COGNITRONICS CORP
Form 10-Q
November 14, 2005

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, 2005

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the Transition Period from to

Commission file number 1-8496

COGNITRONICS CORPORATION
(Exact name of registrant as specified in its charter)

NEW YORK	13-1953544
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3 Corporate Drive, Danbury, Connecticut	06810-4130
(Address of principal executive offices)	(Zip Code)

(203) 830-3400
(Registrant's telephone number, including area code)

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, and (2) has been subject to such filing requirements for the past 90 days. Yes x No

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

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

The Registrant has 5,751,403 shares of Common Stock, $.20 par value per share outstanding at September 30, 2005.Part I, Item 1.

COGNITRONICS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(dollars in thousands)

	September 30, 2005	December 31, 2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 2,867	$ 2,222
Marketable securities	7,305	5,847
Accounts receivable, net	957	3,737
Inventories	1,662	1,595
Other current assets	137	148
Assets - discontinued subsidiary held for sale	1,983	2,486
TOTAL CURRENT ASSETS	14,911	16,035
LOANS TO OFFICERS	2,013	1,968
PROPERTY, PLANT AND EQUIPMENT, NET	618	806
OTHER ASSETS	89	147
	$17,631	$18,956
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 123	$ 86
Accrued compensation and benefits	728	842
Deferred revenue	2,390	416
Other accrued expenses	746	671
Liabilities - discontinued subsidiary held for sale	1,620	888
TOTAL CURRENT LIABILITIES	5,607	2,903
OTHER NON-CURRENT LIABILITIES	819	1,038
STOCKHOLDERS' EQUITY		
Common Stock, par value $.20 a share, authorized 20,000,000 shares; issued 5,866,878 shares	1,173	1,173
Additional paid-in capital	12,610	12,586
Retained earnings (deficit)	(1,235)	2,865
Accumulated other comprehensive loss	(253)	(225)
Unearned compensation	(187)	(303)
	12,108	16,096
Less cost of 115,475 and 138,308 common shares in treasury	(903)	(1,081)
TOTAL STOCKHOLDERS' EQUITY	11,205	15,015
	$17,631	$18,956

See Note to Condensed Consolidated Financial Statements.

COGNITRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) (UNAUDITED)
(dollars in thousands, except per share amounts)

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
REVENUES:				
Sales	$ 751	$ 535	$ 2,929	$ 3,135
Service	235	236	832	635
	986	771	3,761	3,770
COST AND EXPENSES:				
Cost of products sold and services	598	619	1,969	2,092
Research and development	760	620	2,269	1,850
Selling, general and administrative	772	740	2,510	2,323
Other (income), net	(94)	(31)	(228)	(94)
	2,036	1,948	6,520	6,171
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(1,050)	(1,177)	(2,759)	(2,401)
PROVISION FOR INCOME TAXES	15	15	45	45
LOSS FROM CONTINUING OPERATIONS	(1,065)	(1,192)	(2,804)	(2,446)
INCOME(LOSS) FROM DISCONTINUED OPERATIONS	(266)	(156)	(977)	123
IMPAIRMENT LOSS - DISCONTINUED SUBSIDIARY HELD FOR SALE	(319)		(319)	
NET LOSS	(1,650)	(1,348)	(4,100)	(2,323)
CURRENCY TRANSLATION ADJUSTMENT	(3)	(9)	(28)	69
COMPREHENSIVE LOSS	$(1,653)	$(1,357)	$(4,128)	$(2,254)
INCOME(LOSS) PER BASIC AND DILUTED SHARE:				
Continuing operations	$(.19)	$(.21)	$(.49)	$(.44)
Discontinued operations	$(.05)	$(.03)	$(.17)	$ .02
Impairment loss	$(.06)		$(.06)	
Net loss	$(.29)	$(.24)	$(.72)	$(.42)
WEIGHTED AVERAGE NUMBER OF OUTSTANDING SHARES:				
Basic	5,685,997	5,585,293	5,657,993	5,554,861
Diluted	5,685,997	5,585,293	5,657,993	5,554,861

See Note to Condensed Consolidated Financial Statements.

COGNITRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(dollars in thousands)

	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
NET CASH PROVIDED(USED) BY CONTINUING OPERATIONS	$2,202	$ (294)
INVESTING ACTIVITIES - CONTINUING OPERATIONS		
Purchases of marketable securities	(8,123)	(4,733)
Sales of marketable securities	6,665	5,555
Additions to property, plant and equipment, net	(47)	(65)
NET CASH PROVIDED(USED) BY INVESTING ACTIVITIES	(1,505)	757
FINANCING ACTIVITIES - CONTINUING OPERATIONS		
Shares issued pursuant to employee stock plans	38	47
NET CASH PROVIDED BY FINANCING ACTIVITIES	38	47
DISCONTINUED OPERATIONS	(90)	
INCREASE IN CASH AND CASH EQUIVALENTS	645	510
CASH AND CASH EQUIVALENTS- BEGINNING OF PERIOD	2,222	2,220
CASH AND CASH EQUIVALENTS - END OF PERIOD	$2,867	$2,730
INCOME TAXES PAID	$ 2	$ 63
INTEREST PAID	$ 2	$ 7

See Note to Condensed Consolidated Financial Statements.

NOTE TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

September 30, 2005

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date. For further information, refer to the consolidated financial statements and footnotes thereto and the quarterly financial data included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

Reclassifications

Certain current and prior period amounts have been reclassified to conform to the presentation for discontinued operations under Statement of Financial Accounting Standards ("SFAS") No. 144 resulting from the discontinued operations of the Company's subsidiary (discussed below).

Inventories (in thousands):

	September 30, 2005	December 31, 2004
Finished and in process	$1,061	$ 864
Materials and purchased parts	601	731
	$1,662	$1,595

Other Non-Current Liabilities (in thousands):

	September 30, 2005	December 31, 2004
Accrued supplemental pension plan	$ 332	$ 368
Accrued deferred compensation	186	207
Accrued pension expense	579	740
	1,097	1,315
Less current portion	278	277
	$ 819	$1,038

Income Per Share

In computing basic earnings (loss) per share, the dilutive effect of stock options and warrants are excluded; whereas, for dilutive earnings, they are included.

Stock Based Compensation

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value at the date of grant. The Company accounts for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees", and therefore recognizes no compensation expense for stock options granted.

The Company applies the disclosure only provisions of SFAS No. 123, "Accounting for Stock-based Compensation" and SFAS No. 148, "Accounting for

Stock-Based Compensation - Transition and Disclosure" for employee stock option awards. Had compensation cost for the Company's stock option plans been determined in accordance with the fair value-based method prescribed under SFAS 123, the Company's net income(loss) and basic and diluted net income(loss) per share would have approximated the pro forma amounts indicated below (dollars in thousands except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income(loss) as reported	$(1,650)	$(1,348)	$(4,100)	$(2,323)
Add: Stock-based compensation expense included therein	76	85	233	277
Deduct: Total stock-based compensation expense determined under the fair value based method	(102)	(145)	(361)	(545)
Pro forma net income(loss)	$(1,676)	$(1,408)	$(4,228)	$(2,591)
Net loss per basic and diluted share				
As reported	$(.29)	$(.24)	$(.72)	$(.42)
Pro forma	$(.29)	$(.25)	$(.75)	$(.47)

There were 30,000 options granted in each of the three-month periods ended September 30, 2005 and 2004.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (Revised 2004), "Share-based Payment" that will require the Company to expense costs related to share-based payment transactions with employees. With limited exceptions, SFAS No. 123(R) requires that the fair value of share-based payments to employees be expensed over the period service is received and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB No. 25, and allowed under the original provisions of SFAS No. 123. SFAS No. 123(R) becomes mandatorily effective for the Company on January 1, 2006. SFAS No. 123(R) allows for either prospective recognition of compensation expense or retrospective recognition, which may be back to the original issuance of SFAS No. 123 or to interim periods in the year of adoption. The Company is currently evaluating these transition methods.

Pension Plan

The Company and its domestic subsidiaries have a defined benefit pension plan. No additional service cost benefits were earned subsequent to June 30, 1994. The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, plus such additional amounts as the Company may determine to be appropriate from time to time.

The components of net periodic benefit cost of the plan for the three and nine months ended September 30 are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004

Interest cost on projected benefit obligation	$22	$23	$67	$69
Expected return on plan assets	(14)	(15)	(43)	(43)
Amortization of net loss	8	3	23	8
Net periodic pension cost	$16	$11	$47	$34

The Company expects the funding requirement to be $202,000 in 2005 of which $154,000 was funded during the nine months ended September 30, 2005.

In September of 2005, the Board of Directors voted to apply to the Pension Benefit Guarantee Company and the Internal Revenue Service for permission to terminate the Company's defined benefit plan. If permission is granted, it is estimated that the Company would be required to contribute $850,000 of additional funds and recognize a charge of like amount.

