)	**$37,744**	$15,951	$ (6,027)
Basic:			
Weighted-average common shares outstanding	**45,480**	43,173	43,503
Net income (loss) per common share	**$ 0.83**	$ 0.37	$ (0.14)
Diluted:			
Weighted-average common shares outstanding	**45,480**	43,173	43,503
Effect of dilutive stock options	**1,878**	1,293	–
Weighted-average common and common equivalent shares outstanding	**47,358**	44,466	43,503
Net income (loss) per common and common equivalent share	**$ 0.80**	$ 0.36	$ (0.14)

Stock options to purchase 1,656,927, 2,934,936, and 6,347,233 shares of common stock were outstanding in 2004, 2003, and 2002, respectively, but were not included in the calculation of diluted net income (loss) per share because the options' exercise prices were greater than the average market price of the Company's common stock during those years. Additionally, stock options to purchase 939,961 shares of common stock were not included in the calculation of diluted net loss per share in 2002 because they were antidilutive.

Note 17: Segment and Geographic Information

The Company has two reportable segments: the Modular Vision Systems Division (MVSD) and the Surface Inspections Systems Division (SISD). MVSD designs, develops, manufactures, and markets modular vision systems that are used to control the manufacturing of discrete items by locating, identifying, inspecting, and measuring them during the manufacturing process. SISD designs, develops, manufactures, and markets surface inspection vision systems that are used to inspect surfaces of materials that are processed in a continuous fashion to ensure there are no flaws or defects in the surfaces. Segments are determined based upon the way that management organizes its business for making operating decisions and assessing performance. The Company evaluates segment performance based upon income or loss from operations, excluding unusual items.

The following table summarizes information about the Company's segments (in thousands):

	MVSD	SISD	Reconciling Items	Consolidated
Year Ended December 31, 2004				
Product revenue	**$155,966**	**$20,603**	**–**	**$176,569**
Service revenue	**17,923**	**7,465**	**–**	**25,388**
Depreciation and amortization	**5,526**	**341**	**$ 207**	**6,074**
Operating income (loss)	**53,572**	**1,336**	**(8,059)**	**46,849**
Year Ended December 31, 2003				
Product revenue	$ 108,170	$ 22,500	–	$ 130,670
Service revenue	12,846	6,576	–	19,422
Depreciation and amortization	5,863	392	$ 179	6,434
Operating income (loss)	21,397	3,830	(5,717)	19,510
Year Ended December 31, 2002				
Product revenue	$ 78,270	$ 17,932	–	$ 96,202
Service revenue	12,088	5,817	–	17,905
Depreciation and amortization	6,487	388	$ 202	7,077
Operating income (loss)	(497)	1,369	(10,630)	(9,758)

Reconciling items consist of unallocated corporate expenses, which primarily include corporate headquarters costs, professional fees, and patent infringement litigation. Asset information by segment is not produced internally for use by the chief operating decision maker, and therefore, is not presented. Asset information is not provided because the cash and investments are commingled and the divisions share assets and resources in a number of locations around the world.

No customer accounted for greater than 10% of revenue in 2004, 2003, or 2002.

The following table summarizes information about geographic areas (in thousands):

	United States	Japan	Ireland	Other	Consolidated
Year Ended December 31, 2004					
Product revenue	**$50,548**	**–**	**$126,021**	**–**	**$176,569**
Service revenue	**16,254**	**–**	**9,134**	**–**	**25,388**
Long-lived assets	**26,217**	**$2,396**	**12,797**	**$1,024**	**42,434**
Year Ended December 31, 2003					
Product revenue	$ 43,001	–	$ 87,669	–	$ 130,670
Service revenue	12,792	–	6,630	–	19,422
Long-lived assets	27,921	$ 2,434	13,358	$ 925	44,638
Year Ended December 31, 2002					
Product revenue	$ 44,292	$14,355	$ 37,555	–	$ 96,202
Service revenue	13,263	2,119	2,523	–	17,905
Long-lived assets	28,891	3,077	2,744	$1,040	35,752

Revenue is presented geographically based upon the country in which the sale is recorded. The "Other" column represents all long-lived assets in other countries, none of which were individually significant.

