

Cogent, Inc.
Form 10-Q
November 06, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

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

Commission file number 000-50947

COGENT, INC.

(Exact name of registrant as specified in its charter)

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Delaware (State or other jurisdiction of incorporation or organization)	95-4305768 (I.R.S. Employer Identification No.)
639 North Rosemead Blvd.	
Pasadena, California (Address of principal executive offices)	91107 (Zip Code)
Registrant's telephone number, including area code: (626) 325-9600	

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of November 1, 2008 there were 89,700,304 shares of the registrant's common stock outstanding.

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FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****COGENT, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except share data)

(unaudited)

	December 31, 2007	September 30, 2008
ASSETS		
Current assets:		
Cash	\$ 8,955	\$ 43,805
Investments in marketable securities	344,085	336,941
Billed accounts receivable, net of allowance for doubtful accounts of \$477 and \$514 at December 31, 2007 and September 30, 2008, respectively	31,845	41,595
Unbilled accounts receivable	1,201	984
Inventory and contract related costs	11,359	22,941
Prepaid expenses and other current assets	1,788	2,164
Deferred income taxes	10,739	14,563
Total current assets	409,972	462,993
Investments in marketable securities	91,267	75,503
Property and equipment, net	33,644	36,511
Deferred income taxes	15,404	22,043
Intangible and other assets	901	8,540
Total assets	\$ 551,188	\$ 605,590
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 3,822	\$ 4,509
Accrued expenses	6,654	13,114
Income taxes payable	92	4,157
Deferred revenues	24,668	68,215
Total current liabilities	35,236	89,995
Long-term liabilities		
Deferred revenues	2,980	4,457
Other liabilities	2,756	9,879
Total liabilities	40,972	104,331
Commitments and contingencies (Note 17)		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2007 and September 30, 2008, respectively	120	120

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Common stock, \$0.001 par value; 245,000,000 shares authorized; 94,970,967 and 95,683,401 shares issued and outstanding at December 31, 2007 and September 30, 2008, respectively

Additional paid-in capital	425,139	432,737
Retained earnings	102,297	135,969
Accumulated other comprehensive income (loss)	382	(8,039)
Treasury stock, at cost; 1,482,302 and 5,973,305 shares at December 31, 2007 and September 30, 2008, respectively	(17,722)	(59,528)
Total stockholders' equity	510,216	501,259
 Total liabilities and stockholders' equity	 \$ 551,188	 \$ 605,590

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**COGENT, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(in thousands, except per share data)****(unaudited)**

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2008	2007	2008
Revenues:				
Product revenues	\$ 16,016	\$ 24,656	\$ 65,714	\$ 59,454
Maintenance and services revenues	6,496	10,376	18,205	26,250
Total revenues	22,512	35,032	83,919	85,704
Cost of revenues:				
Cost of product revenues	8,144	6,006	28,906	16,605
Cost of maintenance and services revenues	1,955	4,490	5,446	10,784
Total cost of revenues	10,099	10,496	34,352	27,389
Gross profit	12,413	24,536	49,567	58,315
Operating expenses:				
Research and development	2,670	4,039	7,775	10,585
Selling and marketing	2,361	3,625	6,442	9,308
General and administrative	5,670	2,144	17,546	7,757
Income from settlement of lawsuit				(10,000)
Total operating expenses	10,701	9,808	31,743	17,650
Operating income	1,712	14,728	17,824	40,665
Other income:				
Interest income	5,756	4,000	16,530	13,063
Other, net	(195)	376	185	174
Total other income	5,561	4,376	16,715	13,237
Income before income taxes	7,273	19,104	34,539	53,902
Income tax provision	3,129	7,070	13,607	20,230
Net income	\$ 4,144	\$ 12,034	\$ 20,932	\$ 33,672
Basic net income per share	\$ 0.04	\$ 0.13	\$ 0.22	\$ 0.37
Diluted net income per share	\$ 0.04	\$ 0.13	\$ 0.22	\$ 0.37
Shares used in computing basic net income per share	94,436	89,536	94,331	90,122

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Shares used in computing diluted net income per share	95,976	90,403	95,972	91,169
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See accompanying notes to unaudited condensed consolidated financial statements.

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	Nine months Ended September 30,	
	2007	2008
Cash Flows from operating activities:		
Net income	\$ 20,932	\$ 33,672
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,369	2,103
Allowance for doubtful accounts	(16)	37
Share-based compensation	2,193	2,693
Excess tax benefit from share-based compensation		(3,835)
Amortization of bond discount on available-for-sale securities	(4,391)	(310)
Equity in earnings of investee		(78)
Deferred income taxes	11,411	(10,463)
Changes in assets and liabilities:		
Billed accounts receivable	11,784	(9,787)
Unbilled accounts receivable	(384)	217
Inventory and contract related costs	10,289	(11,317)
Prepaid expenses and other current assets	664	(314)
Other assets	124	(70)
Accounts payable	4,424	(149)
Accrued expenses	2,694	6,465
Other liabilities	56	7,123
Income taxes payable	852	7,902
Deferred revenues	(22,077)	45,024
Net cash provided by operating activities	39,924	68,913
Cash Flows from investing activities:		
Purchase of available-for-sale securities	(1,279,046)	(670,489)
Proceeds from maturities of available-for-sale securities	1,243,467	685,135
Purchase of equity investment		(3,000)
Acquisition of Security Solutions Division		(4,927)
Expiration of restrictions on cash	585	
Purchase of property and equipment	(1,814)	(3,571)
Net cash (used in) provided by investing activities	(36,808)	3,148
Cash Flows from financing activities:		
Excess tax benefit from share based compensation		3,835
Proceeds from the exercise of stock options	468	911
Repurchase of common stock		(41,806)
Net cash provided by (used in) financing activities	468	(37,060)
Effect of exchange rate changes on cash	197	(151)

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Net increase in cash	3,781	34,850
Cash, beginning of period	18,801	8,955
Cash, end of period	\$ 22,582	\$ 43,805

Supplemental disclosures of cash flow information

Cash received (paid) during the period for:

Interest income	\$ 11,808	\$ 12,863
Income taxes	\$ (705)	\$ (15,766)

Non-cash financing activities:

Share-based compensation, capitalized and deferred as inventory and contract related costs	\$ 36	\$ 158
Property and equipment included in accounts payable	\$	\$ 628

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. General

Company Background

Cogent, Inc. and subsidiaries (Cogent or the Company) was initially incorporated in the state of California on April 20, 1990 as Cogent Systems, Inc. and was reincorporated in Delaware on May 3, 2004 as Cogent, Inc. Cogent is a provider of advanced automated fingerprint identification systems (AFIS) solutions, which typically consist of Cogent s Programmable Matching Accelerator (PMA) servers and other AFIS equipment, including work stations and live-scans, bundled with Cogent s proprietary software and other fingerprint biometrics products and solutions, to governments, law enforcement agencies and other organizations worldwide. Cogent also provides professional services, technical support and maintenance services to its customers.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2008 and the condensed consolidated statements of income for the three and nine months ended September 30, 2007 and 2008 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and 2008 are unaudited. These statements should be read in conjunction with the audited consolidated financial statements and related notes, together with management s discussion and analysis of financial position and results of operations, contained in the Company s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on March 3, 2008.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or (GAAP). In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2007 and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of September 30, 2008, and its results of operations for the three and nine months ended September 30, 2007 and 2008 and its cash flows for the nine months ended September 30, 2007 and 2008. The condensed consolidated balance sheet as of December 31, 2007 has been derived from the December 31, 2007 audited financial statements. The interim financial information contained in this quarterly report is not necessarily indicative of the results to be expected for any other interim period or for the entire year.

Goodwill and Acquisition-Related Intangible Assets

The Company classifies the difference between the purchase price and the fair market value of net assets acquired as goodwill. The Company classifies intangible assets apart from goodwill if the assets have contractual or other legal rights or if the assets can be separated and sold, transferred, licensed, rented or exchanged.

The Company evaluates the carrying value of goodwill and intangible assets not subject to amortization for impairment as of the first day of the fourth quarter of each calendar year or whenever events or changes in circumstances indicate that the carrying value of goodwill or intangible assets not subject to amortization may not be recoverable. For the evaluation of intangible assets not subject to amortization, the Company compares the fair value of these intangible assets to their carrying amount. If the carrying amount of these intangible assets exceed their fair value, an impairment loss would be recognized in an amount equal to that excess.

For the evaluation of goodwill, the Company applies the two-step process as required by Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets*. The Company identifies its reporting units and determines the carrying value of each reporting unit by assigning the assets and liabilities to those reporting units in order to assess goodwill for impairment. In the first step of a two-step impairment test, the Company determines the fair value of these reporting units. The Company compares the fair value for each reporting unit to its carrying value. If the fair value of a reporting unit exceeds its carrying value, goodwill of the reporting unit is considered not impaired and no further testing is required. If the fair value does not exceed the carrying value, the second step of the impairment test shall be performed to measure the amount of impairment loss, if any. The second step compares the implied fair value of that reporting unit s goodwill with its carrying amount. If the carrying amount of the reporting unit s goodwill exceeds its implied fair value, an impairment loss would be recognized in an amount equal to that excess.

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Classification of revenues

Product Revenues

The timing of product revenues recognition is dependent on the nature of the product sold and is generally comprised of the following:

Revenues associated with AFIS solutions that do not require significant modification or customization of the Company's software, exclusive of amounts allocated to maintenance for which the Company has vendor-specific objective evidence of fair value, or VSOE, are recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided all other criteria for revenue recognition have been met. For example, the Company recognizes revenue in this manner from sales of its PMA servers to the Department of Homeland Security (DHS) under a blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

Revenues associated with AFIS solutions that require significant modification or customization of the Company's software are recognized using the percentage-of-completion method as described by Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. The percentage-of-completion method reflects the portion of the anticipated contract revenue, excluding maintenance that has VSOE, which has been earned, equal to the ratio of labor effort expended to date to the anticipated final labor effort, based on current estimates of total labor effort necessary to complete the project. Material differences may result in the amount and timing of the Company's revenue for any period if actual results differ from the Company's judgments and estimates. The Company recognizes revenue in this manner from sales of significant initial AFIS deployments. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period or until the time when such VSOE is established. Revenues recognized under such arrangements were \$11.8 million and zero for the nine months ended September 30, 2007 and 2008, respectively.