Note 18: Acquisitions

Acquisition of Siemens Dematic AG Wafer Identification Business

On March 31, 2003, the Company acquired the wafer identification business of Siemens Dematic AG, a subsidiary of Siemens AG. Siemens Dematic is a leading supplier of logistics and factory automation equipment and has been a leading supplier of wafer identification systems to semiconductor manufacturers in Europe. Under the terms of the agreement, the Company acquired the rights to all of Siemens' patented and unpatented wafer identification technology, as well as substantially all of the assets related to its wafer identification business. This acquisition enhances the Company's position as a leading provider of wafer identification systems worldwide. The results of operations of the acquired business have been included in the Company's consolidated results of operations since the date of the acquisition. The historical results of operations of the acquired business were not material compared to the consolidated results of operations, and therefore, pro forma results are not presented.

The original purchase price consisted of 7,000,000 Euros in cash (or approximately $7,630,000) paid on March 31, 2003, with the potential for an additional cash payment in 2005 of up to 1,700,000 Euros (or approximately $2,306,000) depending upon the achievement of certain performance criteria. Any contingent consideration will be recorded as purchase price when paid and will be allocated to goodwill. The March 31, 2003 cash payment of 7,000,000 Euros was based upon an estimated balance sheet for the wafer identification business as of March 31, 2003. After receipt of a final March 31, 2003 balance sheet and resolution of certain items in dispute, Siemens reimbursed Cognex 796,000 Euros (or $868,000), of which $354,000 was allocated to receivables and $514,000 was allocated to goodwill.

The final purchase price of 6,204,000 Euros (or approximately $6,762,000) was allocated as follows: $616,000 to inventories; $274,000 to receivables; $25,000 to accrued expenses; $4,469,000 to customer contracts and relationships, to be amortized over eight years; $447,000 to complete technology, to be amortized over five years; $98,000 to patents, to be amortized over five years; $44,000 to non-compete agreements, to be amortized over three years; and $839,000 to goodwill, which is assigned to the MVSD segment and is not deductible for tax purposes.

Acquisition of Gavitec AG Machine Vision Business

On December 1, 2003, the Company acquired the machine vision business of Gavitec AG. Gavitec produces machine vision products for direct part mark identification (or Industrial ID), which can read markings on the surfaces of manufactured items to collect data about product components during the manufacturing process and trace the manufacturing history of the components during the product's lifetime. Under the terms of the agreement, the Company acquired all of the tangible and intangible assets and assumed certain liabilities associated with Gavitec's machine vision business. This acquisition strengthens the Company's overall market position in Germany and combines Gavitec's experience in the design of easy-to-use Industrial ID products with Cognex's global sales force and engineering support to enable the Company to provide additional products for the growing Industrial ID market. The results of operations of the acquired business have been included in the Company's consolidated results of operations since the date of the acquisition. The historical results of operations of the acquired business were not material compared to the consolidated results of operations, and therefore, pro forma results are not presented.

The net purchase price consisted of 3,777,000 Euros in cash (or approximately $4,516,000), including 3,477,000 Euros paid at closing, 100,000 Euros (or approximately $123,000) paid on December 1, 2004, and 200,000 Euros (or approximately $271,000) to be paid on December 1, 2005. There was the potential for two additional cash payments of up to 250,000 Euros (or approximately $339,000) each in the third quarter of 2004 and first quarter of 2005 depending upon the achievement of certain performance criteria. These criteria were not met, and therefore, these contingent payments were not made.