Revenue associated with the sale of the Company's application specific integrated circuit, or ASIC applications, stand-alone live-scans and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with service offerings where the Company maintains and operates a portion of the AFIS systems on an outsourced application-hosting basis is recognized on a per transaction basis provided (i) persuasive evidence of an arrangement exists, (ii) the fee is fixed or determinable and (iii) collection is deemed probable.

Revenue associated with contracts where sufficient VSOE cannot be established for the allocation of revenue to the various elements of the arrangement is deferred until the earlier of the point at which (i) such sufficient VSOE does exist or (ii) all elements of the arrangement have been delivered.

Cash received from customers in advance of recognition of the related revenue is recorded as deferred revenue.

Maintenance Revenues

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. The Company recognizes all maintenance revenue ratably over the applicable maintenance period. The Company determines the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions contained in a particular arrangement. In the absence of such renewal provisions, the deferral of maintenance is based on the Company's established VSOE rate for maintenance for comparable arrangements. The Company considers substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to its normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is

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recognized ratably over the term of the maintenance period.

Services Revenues

Professional services revenue is primarily derived from engineering services and AFIS system operation and maintenance services that are not an element of an arrangement for the sale of products. These services are generally billed on a time-and-materials basis. The majority of the Company's professional services are performed either directly or indirectly for U.S. government organizations. Revenue from such services is recognized as the services are provided.

Consistent with EITF Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the amount of revenue recognized from commissions where the Company is acting as an agent is the net amount after payments are made to the primary obligor responsible for delivering the services.

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The Company derives a significant portion of its revenues and accounts receivable from a limited number of customers as described below:

Percentage of Revenues	Three months ended		Nine months ended	
	September 30, 2007	2008	September 30, 2007	2008
Customer A	*	44%	*	44%
Customer B	26%	15%	*	*
Customer C	18%	*	15%	*
Customer D	*	*	10%	*
Customer E	*	*	*	*
Customer F	*	*	17%	*

Percentage of Billed Accounts Receivable	December 31,	September 30,
	2007	2008
Customer A	*	47%
Customer B	*	*
Customer C	*	*
Customer D	*	*
Customer E	10%	*
Customer F	*	*

(*) Amounts do not exceed 10% for such period

Note 2 Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2 Effective Date of FASB Statement No. 157) which delays, to fiscal years beginning after November 15, 2008, the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Effective January 1, 2008, the Company adopted SFAS 157 for financial assets and liabilities. The adoption of SFAS 157 for financial assets and liabilities did not have a material impact on the Company's condensed consolidated balance sheet, statement of income or cash flows. See Note 8 for information and related disclosures regarding the Company's fair value measurements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits an entity, through an irrevocable option, to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis, at fair value with changes in fair value recorded in earnings. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007 provided that the entity elects to apply the provisions of SFAS 157. The Company has not elected to adopt the fair value option of SFAS 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141R). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Accordingly, SFAS 141R will be applied by the Company to business combinations occurring on or after January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements An amendment of Accounting Research Bulletin No. 51 (SFAS 160). SFAS 160 establishes accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for financial statements issued for fiscal

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years beginning after December 15, 2008. Early adoption is prohibited. The Company does not have a noncontrolling interest in one or more subsidiaries. Accordingly, the Company does not anticipate that the initial application of SFAS 160 will have an impact on the Company.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires enhanced disclosures about a company s derivative and

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hedging activities. SFAS 161 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company does not have transactions which meet the definition of a derivative and, accordingly, does not anticipate that the application of SFAS 161 will have an impact on the Company.

Note 3. Settlement of Claims with Northrop

In April 2005, Cogent initiated a lawsuit against Northrop Grumman Corporation in California State Court (Cogent Systems, Inc. vs. Northrop Grumman Corporation, Northrop Grumman Technology Overseas, Inc., et al., Superior Court of the State of California, in and for the County of Los Angeles, Case No. BC 332199) based on claims of breach of contract, conversion, misappropriation of trade secrets, breach of trust, interference with prospective economic advantage, breach of the implied covenants of good faith and fair dealing, and unfair competition (the Action). On December 5, 2007, Cogent and Northrop entered into a definitive Settlement Agreement and Mutual Release of Claims (the Settlement). Pursuant to the terms of the Settlement, Cogent and Northrop formally settled and released all claims and causes of action alleged in the Action. Under the Settlement, Cogent and Northrop entered into four agreements; collectively, the Agreements:

1. The Settlement Agreement, pursuant to which Northrop agreed to pay Cogent \$25 million, of which \$15 million was paid in January 2008 and \$10 million is to be paid in January 2009;
2. The Software License Agreement, pursuant to which Northrop will pay Cogent \$15 million over three years for a non-exclusive license to use certain of Cogent's automated fingerprint identification software in certain existing programs;
3. The Product and Services Agreement, pursuant to which Northrop will pay Cogent a minimum of \$20 million for products and services over the five year term of the agreement; and
4. The Strategic Alliance Agreement, pursuant to which Cogent and Northrop will meet semiannually over the three year term of the agreement to discuss business opportunities and proposal efforts for the design, development, sale and support of biometric identification solutions.

Total proceeds to Cogent under the agreements will be \$60.0 million. Cogent has accounted for the agreements as one multiple element arrangement. Contractual proceeds to Cogent under each of the agreements do not necessarily represent the fair value of each agreement. The Strategic Alliance Agreement was determined not to be an element requiring accounting recognition. The Company determined that the \$20 million in proceeds scheduled under the Product and Services Agreement includes both a guaranteed payment component valued at \$1.0 million and a component for the purchase of products and services valued at \$19.0 million using VSOE of fair value in accordance with SOP 97-2, Software Revenue Recognition. The Company determined the fair value of the Software License Agreement and the guaranteed payment component of the Product and Services Agreement to be \$30.0 million and \$1.0 million, respectively, based on generally accepted valuation techniques. The residual method was used to derive the \$10.0 million fair value for the Settlement Agreement.

Element	Scheduled Proceeds (in millions)	Allocated
		Fair Value
Product and Services Agreement	\$ 20.0	\$ 20.0
Software License Agreement	15.0	30.0
Settlement Agreement	25.0	10.0
	\$ 60.0	\$ 60.0

Accounting for the Software License Agreement is subject to the guidance of SOP 97-2. However, the provision of the AFIS software under the Software License Agreement did not represent a stand-alone arm's length transaction. Rather, the revenue amount was determined based on a valuation. Thus, the Company did not believe it appropriate to apply the Company's standard maintenance VSOE rate to this amount and the

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Company could not determine the fair value of the associated maintenance commitment. The Company will recognize revenue under the Software License Agreement and the Products and Services Agreement, on a combined basis, based on the lowest proportion of revenue recognizable under the contracts. While the Company was not able to establish VSOE of the maintenance commitment, the Company believes its standard maintenance rate represents a reasonable basis for the allocation of revenues recognized under the Software License Agreement, between product and maintenance, as the revenues are recognized over the term of the Software License Agreement. The Company will therefore allocate a portion of the revenues representing its standard annual maintenance renewal rate (based on VSOE), to maintenance revenues. The remainder will be recorded as product revenues. The \$1.0 million value of the guaranteed payment will be recognized as income on a pro-rata basis (i.e. each dollar of revenue under the Products and Services Agreement will result in ninety-five cents of revenue and five cents of Income from settlement of lawsuit). The residual value allocated to the Settlement Agreement is presented as Income from settlement of lawsuit in the accompanying condensed consolidated statement of income.

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Due to the risks associated with extended payment terms, recognition of the revenues and the gain on settlement of litigation will be limited to the amounts collected from Northrop. Since the recognition of revenues from several elements is limited due to risks associated with the extended payment terms, the Company will allocate cash collections to each element on a basis consistent with their relative fair value.

In January 2008, the Company received its first scheduled payments of \$15.0 million and \$5.0 million in connection with the Settlement Agreement and the Software License Agreement, respectively. During the three and nine months ended September 30, 2008, the Company recognized zero and \$10.0 million, respectively, of income related to the settlement of the lawsuit. For the three and nine months ended September 30, 2008, there were no amounts that were recognized under the Software License Agreement or the Product and Services Agreement. The remainder of \$10.0 million is recorded in deferred revenues as of September 30, 2008.

Note 4 Acquisition of the Security Solutions Division of MAXIMUS, Inc.

Effective April 30, 2008, the Company acquired the Security Solutions Division (the SSD Division) of MAXIMUS Inc. for an aggregate cash purchase price of \$5.2 million which included transaction costs of \$178,000. Of that purchase price, \$250,000 was retained by the Company for a period of one year as security for certain indemnification obligations. The SSD Division provides identity management and credentialing services, security consulting and custom web application development related to logical and physical access services.

The Company allocated the purchase price to the tangible and identifiable intangible assets acquired based on their fair values, which were based on generally accepted valuation techniques. The Company did not assume liabilities from this acquisition. The goodwill that arose from the acquisition reflected value to the Company from:

acquiring a highly trained and qualified workforce,

utilizing their existing platform for growth in the expanding market for identity management and credentialing,

and obtaining the benefits of a strong revenue stream with profitable performance serving governmental customers.

The following table summarizes the allocation of the purchase price (in thousands):

	Estimated Fair Value	Weighted Average Useful Live (in years)
Tangible assets:		
Prepaid and other assets	\$ 37	
Property and equipment	57	
	94	
Intangible assets:		
Backlog	\$ 260	<1
Customer relationships	1,500	3
Non-compete agreement	400	3
Goodwill	2,924	
	5,084	
Total assets acquired	\$ 5,178	

The purchase price allocation was finalized during the three months ended September 30, 2008 resulting in a reclassification in the amount of \$100,000 from customer relationships to goodwill. The impact on amortization of the customer relationships was not material. The weighted

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average useful lives for the above noted intangibles is 2.7 years, excluding Goodwill, which is indefinite-lived. Goodwill is expected to be amortizable for tax purposes.

The results of the operations of the SSD Division have been consolidated with our results since their acquisition. Pro forma results of operations have not been presented because the acquisition was not material in relation to our consolidated financial position or results of operations.

Note 5 Intangible Assets and Goodwill

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually and more frequently if an event occurs that indicate the assets may be impaired. The Company determined there were no events or changes in circumstances that indicates that carrying values of goodwill, indefinite-lived intangible assets or other intangible assets subject to amortization may not be recoverable as of September 30, 2008.

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The following table provides information regarding the Company's intangible assets with finite lives at December 31, 2007 and September 30, 2008 (in thousands):

	Useful lives (years)	December 31, 2007			September 30, 2008		
		Gross carrying amount	Accumulated amortization	Net amount	Gross carrying amount	Accumulated amortization	Net amount
Backlog	<1	\$	\$	\$	\$ 260	\$ 217	\$ 43
Customer relationships	3				1,500	208	1,292
Non-compete agreement	3				400	56	344
Patents	5	750	400	350	750	512	238
Total		\$ 750	\$ 400	\$ 350	\$ 2,910	\$ 993	\$ 1,917

Amortization expense for intangible assets with finite lives was \$112,000 and \$593,000 for the nine months ending September 30, 2007 and 2008, respectively.

Estimated amortization expense for the next five years is expected to be \$239,000 for the remainder of 2008, \$783,000 in 2009, \$683,000 in 2010, \$212,000 in 2011 and zero in 2012. As of September 30, 2008, the Company had intangible assets not subject to amortization in the amount \$2.9 million which relates to goodwill from the SSD Division acquisition.

Note 6 Share-Based Compensation

Share-based compensation expense included in the Company's results of operations was as follows:

	Three months ended		Nine months ended	
	September 30, 2007	September 30, 2008	September 30, 2007	September 30, 2008
	(in thousands)		(in thousands)	
Cost of product revenues	48	119	285	331
Cost of maintenance and services revenues	57	141	262	404
Research and development expenses	72	230	274	670
Selling and marketing expenses	266	213	726	689
General and administrative expenses	168	200	646	599
	611	903	2,193	2,693

The Company has two stock option plans, the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, which authorize the issuance of stock options, nonvested shares and other share-based instruments to employees. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123R) using the modified prospective transition method.

Stock Options

During the three months ended September 30, 2007 and 2008, 131,150 and 30,000 stock options were granted, respectively. The fair values of each award granted under the Company's stock option plans during the three and nine months ended September 30, 2007 and 2008 were estimated at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

Three months ended September 30,	Nine months ended September 30,
-------------------------------------	------------------------------------

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	2007	2008	2007	2008
Volatility	46%	46%	46%	46%
Risk-free interest rate	4.62%	3.27%	4.68%	3.18%
Dividend yield	0.00%	0.00%	0.00%	0.00%
Expected life (years)	6.1	6.1	6.1	6.1

The weighted average estimated grant date fair value of options granted under the Company's stock option plans for the three and nine months ended September 30, 2007 and 2008 were as follows:

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	Three months ended September 30, 2007		Nine months ended September 30, 2007	
Weighted average fair value per share	\$ 7.20	\$ 4.86	\$ 6.55	\$ 4.86

As of September 30, 2008, there was approximately \$1.6 million of total unrecognized compensation cost related to non-vested share-based compensation that is expected to be recognized over a weighted average period of 2.0 years.

The options outstanding as of September 30, 2008 have generally been granted with a 10-year term, vest 25% at the completion of the first year and vest quarterly thereafter over the remaining three-year period. A summary of option activity under the plans for the nine months ended September 30, 2008 is as follows:

	Number of Options	Weighted Average Exercise Price
Outstanding, December 31, 2007	2,265,112	\$ 5.86
Granted	30,000	10.03
Exercised	(712,434)	1.27
Canceled or forfeited	(30,687)	22.65
Outstanding, September 30, 2008	1,551,991	\$ 7.72
Exercisable at September 30, 2008	1,241,952	\$ 6.02

A total of 2,416,810 options remain available for grant under the Company's share-based compensation plans at September 30, 2008.

The following tables further describe stock options outstanding at September 30, 2008.

Range of Exercise Prices	Number Outstanding at September 30, 2008	Options Outstanding			Number Exercisable at September 30, 2008	Options Exercisable		
		Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)		Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
\$ 0.30	75,752	2.2	\$ 0.36	\$ 747	75,752	2.2	\$ 0.36	\$ 747
0.75	224,825	4.5	0.75	2,129	224,825	4.5	0.75	2,129
1.00	255,072	5.3	1.00	2,352	255,072	5.3	1.00	2,352
4.50	406,567	5.7	4.81	2,201	406,567	5.7	4.81	2,201
11.00	589,775	8.0	16.24	6	279,736	7.6	18.11	
0.30	1,551,991	6.2	\$ 7.72	\$ 7,435	1,241,952	5.6	\$ 6.02	\$ 7,429
Vested or expected to vest	1,511,686	6.1	\$ 7.54	\$ 7,434				

The Company defines in-the-money options at September 30, 2008 as options that had exercise prices that were lower than the \$10.22 market value of its common stock at that date. The aggregate intrinsic value of options outstanding at September 30, 2008 is calculated as the difference between the exercise price of the underlying options and the market value of the Company's common stock for the 1.0 million shares that were in-the-money at that date. There were 1.0 million in-the-money options exercisable at September 30, 2008. The total intrinsic value of options exercised during the nine months ended September 30, 2007 and 2008 was \$4.2 million and \$7.0 million, respectively, determined as of the date of exercise. The Company has recognized an income tax benefit for stock-based compensation arrangements of \$625,000 and \$435,000 in the condensed consolidated statements of income for the nine months ended September 30, 2007 and 2008, respectively.

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Nonvested Shares

Beginning in 2007, the Compensation Committee of the Company's Board of Directors issued awards of nonvested shares to certain of the Company's employees and executive officers under the Company's 2004 Equity Incentive Plan. These nonvested share awards are grants that entitle the holder to shares of common stock subject to certain terms and, generally, vest in 25% increments each year on the anniversary of the grant date throughout a four year vesting period. The nonvested share awards are valued based on the closing market price on the date of award. Nonvested share compensation is to be amortized and charged to operations on a

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straight-line basis over the four year vesting period. A summary of nonvested share activity for the nine months ended September 30, 2008 is as follows:

	Shares	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value (in thousands)
Nonvested shares outstanding at December 31, 2007	1,035,600	\$ 11.42	\$ 11,826
Granted	163,100	11.21	
Vested			
Cancelled or forfeited	(72,100)	11.37	
Nonvested shares outstanding at September 30, 2008	1,126,600	\$ 11.39	\$ 11,514

As of September 30, 2008, there was approximately \$9.3 million of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 3.3 years.

Note 7. Investments in Marketable Securities

The Company has investments classified as available-for-sale securities included in short-term and long-term investments, categorized as follows (in thousands):

September 30, 2008

Type of Security	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term instruments	\$ 20,747	\$	\$	\$ 20,747
Corporate debt securities with maturities of less than one year	206,131	252	(7,625)	198,758
Municipal securities with maturities of less than one year				
U.S. government securities with maturities of less than one year	117,544	54	(162)	117,436
Total short-term investments	344,422	306	(7,787)	336,941
Corporate debt securities with maturities between one and two years	74,592	34	(995)	73,631
Municipal securities with maturities through October 2017	1,872			1,872
U.S. government securities with maturities between one and two years				
Total long-term investments	76,464	34	(995)	75,503
	\$ 420,886	\$ 340	\$ (8,782)	\$ 412,444

December 31, 2007

Type of Security	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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Short-term instruments	\$ 9,875	\$	\$ (1)	\$ 9,874
Corporate debt securities with maturities of less than one year	255,339	150	(446)	255,043
Municipal securities with maturities of less than one year	17,920	1		17,921
U.S. government securities with maturities of less than one year	61,161	96	(10)	61,247
 Total short-term investments	 344,295	 247	 (457)	 344,085
Corporate debt securities with maturities between one and three years	86,140	415	(106)	86,449
Municipal securities with maturities through October 2017				
U.S. government securities with maturities between one and three years	4,787	31		4,818
 Total long-term investments	 90,927	 446	 (106)	 91,267
	\$ 435,222	\$ 693	\$ (563)	\$ 435,352

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The Company's short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper. These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of stockholders' equity. The accumulated unrealized gain (loss) on available-for-sale securities at December 31, 2007 and September 30, 2008 was as follows:

	December 31, 2007	September 30, 2008
	(in thousands)	
Accumulated unrealized gain (loss)	\$ 130	\$ (8,442)

The Company utilizes specific identification in computing realized gains and losses on the sale of investments. We have the intent, ability and history of holding these investments until maturity and have evaluated them for other-than-temporary impairment in accordance with FASB Staff Position (FSP) 115-1 and 124-1 The Meaning of Other-Than-Temporary Impairment and Its Applications to Certain Investments . Under FAS 115, unrealized holding gains and losses are excluded from earnings and reported net of the related tax effect in other comprehensive income (OCI) as a separate component of shareholders' equity. When the fair value of an investment declines below its original cost, we consider all available evidence to evaluate whether the decline is other-than-temporary. Among other things, we consider the duration and extent of the decline and economic factors influencing the markets. If a decline in fair value is judged to be other-than-temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings (that is, accounted for as a realized loss). Based on this evaluation the Company determined that the investments were not other-than-temporarily impaired and recorded no realized gain or loss for the three and nine months ended September 30, 2007 and 2008.