The purchase price was allocated as follows: $213,000 to inventories; $76,000 to receivables; $60,000 to fixed assets; $114,000 to accrued expenses; $2,726,000 to customer contracts and relationships, to be amortized over nine years; $155,000 to complete technology, to be amortized over three years; and $1,400,000 to goodwill, which is assigned to the MVSD segment and is not deductible for tax purposes.

Note 19: Dividends

Beginning in the third quarter of 2003, the Company's Board of Directors has declared and paid a cash dividend in each quarter. During the third quarter of 2004, the Company's Board of Directors voted to increase the quarterly cash dividend from $0.06 per share to $0.08 per share. Dividend payments amounted to $12,756,000 in 2004 and $5,237,000 in 2003.

Note 20: Subsequent Events

On January 28, 2005, the Company's Board of Directors declared a cash dividend of $0.08 per share. The dividend was paid on February 25, 2005 to all shareholders of record at the close of business on February 11, 2005 and amounted to $3,698,000.

On January 19, 2005, the Company signed an amendment to its agreement with Venrock Associates III L.P., a venture capital fund in which the Company is a limited partner. The amendment reduced the Company's commitment to $22,500,000 from $25,000,000 and extended the commitment period through December 31, 2010.

Note 21: Supplemental Disclosures

Cash paid for income taxes totaled $2,327,000 in 2004, $4,169,000 in 2003, and $1,180,000 in 2002.

Common stock received as payment for stock option exercises totaled $317,000 in 2004, $134,000 in 2003 and $2,467,000 in 2002.

The Company retired certain fully depreciated property, plant, and equipment totaling $1,824,000 in 2004, $2,497,000 in 2003, and $5,407,000 in 2002.

Advertising costs are expensed as incurred and totaled $2,000,000 in 2004, $1,684,000 in 2003, and $1,753,000 in 2002.

To the Board of Directors and Shareholders of Cognex Corporation:

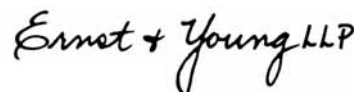
We have audited the accompanying consolidated balance sheets of Cognex Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the two years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cognex Corporation and subsidiaries at December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Cognex Corporation and subsidiaries internal control over financial reporting as of December 31 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 4, 2005 expressed an unqualified opinion thereon.

Boston, Massachusetts
March 4, 2005



To the Board of Directors and Shareholders of Cognex Corporation:

In our opinion, the accompanying consolidated statements of operations, of shareholders' equity and cash flows for the year ended December 31, 2002 present fairly, in all material respects, the results of operations and cash flows of Cognex Corporation and its subsidiaries for the year ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Boston, Massachusetts
January 24, 2003

Cognex Corporation: Five-Year Summary of Selected Financial Data

(in thousands, except per share amounts)

Statement of Operations Data:

Year Ended December 31,	**2004**	2003	2002	2001	2000
Revenue	**$201,957**	$150,092	$114,107	$140,729	$250,726
Cost of revenue	**57,371**	50,139	39,859	62,345	63,820
Gross margin	**144,586**	99,953	74,248	78,384	186,906
Research, development, and engineering expenses	**27,063**	24,719	25,630	30,094	33,341
Selling, general, and administrative expenses	**70,674**	55,724	58,376	61,262	62,015
Amortization of goodwill	–	–	–	3,108	1,964
Charge for intangible asset impairment	–	–	–	10,932	–
Operating income (loss)	**46,849**	19,510	(9,758)	(27,012)	89,586
Nonoperating income	**6,311**	3,738	1,554	11,341	10,632
Income (loss) before taxes	**53,160**	23,248	(8,204)	(15,671)	100,218
Income tax provision (benefit)	**15,416**	7,297	(2,177)	(4,544)	32,070
Net income (loss)	**$ 37,744**	$ 15,951	$ (6,027)	$ (11,127)	$ 68,148
Basic net income (loss) per share	**$ 0.83**	$ 0.37	$ (0.14)	$ (0.25)	$ 1.58
Diluted net income (loss) per share	**$ 0.80**	$ 0.36	$ (0.14)	$ (0.25)	$ 1.49
Basic weighted-average common shares outstanding	**45,480**	43,173	43,503	43,639	43,043
Diluted weighted-average common shares outstanding	**47,358**	44,466	43,503	43,639	45,698
Cash dividends per common share	**$ 0.28**	$ 0.12	$ –	$ –	$ –