Note 8. Fair Value Measurements

As indicated in Note 2, the Company adopted the provisions of SFAS 157 for financial assets and liabilities effective January 1, 2008. SFAS 157 clarifies the definition of fair value as an exit price representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier value hierarchy, which prioritizes, in descending order, the inputs used in measuring fair value as follows:

Level 1 Observable inputs such as quoted prices in active markets

Level 2 Inputs other than the quoted prices in active markets that are observable either directly or indirectly

Level 3 Unobservable inputs in which there is little or no market data, which require us to develop our own assumptions.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures certain financial assets and liabilities at fair value, including its marketable securities. The Company's investment instruments, except for auction rate securities, listed below are classified within Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company's auction rate securities are classified as Level 3 of the fair value hierarchy due to the limited market data for pricing these securities.

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As of September 30, 2008	Fair value	Level 1	Level 2	Level 3
	(in thousands)			
Short-term instruments	\$ 20,747	\$	\$ 20,747	\$
Corporate debt securities	272,389		269,809	2,580
Municipal securities	1,872			1,872
U.S. government securities	117,436		117,436	
	\$ 412,444	\$	\$ 407,991	\$ 4,453

As of September 30, 2008, the Company's investments included \$4.5 million of auction rate securities which are classified as long-term investments in marketable securities. Auction rate securities are generally long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. This mechanism generally allows existing investors to rollover their holdings and continue to own their respective securities or liquidate their holdings by selling their securities at par value.

As of September 30, 2008, the Company's auction rate securities consisted of three positions issued by closed-end funds totaling \$2.6 million and one position issued by a municipal agency totaling \$1.9 million. These investments have high credit quality ratings of AA or AAA. The auction rate securities issued by the closed-end funds are fully collateralized by bonds and other financial instruments. Since February 2008, uncertainties in the credit markets have prevented the Company and other investors from liquidating investments in auction rate securities as, in recent auctions, the amount of securities submitted for sale has exceeded the amount of purchase orders. Since December 31, 2007, none of the auction rate securities held by the Company have been downgraded, and none of the issuers have defaulted on their scheduled interest payments. Additionally, in June 2008, the issuer of auction rate securities for two of the closed-end funds held by the Company redeemed approximately 90% of the funds' outstanding auction preferred shares that were held by the Company. Based on its analysis of impairment factors, including, but not limited to, whether the credit ratings of the issuers deteriorate, or the collateral of the securities deteriorates, the Company's auction rate securities are not deemed to be impaired as of September 30, 2008. In the event the Company encounters impairment factors including, but not limited to, a deterioration in the credit ratings of the issuers, or the collateral of the securities, the Company may be required to reflect a write-down of certain of its auction rate securities. Based on the Company's expected operating cash flows, and the Company's other sources of cash, the Company does not expect the potential lack of liquidity in these investments to affect its ability to execute its current business plan.

The following table sets forth a reconciliation of changes in the fair value of financial assets classified as Level 3 in the fair value hierarchy:

	Fair Value Measurements Using Significant Unobservable Inputs Level 3 (in thousands)
Balance at January 1, 2008	\$ 17,921
Total gains or losses (realized or unrealized)	
Included in earnings	
Included in comprehensive income	
Purchases, issuances, and settlements	(13,468)
Transfers in and/or out of Level 3	
Balance at September 30, 2008	\$ 4,453

Note 9. Inventory and Contract Related Costs

Inventory and contract related costs consist of the following:

December 31, 2007	September 30, 2008
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	(in thousands)	
Materials and components	\$ 3,462	\$ 4,811
Inventory and costs related to long-term contracts	4,455	4,600
Deferred costs of revenue	3,442	13,530
	\$ 11,359	\$ 22,941

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Materials and components are stated at the lower of cost or market determined using the first-in, first-out method. Inventoried costs relating to long-term contracts are stated at actual production costs incurred to date reduced by amounts identified with revenue recognized on progress completed. Deferred costs of revenue relate to contracts for which revenue has been deferred, and such costs are stated at actual production costs incurred to date, which primarily include materials, labor and subcontract costs which are directly related to the contract. Deferred costs of revenue are amortized to costs of revenue at the time revenues are recognized.

Note 10. Net Income Per Share

Basic net income per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share reflects the effects of potentially dilutive securities, which consist of stock options and nonvested shares. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	Three months ended September 30, 2007		2008		Nine months ended September 30, 2007		2008	
	(in thousands, except per share data)							
Numerator:								
Net income available to common stockholders	\$	4,144	\$	12,034	\$	20,932	\$	33,672
Denominator:								
Denominator for basic net income per share weighted average shares		94,436		89,536		94,331		90,122
Dilutive potential common stock options and nonvested shares		1,540		866		1,641		1,046
Denominator for diluted net income per share adjusted weighted average shares		95,976		90,403		95,972		91,169
Basic net income per share	\$	0.04	\$	0.13	\$	0.22	\$	0.37
Diluted net income per share	\$	0.04	\$	0.13	\$	0.22	\$	0.37

During the three months ended September 30, 2007 and 2008, options to purchase 274,350 and 501,775 shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares for each of these respective periods. For the nine months ended September 30, 2007 and 2008, options to purchase 445,100 and 559,775, respectively, were similarly excluded.

Note 11. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income. Specifically, cumulative foreign currency translation adjustments, the effect of the foreign exchange translation for the Company's foreign tax liabilities and unrealized gains or losses on the Company's investments in marketable securities are included in accumulated other comprehensive income (loss).

	Three months ended September 30, 2007		2008		Nine months ended September 30, 2007		2008	
Net income	\$	4,144	\$	12,034	\$	20,932	\$	33,672
Other comprehensive income (loss):								
Change in unrealized (loss), net of tax		265		(7,955)		112		(8,572)
Change in foreign currency translation adjustment		61		471		136		151
Total comprehensive income	\$	4,470	\$	5,550	\$	21,180	\$	26,322

Note 12. Income Taxes

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 (FIN 48). FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. For those benefits to be recognized, a tax position must be more likely than not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

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As of September 30, 2008, the Company had cumulative unrecognized tax benefits of \$9.3 million. As of December 31, 2007, the Company had cumulative unrecognized tax benefits of \$3.6 million. The increase in the cumulative unrecognized tax benefits is a result of increases in tax positions for prior years resulting from the effect of the foreign exchange translation for the Company's foreign tax liabilities. The increase is also due to a tax liability recorded in the third quarter of 2008 relating to the treatment of the Northrop Settlement Agreement (see Note 3). The Company continues to recognize accrued interest and penalties related to unrecognized tax benefits in the income tax provision. During the three and nine months ended September 30, 2008, an additional \$155,000 and \$473,000, respectively, of interest before tax benefits was accrued.

The Company files Federal income tax returns, as well as multiple state, local and foreign jurisdiction tax returns. With few exceptions, the Company is no longer subject to examination for its U.S. Federal and state, foreign and local jurisdictions for years prior to 2003. The Internal Revenue Service completed its examination of the Company's Federal consolidated tax returns for 2004 and 2005 and issued a "no change" letter during the year ended December 31, 2007.

Note 13. Deferred Revenues and Deferred Costs

In December 2007, the Company settled its lawsuit with Northrop Grumman (See Note 3). As of September 30, 2008, deferred revenue related to the settlement of the lawsuit was \$10.0 million.

In November 2007, the Company entered into a contract to provide a turnkey AFIS to certain law enforcement agencies in Spain for \$11.0 million. The new turnkey AFIS will provide a broader range of functional capabilities than the current system. In December 2007, the Company recorded \$6.0 million in deferred revenue representing a scheduled billing under the contract. Deferred costs related to this contract are included in inventory and will be recognized as costs of product revenues as the revenues are recognized. Deferred revenue related to the contract was \$6.0 million as of December 31, 2007 and September 30, 2008.

In August 2006, the Company entered into a contract with a law enforcement agency in Maryland to provide an integrated AFIS system as well as provide other services to re-engineer some of their clearance and record maintenance systems. As of September 30, 2008, the Company has \$5.2 million in deferred revenue which represents billing for services rendered over the contract period.

The remaining portion of deferred revenues consist primarily of unamortized maintenance revenues and contracts for which receipt of written acceptance of the solution by the customer is pending.

Note 14. Stock Repurchase Program

On November 1, 2007, the Company announced that its Board of Directors authorized a program to repurchase up to \$100 million of its common shares over a 12 month period expiring in October 2008. Acting pursuant to this approval, the Company repurchased 4,491,003 shares at an aggregate cost of \$41.8 million, during the nine months ended September 30, 2008. There were no shares repurchased during the three months ended September 30, 2008.

The shares were purchased in the open market using the Company's cash resources. The shares will be held in treasury until the Company's Board of Directors designates that these shares be retired or used for other purposes. The authorized amount remaining available for share repurchase as of September 30, 2008 was \$44.3 million. In October 2008, the Company repurchased an additional 363,472 shares at an aggregate cost of \$3.3 million. The share repurchase program terminated October 29, 2008.

Table of Contents**Note 15. Segment Information**

The Company considers its business activities to constitute a single segment. A summary of the Company's revenues by geographic area follows (in thousands):

	Three months ended September 30, 2008				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	\$ 19,923	\$ 24	\$ 256	\$ 4,453	\$ 24,656
Maintenance and services revenues	8,162	358	234	1,622	10,376
Total	\$ 28,085	\$ 382	\$ 490	\$ 6,075	\$ 35,032

	Three months ended September 30, 2007				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	\$ 9,674	\$ 69	\$ 345	\$ 5,928	\$ 16,016
Maintenance and services revenues	5,608	646	238	4	6,496
Total	\$ 15,282	\$ 715	\$ 583	\$ 5,932	\$ 22,512

	Nine months ended September 30, 2008				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	\$ 50,598	\$ 497	\$ 468	\$ 7,891	\$ 59,454
Maintenance and services revenues	22,056	1,768	665	1,761	26,250
Total	\$ 72,654	\$ 2,265	\$ 1,133	\$ 9,652	\$ 85,704

	Nine months ended September 30, 2007				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	\$ 54,211	\$ 2,863	\$ 522	\$ 8,118	\$ 64,714
Maintenance and services revenues	15,529	1,751	699	226	18,205
Total	\$ 69,740	\$ 4,614	\$ 1,221	\$ 8,344	\$ 83,919

At December 31, 2007 and September 30, 2008, the Company's property and equipment and intangible assets, net of accumulated depreciation and amortization in the United States and in other countries was as follows (in thousands):

	December 31, 2007	September 30, 2008
Property and equipment, net of accumulated depreciation in the United States	\$ 32,075	\$ 33,876
Property and equipment, net of accumulated depreciation in other countries	1,569	2,635
	\$ 33,644	\$ 36,511
Intangible assets, net of accumulated amortization in the United States	\$ 350	\$ 4,841

Note 16. Equity Investment in ANP

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Effective January 2008, Cogent and ANP Technologies, Inc. (ANP), a biological detection company producing nano-assays entered into an agreement whereby Cogent obtained 20% of the outstanding shares of ANP in exchange for \$3 million in cash and the transfer of Cogent's reader technology, applicable only for the biological market. In addition, Cogent entered into an agreement pursuant to which Cogent develops and supplies a variety of readers to ANP. Cogent's investment in ANP is accounted for under the equity method in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). The Company's share of its equity in earnings of the investee, which totaled \$26,000 and \$78,000 during the three and nine months ended September 30, 2008, is not material and therefore is reported in the Other, net line item in the Company's condensed consolidated statement of income.

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Note 17. Commitments and Contingencies

The Company evaluates all pending or threatened contingencies and any commitments, if any, which are reasonably likely to have a material adverse effect on its operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies. If information available prior to the issuance of the Company's financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the Company's financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

During the normal course of business, the Company may be subject to litigation involving various business matters. Management believes that an adverse outcome of any such known matters would not have a material adverse impact on the Company.

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

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report to conform such statements to actual results or to changes in our expectations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part II of this Quarterly Report under the caption Risk Factors and under the captions Management's Discussion and Analysis of Financial Condition and Results of Operations, and Risk Factors and in our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2007, previously filed with the Securities and Exchange Commission (SEC).

Risk factors that could cause actual results to differ from those contained in the forward-looking statements include but are not limited to: changes in government policies; uncertain political conditions in international markets; deriving a significant portion of revenues from a limited number of customers; deriving a significant portion of revenues from the sale of solutions pursuant to government contracts; failure of the biometrics market to experience significant growth; failure of our products to achieve broad acceptance; potential fluctuations in quarterly and annual results; changes in our effective tax rate; failure to successfully compete; failure to comply with government regulations; failure to accurately predict financial results due to long sales cycles; negative publicity and/or loss of clients due to security breaches resulting in the disclosure of confidential information; loss of export licenses or changes in export laws; failure to manage projects; rapid technology change in the biometrics market; loss of a key member of management team; termination of backlog orders; loss of limited source suppliers; negative audits by government agencies; failure to protect intellectual property; and exposure to intellectual property and product liability claims.

Overview

We are a leading provider of advanced Automated Fingerprint Identification Systems, (AFIS), and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. We were incorporated and commenced operations in 1990. We have been researching, designing, developing and marketing AFIS and other fingerprint biometrics solutions since inception. During most of our operating history, we have achieved positive income and cash flows from operations. From the fourth quarter of 2003 through the year ended December 31, 2005, we experienced significant increases in our revenues and net income as the market for our AFIS solutions expanded primarily due to increased demand by the Department of Homeland Security, or DHS, as well as the National Electoral Council of Venezuela, or CNE. We experienced a decline in revenues during the year ended December 31, 2006 due to the completion of a number of significant contracts, the timing of revenue recognition related to contracts entered into in previous periods and slowdowns in the procurement process at the U.S. government. In 2007 our revenues improved over 2006 levels as we recorded revenue from an increased number of customers. We

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believe that we are positioned to experience an increase in revenues in 2008 over 2007 levels as we expect to recognize revenue from previously announced contracts with customers including Morocco, Spain and the DHS, as well as from new contracts with core customers such as the DHS, the County of Los Angeles and various programs in Europe.

Table of Contents**Sources of Revenue**

We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator (PMA) servers and other AFIS equipment, including workstations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. We generate maintenance revenues from maintenance contracts that are typically included with the sale of our AFIS solutions. Maintenance contracts for technical support and software updates generally cover a period of one year, and after contract expiration, our customers have the right to purchase maintenance contract renewals, which generally cover a period of one year. Revenues from maintenance contracts are deferred and amortized on a straight-line basis over the life of the maintenance obligation. We generate services revenues from engineering services and AFIS system operation services that are not an element of an arrangement for the sale of products. These services are typically performed under fixed-price and time-and-material agreements.

We market our solutions primarily to U.S. and foreign government agencies and law enforcement agencies. In a typical contract with a government agency for an initial AFIS deployment, we agree to design the AFIS, supply and install equipment and software and integrate the AFIS within the agency's existing network infrastructure. These initial deployment contracts frequently require significant modification or customization of our solution as part of our integration services. These contracts provide for billings up to a fixed price total contract value upon completion of agreed milestones or deliveries, with each milestone or delivery typically having a value specified in the contract. These customers usually impose specific performance and acceptance criteria that must be satisfied prior to invoicing for each milestone or delivery. When customers purchase AFIS solutions that do not require significant modification or customization of our software, whether as an initial deployment or as an expansion of an existing AFIS, we typically agree to deliver the products and perform limited installation services subject to customer-specific acceptance criteria. Certain of our customers, including the DHS, submit purchase orders under blanket purchase order agreements. Blanket purchase order agreements set out the basic terms and conditions of our arrangement with the customer and simplify the procedures for ordering our products to avoid administrative processes that would otherwise apply, particularly with the federal government. The billing of these contracts is generally tied to delivery and acceptance of specific AFIS equipment, usually our PMA servers or live-scans. Most of our contracts for AFIS solutions also include an ongoing maintenance obligation that we honor over a term specified in the deployment contract or the blanket purchase order agreement. The nature of our business and our customer base is such that we negotiate a set of unique terms for each contract that are based upon the purchaser's standard form of documentation.

The most significant portion of our revenues since the fourth quarter of 2003 has arisen from increased demand by the DHS and the CNE for our AFIS solutions. The DHS uses our solutions in connection with the implementation of the United States Visitor and Immigrant Status Indicator Technology, or US-VISIT, program, and the CNE uses our solutions for national, regional and local elections. We anticipate that the DHS will account for a significant portion of our revenues for the foreseeable future. Our most recent arrangement with the CNE was completed in December 2006 and revenues from all of our arrangements with the CNE were fully recognized by June 30, 2007. Excluding our Product and Services Agreement with Northrop under the Settlement Agreement (see Note 3 to the unaudited Notes to the Condensed Consolidated Financial Statements), we do not have any long-term contracts with any of our customers, including the DHS, for the sale of our products, and our future sales will depend upon the receipt of new orders. Any delay or other change in the rollout of US-VISIT or any failure to obtain new orders from the DHS could cause our revenues to fall short of our expectations.

We also expect to experience continued demand from a number of other governments as they deploy AFIS solutions in elections, at points of entry and exit, including borders, seaports and airports, and in connection with national identification programs. For example, in Canada, we have been awarded an initial contract and several follow-on orders, and we believe we may receive additional follow-on orders related to the Royal Canadian Mounted Police (RCMP)'s Real Time Identification Initiative. Another example is our September 2005 contract with the Direction Générale De la Sureté Nationale of Morocco (DGSN) to provide an integrated turn-key AFIS. The quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations. Government contracts for security solutions in elections, at points of entry and exit and in connection with national identification programs are typically awarded in open competitive bidding processes. Therefore, our future level of sales of AFIS solutions for deployments in elections and at points of entry and exit may vary substantially, and will depend on our ability to successfully compete for this business.

Cost of Revenues and Operating Expenses

Cost of Revenues. Cost of product revenues consists principally of compensation costs incurred in designing, integrating, installing and customizing AFIS solutions, the costs associated with manufacturing, assembling and testing our AFIS solutions and utilizing subcontractors. A substantial portion of these costs represents components, such as servers, integrated circuits, workstations, live-scans and other hardware. Cost of product revenues also includes related overhead, compensation, final assembly, quality-assurance, inventory management, support costs and payments to contract manufacturers that perform assembly functions. Cost of maintenance and services revenues consists of customer support costs and training and professional service expenses, including compensation. Cost of revenues also includes share-based compensation allocable to personnel performing services related to cost of revenues. We expect our gross margin to be affected by many factors, including our mix of products and the amount of third party hardware included in our AFIS solutions. Additionally, our margins on maintenance revenues

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could be affected by the types of services performed by our SSD division whose gross margins tend to be lower than our historic margins on maintenance. Other

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factors that may affect our gross margin include changes in selling prices of our products, maintenance and services, fluctuations in demand for our products, the timing and size of customer orders, fluctuations in manufacturing volumes, changes in costs of components and new product introductions by us and our competitors and agreements entered into with our subcontractors.