Balance Sheet Data:

December 31,	**2004**	2003	2002	2001	2000
Working capital	**$242,460**	$150,311	$162,808	$143,712	$167,913
Total assets	**533,308**	432,533	385,934	406,904	436,141
Long-term debt	–	–	–	–	–
Shareholders' equity	**462,807**	384,994	354,520	378,044	383,949

Cognex Corporation: Selected Quarterly Financial (Unaudited)

(in thousands, except per share amounts and stock prices)

2004 Quarter Ended	April 4	July 4	October 3	December 31
Revenue	**$48,169**	**$54,467**	**$55,412**	**$43,909**
Gross margin	**33,380**	**38,562**	**40,526**	**32,118**
Operating income	**10,168**	**14,339**	**15,875**	**6,467**
Net income	**8,567**	**10,878**	**11,655**	**6,644**
Basic net income per share	**0.19**	**0.24**	**0.26**	**0.15**
Diluted net income per share	**0.18**	**0.23**	**0.25**	**0.14**
Cash dividends per common share	**0.06**	**0.06**	**0.08**	**0.08**
Common stock prices:				
High	**35.05**	**38.48**	**37.06**	**29.90**
Low	**28.24**	**30.09**	**23.50**	**23.14**

2003 Quarter Ended	March 30	June 29	September 28	December 31
Revenue	$ 32,888	$ 36,622	$ 38,704	$ 41,878
Gross margin	21,172	24,623	25,514	28,644
Operating income	1,945	4,411	5,507	7,647
Net income	1,793	3,306	5,138	5,714
Basic net income per share	0.04	0.08	0.12	0.13
Diluted net income per share	0.04	0.08	0.11	0.13
Cash dividends per common share	–	–	0.06	0.06
Common stock prices:				
High	24.40	24.00	31.79	31.11
Low	18.17	17.91	20.55	25.00

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Form 10-K
A copy of the Annual Report on Form 10-K filed with the Securities and Exchange Commission is available to shareholders, without charge, upon request to:

Department of Investor Relations
Cognex Corporation
One Vision Drive
Natick, MA 01760

Additional copies of this annual report are also available, without charge, upon request to the above address, or on-line at http://www.cognex.com

The Company's report on internal controls over financial reporting and the report of the Company's independent registered accounting firm is included in Item 9A of the Annual Report on Form 10-K.

The Company's common stock is traded on the NASDAQ Stock Market, under the symbol CGNX. As of February 11, 2005, there were approximately 600 shareholders of record of the Company's common stock. The Company believes the number of beneficial owners of the Company's common stock on that date was substantially greater.

The Company declared and paid a cash dividend of $0.06 per share in the first and second quarters of 2004, and a cash dividend of $0.08 per share in the third and fourth quarters of 2004. Any future declaration and payment of cash dividends will be subject to the discretion of the Board of Directors and will depend upon such factors as the Board of Directors deems relevant. The Board of Directors may modify the Company's dividend policy from time to time.

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Patrick A. Alias
Executive Vice President
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Jerald G. Fishman
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Anthony Sun
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Richard A. Morin
Senior Vice President of Finance and Administration, Chief Financial Officer, and Treasurer

John McGarry
Senior Vice President,
In-Sight Products

William Silver
Senior Vice President and
Chief Technology Officer, MVSD

This annual report, including the letter to shareholders, contains “forward-looking statements” within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. Please see the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Forward-looking Statements” in this report for a discussion regarding risks associated with these statements.

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