Research and Development. Research and development expenses consist primarily of salaries and related expenses for engineering personnel, fees paid to consultants and outside service providers, depreciation of development and test equipment, prototyping expenses related to the design, development, testing and enhancements of our products, and the cost of computer support services. We expense all research and development costs as incurred. Under our customer contracts, we typically obtain the rights to use any improvements to our technology developed on a particular customer deployment on other customer deployments. As a result, we have historically been able to moderate our research and development expenses by leveraging the improvements developed by our personnel working on customer engagements. Research and development expenses also include share-based compensation allocable to personnel performing services related to research and development.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses also include share-based compensation allocable to personnel performing services related to sales and marketing.

General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses also include share-based compensation allocable to personnel performing general and administrative services.

Settlement of Claims against Northrop

In April 2005, we initiated a lawsuit against Northrop Grumman in California State Court (Cogent Systems, Inc. vs. Northrop Grumman Corporation, Northrop Grumman Technology Overseas, Inc., et al., Superior Court of the State of California, in and for the County of Los Angeles, Case No. BC 332199) based on claims of breach of contract, conversion, misappropriation of trade secrets and other claims (the Action). On December 5, 2007, we and Northrop entered into a definitive Settlement Agreement and Mutual Release of Claims (the Settlement). Pursuant to the terms of the Settlement, we and Northrop formally settled and released all claims and causes of action alleged in the Action. Under the Settlement, we entered into four agreements with Northrop (collectively, the Agreements):

1. The Settlement Agreement, pursuant to which Northrop agreed to pay us \$25 million, of which \$15 million was paid in January 2008 and \$10 million is to be paid in January 2009;
2. The Software License Agreement, pursuant to which Northrop will pay us \$15 million over three years for a non-exclusive license to use certain of our automated fingerprint identification software in certain existing programs;
3. The Product and Services Agreement, pursuant to which Northrop will pay us a minimum of \$20 million for products and services over the five year term of the agreement; and
4. The Strategic Alliance Agreement pursuant to which we and Northrop will meet semiannually over the three year term of the agreement to discuss business opportunities and proposal efforts for the design, development, sale and support of biometric identification solutions.

Our total proceeds under the agreements will be \$60.0 million. We have accounted for the agreements as one multiple element arrangement. The contract values for each of the agreements do not necessarily represent the fair value of each agreement. The Strategic Alliance Agreement was determined not to be an element requiring accounting recognition. We determined that the \$20 million in proceeds scheduled under the Product and Services Agreement includes both a guaranteed payment component valued at \$1.0 million and a component for the purchase of products and services valued at \$19.0 million using VSOE of fair value in accordance with SOP 97-2, Software Revenue Recognition. We determined the fair value of the Software License Agreement and the guaranteed payment component of the Product and Services Agreement to be \$30.0 million and \$1.0 million, respectively, based on generally accepted valuation techniques. The residual method was used to derive the \$10.0 million fair value for the Settlement Agreement.

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Accounting for the Software License Agreement is subject to the guidance of SOP 97-2. However, the provision of the AFIS software under the Software License Agreement did not represent a stand-alone arm's length transaction. Rather, the revenue amount was determined based on a valuation. Thus, we did not believe it appropriate to apply our standard maintenance VSOE rate to this amount and we could not determine the fair value of the associated maintenance commitment. We will recognize revenue under the Software License Agreement and the Products and Services Agreement, on a combined basis, based on the lowest proportion of revenue recognizable under the contracts. While we were not able to establish VSOE of the maintenance commitment, we believe our standard maintenance rate represents a reasonable basis for the allocation of revenues recognized under the Software License Agreement, between product and maintenance, as the revenues are recognized over the term of the Software License Agreement. We will therefore allocate a portion of the revenues representing our standard annual maintenance renewal rate (based on VSOE), to maintenance revenues. The remainder will be recorded as product revenues. The \$1.0 million value of the guaranteed payment will be recognized as income on a pro-rata basis (i.e. each dollar of revenue under the Products and Services Agreement will result in ninety-

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five cents of revenue and five cents of Income from settlement of lawsuit). The residual value allocated to the Settlement Agreement is presented as Income from settlement of lawsuit in the accompanying condensed consolidated statement of income for the nine months ended September 30, 2008.

Due to the risks associated with extended payment terms, recognition of the revenues and the gain on settlement of litigation will be limited to the amounts collected from Northrop. Since the recognition of revenues from several elements is limited due to risks associated with the extended payment terms, we will allocate cash collections to each element on a basis consistent with their relative fair value.

Application of Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to percentage-of-completion, bad debts, investments, income taxes, share-based compensation, commitments, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are 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 may differ from these estimates under different assumptions or conditions.

We consider the following accounting estimates to be both those most important to the portrayal of our results of operations and financial condition and those that require the most subjective judgment:

revenue recognition;

commitments and contingencies;

allowance for doubtful accounts;

investments in marketable securities;

accounting for taxes; and

accounting for share-based compensation.

Revenue Recognition. Because our proprietary software is essential to the functionality of our AFIS solutions and other biometrics products, we apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. For arrangements that require significant production, modification, or customization of software, we apply the provisions of Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. To the extent an element within our software arrangements falls within a level of accounting literature that is higher than SOP 97-2, we record revenue on such element in accordance with the relevant authoritative literature. For arrangements that contain the lease of equipment, we account for the lease element in accordance with Statement of Financial Accounting Standards (SFAS) No. 13 Accounting for Leases and account for the remaining elements in the arrangement in accordance with SOP 97-2. For arrangements that contain a non-software deliverable such as hardware, we apply the provisions of Emerging Issues Task Force (EITF) 03-05 Applicability of AICPA Statement of Position 97-2 to Non- Software Deliverables in an Arrangement Containing More-Than-Incidental Software and recognize revenue when all other revenue recognition criteria are met. For multiple element arrangements not subject to accounting under SOP 97-2, we account for these arrangements in accordance with EITF No. 00-21 Revenue Arrangements with Multiple Deliverables. The application of the appropriate accounting principle to our revenue is dependent upon the specific transaction and whether the sale includes systems, software and services or a combination of these items. As our business evolves, the mix of products and services sold will impact the timing of when revenue and related costs are recognized. Additionally, revenue recognition involves

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judgments, including estimates of costs to complete contracts accounted for using the percentage of completion method of accounting and assessments of the likelihood of nonpayment. We analyze various factors, including a review of specific transactions, the credit-worthiness of our customers, our historical experience and market and economic conditions. Changes in judgments on these factors could materially impact the timing and amount of revenue and costs recognized.

Product Revenues

The timing of product revenues recognition is dependent on the nature of the product sold.

Revenues associated with AFIS solutions that do not require significant modification or customization of our software, exclusive of amounts allocated to maintenance for which we have VSOE are recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided all other criteria for revenue recognition have been met. For example, we recognize revenue in this manner from sales of our PMA

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servers to the DHS under our blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

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Revenues associated with AFIS solutions that require significant modification or customization of our software, are recognized using the percentage-of-completion method as described by SOP 81-1. The percentage-of-completion method reflects the portion of the anticipated contract revenue which has been earned, equal to the ratio of labor effort expended to date to the anticipated final labor effort, based on current estimates of total labor effort necessary to complete the project. The amount subject to the percentage-of-completion method is exclusive of the maintenance, the fair value of which is established by VSOE. Material differences may result in the amount and timing of our revenue for any period if actual results differ from our judgments and estimates. We recognize revenue in this manner from sales of significant initial AFIS deployments. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period or until the time when such VSOE is established. Revenues recognized under such arrangements were \$11.8 million and zero for the nine months ended September 30, 2007 and 2008, respectively.

Revenue associated with the sale of our application specific integrated circuit, or ASIC applications, stand-alone live-scans and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with service offerings where we maintain and operate a portion of the AFIS systems on an outsourced application-hosting basis is recognized on a per transaction basis provided (i) persuasive evidence of an arrangement exists, (ii) the fee is fixed or determinable and (iii) collection is deemed probable.

Revenue associated with contracts where sufficient VSOE cannot be established for the allocation of revenue to the various elements of the arrangement is deferred until the earlier of the point at which (i) such sufficient VSOE does exist or (ii) all elements of the arrangement have been delivered.

Cash received from customers in advance of recognition of the related revenue is recorded as deferred revenue.

Maintenance Revenues

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. We recognize all maintenance revenue ratably over the applicable maintenance period. We determine the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions contained in a particular arrangement. In the absence of such renewal provisions, the deferral of maintenance is based on the Company's established VSOE rate for maintenance for comparable arrangements. We consider substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to our normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is included in product revenues and recognized ratably over the term of the maintenance period.

Services Revenues

Professional services revenue is primarily derived from engineering services and AFIS system operation and maintenance services that are not an element of an arrangement for the sale of products. These services are generally billed on a time-and-materials basis. The majority of our professional services are performed either directly or indirectly for U.S. government organizations. Revenue from such services is recognized as the services are provided.

Consistent with EITF Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the amount of revenue recognized from commissions where we are acting as an agent is the net amount after payments are made to the primary obligor responsible for delivering the services.

Revenue Recognition Criteria

We recognize revenue when persuasive evidence of an arrangement exists, the element has been delivered, the fee is fixed or determinable and collection of the resulting receivable is probable.

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Persuasive evidence of an arrangement: We use either contracts signed by both the customer and us or written purchase orders issued by the customer that legally bind us and the customer as evidence of an arrangement.

Product delivery: We deem delivery to have occurred when AFIS solutions are installed and, when required under the terms of a particular arrangement, upon acceptance by the customer. Shipments of our ASICs, stand-alone live-scans and other biometric products are recognized as revenue when shipped and title and risk of ownership has passed to the buyer.

Fixed or determinable fee: For product arrangements not accounted for using the percentage-of-completion method, we consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment and the payment terms are within normal established practices. If the fee is not fixed or determinable, we recognize the revenue as amounts become due and payable.

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Collection is deemed probable: We conduct a credit review for all significant transactions at the time of the arrangement to determine the credit-worthiness of the customer. Collection is deemed probable if we expect that the customer will pay amounts under the arrangement as payments become due.

Deferred Revenue. Our deferred revenue balance results primarily from payments received from customers in advance of recognition of the related revenue and, to a lesser extent, from invoicing of customers prior to recognition of the related revenue. Certain customers make upfront payments resulting in cash collected prior to our recognition of revenue. These payments can be significant. We record this upfront payment as deferred revenue and reduce the deferred revenue balance as revenue is recognized. As a result, our deferred revenue balance fluctuates from quarter to quarter because it is a function of the timing of (i) the receipt of cash payments from those customers who pay in advance of revenue recognition, (ii) invoicing of customers in advance of revenue recognition and (iii) amortization of deferred revenues into revenues. Deferred revenues also consist of payments received in advance from our customers for maintenance agreements, under which revenues are recognized ratably over the term of the maintenance period. However, the fluctuation in the deferred revenue balance from quarter to quarter is generally not significantly affected by the deferred maintenance revenue. Because the mix of customers who pay or are invoiced in advance of revenue recognition changes from period to period, fluctuations in our deferred revenue balance are not a reliable indicator of total revenue to be recognized in any future period. Our cash flow from operations is also affected each quarter as a result of fluctuations in the deferred revenue balance.

Commitments and Contingencies. We evaluate all pending or threatened contingencies and commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position. We assess the probability of an adverse outcome and determine if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies. If information available prior to the issuance of our financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of our financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Allowances for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in a provision for bad debt expense. We determine the adequacy of this allowance by evaluating individual customer accounts receivable, through consideration of the customer's financial condition, credit history and current economic conditions. If the financial condition of our customers was to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Investments in Marketable Securities. Our investments in marketable securities consist primarily of money market funds, certificates of deposit and commercial paper, U.S. Treasury securities, government-sponsored enterprise securities, municipal bonds, foreign government bonds and corporate bonds and notes. We account for our investments in debt and equity securities under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, (FAS 115). Marketable securities are classified as available-for-sale securities and are accounted for at their fair value. We have the intent, ability and history of holding these securities until maturity. Under FAS 115, unrealized holding gains and losses are excluded from earnings and reported net of the related tax effect in other comprehensive income (OCI) as a separate component of shareholders' equity. When the fair value of an investment declines below its original cost, we evaluate the investment in accordance with FASB Staff Position (FSP) 115-1 and 124-1 *The Meaning of Other-Than-Temporary Impairment and Its Applications to Certain Investments* which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. When the fair value of an investment declines below its original cost, we consider all available evidence to evaluate whether the decline is other-than-temporary. Among other things, we consider the duration and extent of the decline and economic factors influencing the markets. If a decline in fair value is judged to be other-than-temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings (that is, accounted for as a realized loss). The new cost basis is not to be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities are included in OCI; subsequent decreases in fair value, if not an other-than-temporary impairment, also are included in OCI. The determination of whether a loss is other than temporary is highly judgmental and may have a material impact on our results of operations.

As of September 30, 2008, our investments included \$4.5 million of auction rate securities which are classified as long-term investments in marketable securities. Auction rate securities are generally long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. This mechanism generally allows existing investors to rollover their holdings and continue to own their respective securities or liquidate their holdings by selling their securities at par value.

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As of September 30, 2008, our auction rate securities consisted of three positions issued by closed-end funds totaling \$2.6 million and one position issued by a municipal agency totaling \$1.9 million. These investments have high credit quality ratings of AA or AAA. The auction rate securities issued by the closed-end funds are fully collateralized by bonds and other financial instruments. Since February 2008, uncertainties in the credit markets have prevented us and other investors from liquidating investments in auction rate securities as, in recent auctions, the amount of securities submitted for sale has exceeded the amount of purchase orders. Since December 31, 2007, none of the auction rate securities held by us have been downgraded, and none of the issuers have defaulted on their scheduled interest payments. Additionally, in June 2008, the issuer of auction rate securities for two of the closed-end funds redeemed approximately 90% of the funds' outstanding auction preferred shares that we held at that time. Based on our analysis of impairment factors, including, but not limited to, whether the credit ratings of the issuers deteriorate, or the collateral of the securities deteriorates, our auction rate securities are not deemed to be impaired as of September 30, 2008. In the event we encounter impairment factors including, but not limited to, a deterioration in the credit ratings of the issuers, or the collateral of the securities, we may be required to reflect a write-down of certain of our auction rate securities as a charge to earnings in future periods. Based on our expected operating cash flows, and other sources of cash, we do not expect the potential lack of liquidity in these investments to affect our ability to execute our current business plan.

Accounting for Taxes. In preparing our consolidated financial statements, we estimate our income tax liability in each of the jurisdictions in which we operate by estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. As of September 30, 2008, our net deferred tax assets were \$36.6 million. Management judgment is required in assessing the realizability of our deferred tax assets. In performing this assessment, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from our estimates or we adjust our estimates in future periods, we may need to make or adjust valuation allowances with respect to our deferred tax assets, which could materially impact our financial position and results of operations. Our income tax provision is based on calculations and assumptions that may be subject to examination by the Internal Revenue Service and other tax authorities. Should the actual results differ from our estimates, we would have to adjust the income tax provision in the period in which the facts that give rise to the revision become known. Tax law and rate changes are reflected in the income tax provision in the period in which such changes are enacted.

We generate a significant portion of our revenues from contracts with foreign government agencies. Each country with which we do business has its own particular rules to determine the point at which our activities within such country will become subject to taxes, if any. To the extent our contracts with foreign government agencies are subject to income taxes and we do not generate adequate foreign tax credits for purposes of our Federal income tax return, our effective tax rate may be impacted.

Effective January 1, 2007, we adopted FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement 109 (FIN 48). FIN 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect our operating results.

Accounting for Share-Based Compensation. The calculation of share-based employee compensation expense involves estimates that require management's judgment. These estimates include the fair value of each of our stock option awards, which is estimated on the date of grant using a Black-Scholes option-pricing model as discussed in Note 6 of our condensed consolidated financial statements included elsewhere in this report. The fair value of our stock option awards is expensed on a straight-line basis over the vesting life of the options. We estimate the volatility of our common stock at the date of grant based on the implied volatility of publicly traded 30-day to 270-day options on our common stock, consistent with SFAS 123R and SEC Staff Accounting Bulletin No. 107. Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our belief that implied volatility is more representative of future stock price trends than historical volatility. We base the risk-free interest rate that we use in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms. We do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. SFAS 123R requires us to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. Upon adoption of SFAS 123R, the Company estimates the expected term for options granted after April 1, 2006, using the simplified method in accordance with Staff Accounting Bulletin 107, *Share-Based Payment* (SAB 107), which utilizes the weighted average expected life of each tranche of stock option, determined based on the sum of each tranche's vesting period plus one-half of the period from the vesting date of each tranche to the stock option's expiration. For options granted before January 1, 2006, we amortize the fair value on an accelerated basis. For options granted on or after January 1, 2006, we amortize the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods.

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Beginning in 2007, the Compensation Committee of the Company's Board of Directors issued awards of nonvested shares to certain of the Company's employees and executive officers under the Company's 2004 Equity Incentive Plan. These nonvested share awards are grants that entitle the holder to shares of common stock subject to certain terms and, generally, vest in 25% increments each year on the anniversary of the grant date throughout a four year vesting period. The nonvested share awards are valued based on the closing market price on the date of award. Nonvested share compensation is to be amortized and charged to operations on a straight-line basis over the four year vesting period.

Results of Operations

The following table sets forth selected statements of income data for each of the periods indicated expressed as a percentage of total revenues:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2007	2008	2007	2008
Consolidated Statements of Income Data:				
Revenues:				
Product revenues	71.1%	70.4%	78.3%	69.4%
Maintenance and services revenues	28.9	29.6	21.8	30.6
Total revenues	100.0	100.0	100.00	100.0
Cost of revenues:				
Cost of product revenues	36.2	17.2	34.4	19.4
Cost of maintenance and services revenues	8.7	12.8	6.5	12.6
Total cost of revenues	44.9	30.0	40.9	32.0
Gross profit	55.1	70.0	59.1	68.0
Operating expenses:				
Research and development	11.9	11.5	9.3	12.4
Selling and marketing	10.5	10.3	7.7	10.8
General and administrative	25.2	6.2	20.9	9.1
Income from settlement of lawsuit				(11.7)
Total operating expenses	47.6	28.0	37.9	20.6
Operating income	7.5	42.0	21.2	47.4
Interest income	25.6	11.4	19.7	15.3
Other, net	(0.9)	1.1	0.2	0.2
Income before income taxes	32.2	54.5	41.1	62.9
Income tax provision	13.9	20.2	16.2	23.6
Net income	18.3%	34.3%	24.9%	39.3%

Comparison of Results for the three months ended September 30, 2008 and 2007

Revenues. Revenues were \$35.0 million for the three months ended September 30, 2008, compared to \$22.5 million for the three months ended September 30, 2007. Product revenues were \$24.6 million for the three months ended September 30, 2008, compared to \$16.0 million for the three months ended September 30, 2007. The \$8.6 million increase in product revenues resulted primarily from an increase in revenues of \$10.9 million from the DHS. This increase in product revenues was partially offset by decrease in product sales to other customers.

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Maintenance and services revenues increased to \$10.4 million for the three months ended September 30, 2008 from \$6.5 million for the three months ended September 30, 2007. The increase of \$3.9 million was primarily due to (i) an increase in maintenance renewals and engineering services associated with product sales in prior periods, (ii) maintenance revenues related to recently completed product contracts with the DHS and Morocco and (iii) the identity management and credentialing services division we purchased from MAXIMUS Inc. on April 30, 2008 (the SSD Division).

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Gross Profit. Gross profit as a percentage of revenues was 70.0% for the three months ended September 30, 2008, compared to 55.1% for the three months ended September 30, 2007. Product gross margins were 75.6% for the three months ended September 30, 2008, compared to 49.2% for the three months ended September 30, 2007. The increase in margins on product revenues was primarily due to a change in the mix of products sold during the three months ended September 30, 2008. During the three months ended September 30, 2008, we recognized a greater portion of our revenues from software intensive AFIS solutions which typically have higher margins than our hardware intensive solutions.

Costs of maintenance and service revenues increased \$2.5 million to \$4.5 million for the three months ended September 30, 2008 from \$2.0 million for the three months ended September 30, 2007. This increase was the result of the increase in maintenance and support services provided during the period as well as contribution from the SSD Division. Margins on maintenance and services decreased from 69.9% during the three months ended September 30, 2007 to 56.7% during the three months ended September 30, 2008 primarily due to an increase in the number of personnel engaged in providing maintenance and support services, due to expanded capacity in response to increasing demand. In addition, the decrease in margins on maintenance and services was partially due to the SSD Division, which has lower gross margins than our historic service gross margins.

Research and Development. Research and development expenses increased to \$4.0 million, or 11.5% of revenues, for three months ended September 30, 2008, compared to \$2.7 million, or 11.9% of revenues, for the three months ended September 30, 2007. The increase of \$1.3 million was primarily due to an increase in salary expense and other labor related costs driven by an increase in research and development headcount. In connection with our effort to develop new products for our customers, we increased research and development headcount by 40% to 158 as of September 30, 2008 from 113 as of September 30, 2007.

Selling and Marketing. Selling and marketing expenses increased to \$3.6 million, or 10.3% of revenues, for the three months ended September 30, 2008, compared to \$2.4 million, or 10.5% of revenues, for the three months ended September 30, 2007. The increase in selling and marketing expenses of \$1.2 million was primarily due to an increase in salary expenses and other labor related costs which was driven by an increase in headcount from 31 at September 30, 2007 to 36 at September 30, 2008. In anticipation of a general increase in the number and size of contracts coming up for proposal in the biometric security industry, management had instituted an effort to expand its marketing and business development capabilities during 2008.

General and Administrative. General and administrative expenses decreased to \$2.1 million, or 6.2% of revenues, for the three months ended September 30, 2008, compared to \$5.7 million, or 25.2% of revenues, for the three months ended September 30, 2007. The \$3.6 million decrease was primarily due to the settlement, effective as of September 2007, of our legal action against Northrop Grumman. Legal fees incurred in connection with our lawsuit against Northrop Grumman were \$3.7 million during the three months ended September 30, 2007.

Interest Income. We earned interest income of \$4.0 million during the three months ended September 30, 2008, compared to \$5.8 million during the three months ended September 30, 2007. The decrease in interest income was primarily due to a decrease in interest rates and a lower average cash and investment balances as a result of our stock repurchase program partially offset by cash generated from operations.

Income Tax Provision. We recognized an income tax provision of \$7.1 million during the three months ended September 30, 2008 as a result of the net income earned in the period. Our effective tax rate of 37.0% for the three months ended September 30, 2008 represents federal, state and foreign taxes on our income reduced primarily as a result of the production activities deduction as well as state research and development credits and benefits resulting from the disqualifying disposition of incentive stock options. We recognized an income tax provision of \$3.1 million, with an effective tax rate of 43.0%, during the three months ended September 30, 2007 as a result of the net income earned in the period. Our effective tax rate of 43.0% for the three months ended September 30, 2007 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by federal and state research and development credits. The decrease in the effective tax rate from 43.0% during the three months ended September 30, 2007 to 37.0% for the three months ended September 30, 2008, is primarily due to a significant decrease during the three months ended September 30, 2007 in disqualifying dispositions of incentive stock options and the associated tax benefit which was coupled with the income tax-related interest of \$308,000. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding and held by our employees. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place.

Comparison of Results for the nine months ended September 30, 2008 and 2007

Revenues. Revenues were \$85.7 million for the nine months ended September 30, 2008, compared to \$83.9 million for the nine months ended September 30, 2007. Product revenues were \$59.4 million for the nine months ended September 30, 2008, compared to \$65.7 million for the nine months ended September 30, 2007. The \$6.3 million decrease in product revenues resulted primarily from a

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decrease in revenues of \$14.0 million from the CNE due to the completion of their contract in 2007, which was partially offset by an increase in revenues from the DHS.

Maintenance and services revenues increased to \$26.3 million for the nine months ended September 30, 2008 from \$18.2 million for the same period of the prior year. The increase of \$8.1 million, was primarily due to (i) an increase in maintenance renewals and engineering services associated with product sales in prior periods, (ii) maintenance revenues earned under recent completed arrangements for systems for DHS, Morocco and the RCMP and (iii) the contribution from the SSD Division.

Gross Profit. Gross profit as a percentage of revenues was 68.0% for the nine months ended September 30, 2008, compared to 59.1% for the nine months ended September 30, 2007. Product gross margins were 72.1% for the nine months ended September 30, 2008, compared to 56.0% for the nine months ended September 30, 2007. The improvement in margins on product revenues was primarily due to a change in the mix of products sold during the nine months ended September 30, 2008. During the nine months ended September 30, 2007, we recognized a significant portion of our revenues from hardware intensive AFIS solutions which typically have lower margins than our software intensive solutions.

Costs of maintenance and service revenues increased \$5.4 million, or 98.0%, to \$10.8 million for the nine months ended September 30, 2008 from \$5.4 million for the nine months ended September 30, 2007. This increase was the result of the increase in maintenance and support services provided during the period as well as contribution from the SSD Division. Margins on maintenance and services decreased from 70.1% during the nine months ended September 30, 2007 to 58.9% during the nine months ended September 30, 2008 primarily due to an increase in the number of personnel engaged in providing maintenance and support services, as we expand capacity in response to increasing demand. In addition, the decrease in margins on maintenance and services were partially due to the SSD Division, which has lower gross margins than our historic service gross margins.

Research and Development. Research and development expenses increased to \$10.6 million, or 12.4% of revenues, for nine months ended September 30, 2008, compared to \$7.8 million, or 9.3% of revenues, for the nine months ended September 30, 2007. The increase of \$2.8 million, was primarily due to an increase in salary expense and other labor related costs driven by an increase in research and development headcount. In connection with our effort to develop new products for our customers, we increased research and development headcount by 40% to 158 as of September 30, 2008 from 113 as of September 30, 2007.

Selling and Marketing. Selling and marketing expenses increased to \$9.3 million, or 10.8% of revenues, for the nine months ended September 30, 2008, compared to \$6.4 million, or 7.7% of revenues, for the nine months ended September 30, 2007. The increase in selling and marketing expenses of \$2.9 million, was primarily due to an increase in salary expenses and other labor related costs driven by an increase in headcount. This increase in headcount was in anticipation of a general increase in the number and size of contracts coming up for proposal in the biometric security industry. In response to this anticipated demand, management instituted an effort to expand its marketing and business development capabilities during 2008.

General and Administrative. General and administrative expenses decreased to \$7.8 million, or 9.1% of revenues, for the nine months ended September 30, 2008, compared to \$17.5 million, or 20.9% of revenues, for the nine months ended September 30, 2007. The \$9.7 million decrease was primarily due to the settlement, effective as of September 2007, of our legal action against Northrop Grumman. Legal fees incurred in connection with our lawsuit against Northrop Grumman were \$10.5 million during the nine months ended September 30, 2007.

Income from Settlement of Lawsuit. In January 2008, we received \$20.0 million in connection with the settlement of our legal claims against Northrop. Upon collecting the proceeds from the settlement we recognized \$10.0 million in the quarter ended March 31, 2008, representing the residual fair value of the Settlement Agreement component, as Income from settlement of lawsuit.

Interest Income. We earned interest income of \$13.1 million during the nine months ended September 30, 2008, compared to \$16.5 million during the nine months ended September 30, 2007. The decrease in interest income was primarily due to a decrease in interest rates and lower average cash and investment balances as a result of our stock repurchase program partially offset by cash generated from operations.

Income Tax Provision. We recognized an income tax provision of \$20.2 million during the nine months ended September 30, 2008 as a result of the net income earned in the period. Our effective tax rate of 37.5% for the nine months ended September 30, 2008 represents federal, state and foreign taxes on our income reduced primarily as a result of the production activities deduction as well as state research and development credits and benefits resulting from the disqualifying disposition of incentive stock options. We recognized an income tax provision of \$13.6 million, with an effective tax rate of 39.4%, during the nine months ended September 30, 2007 as a result of the net income earned in the period. Our effective tax rate of 39.4% for the nine months ended September 30, 2007 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by federal and state research and

development credits.

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Since our inception we have financed our operations by generating cash from operations. Since September 2004 we have supplemented our cash resources through public offerings of our common stock, raising \$228.6 million in our initial public offering in September 2004 and \$96.8 million in a subsequent public offering in June 2005. As of September 30, 2008, we had \$43.8 million in cash and \$412.4 million in investments in marketable securities.

Cash provided by operations

In addition to our net income, the key drivers of our cash flows from operations are changes in accounts receivable, inventory, deferred revenues and deferred income taxes and taxes payable. The effect of these key drivers on our cash provided by operations for the nine months ended September 30, 2007 and 2008 was as follows:

	Nine months Ended September 30, 2007 2008 (in thousands)	
<u>Key Drivers of Cash Provided by Operations</u>		
Net income	\$ 20,932	\$ 33,672
Changes in:		