Discontinued Operations, Goodwill, Intangible Assets and Other Long-Lived Assets

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets of businesses acquired and is not amortized. Other intangible assets are amortized on a straight-line basis over the estimated future periods to be benefitted, ranging from two to five years.
The Company accounts for its long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed of," which requires that long-lived assets and certain intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the fair value of the assets is less than the carrying value of the assets, an impairment loss is to be recognized. Fair value may be determined using various valuation techniques including present value techniques based on future cash flows or recent sales offers.

The Company reviews the recoverability of goodwill annually, or when events and circumstances change, by comparing the estimated fair values, based on appropriate valuation techniques, including a discounted forecast of future cash flows or recent sales offers (what a willing buyer would pay a willing seller), of reporting units with their respective carrying values. If the fair value of a reporting unit exceeds its carrying amount, the goodwill of the reporting unit is not considered impaired. If the carrying amount of the reporting unit exceeds its fair value, the goodwill impairment loss is measured as the excess of the carrying value of goodwill over its implied fair value. There was no impairment of goodwill at December 31, 2004 based on a discounted forecast of future cash flows. Impairment of assets held for sale, including goodwill at September 30, 2005, is discussed below.

During the third quarter of 2005, the Company initiated a plan to sell its UK subsidiary, Dacon Electronics Plc ("Dacon"). As a result, the Company has reclassified the carrying value of Dacon's as assets and liabilities as those of discontinued subsidiary held for sale", respectively, in its consolidated balance sheets at September 30, 2005 and December 31, 2004, and has reclassified Dacon's results of operations for the three and nine months ended September 30, 2005 and September 30, 2004, as results from discontinued operations. Based on the solicitation offers received for the sale of Dacon, the Company determined that the carrying value of Dacon exceeded its fair value and accordingly, recorded an impairment loss to goodwill of $319,000 against its carrying value in accordance with the provisions and guidance of SFAS 144. If market conditions become less favorable, the Company may be required to recognize additional impairment charges. The Company expects to complete the sale of Dacon during the fourth quarter of 2005.

Assets and liabilities of the discontinued subsidiary held for sale at September 30, 2005 and December 31, 2004 are as follows (in thousands):

	September 30, 2005	December 31, 2004
Assets-discontinued subsidiary held for sale:		
Cash	$ 182	$ 614
Accounts receivable, net	1,127	729
Other current assets	580	708
Fixed assets, net	94	116
Goodwill, net	319	319
Asset Impairment write-off	(319)	
Total assets held for sale	$1,983	$2,486
Liabilities-discontinued subsidiary held for sale:		
Accounts payable	$ 743	$ 262
Other current liabilities	592	466
Deferred revenue	285	160
Total liabilities held for sale	$1,620	$ 888

Summary results of discontinued operations of Dacon for the three and nine months ended September 30, 2005 are as follows (in thousands):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Revenue	$1,352	$2,942
Operating expense	$1,618	$3,922
Loss from discontinued perations	$ (266)	$ (980)

Subsequent Event

On October 28, 2005, the Company entered into a definitive agreement to acquire privately held ThinkEngine Networks, Inc. for approximately 1,150,000 shares of common stock, $1,250,000 in cash and a note for $300,000.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain Factors That May Affect Future Results

The following information, including, without limitation, the Quantitative and Qualitative Disclosures About Market Risk that are not historical facts, may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements generally are characterized by the use of terms such as "believe", "expect" and "may". Although the Company believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions, the Company's actual results could differ materially from those set forth in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, variability of sales volume from quarter to quarter, product demand, pricing, market acceptance, litigation, risk of dependence on significant customers and third party suppliers, intellectual property rights, risks in product and technology development and other risk factors detailed in this Quarterly Report on Form 10-Q and in the Company's other Securities and Exchange Commission filings.

Results of Operations

The Company reported losses from continuing operations of $1.1 million for the three months ended September 30, 2005 and $2.8 million for the nine months ended September 30, 2005 versus loss of $1.2 million and $2.4 million, respectively, in the prior year periods.

Revenues from continuing operations for the quarter ended September 30, 2005 increased $.2 million (28%) to $1 million due to increased sales to a cable operator. Revenues for the nine months ended September 30, 2005 were essentially the same as the prior year period. Sales of product decreased by approximately $.2 million for the nine months ended September 30, 2005 compared to the prior year period, offset by an increase in service revenue. The decrease in sales reflects lower sales of $1.5 million to a large telecommunication service provider, offset, in part, by higher sales to a worldwide telecommunications system integrator and a domestic cable system operator. During the third quarter, the Company delivered approximately $2 million of equipment to the above referenced large telecommunication services provider. It is anticipated that this revenue will be recognized in the fourth quarter of 2005.

Gross margin percentage was 39% for the three months and 48% for the nine months ended September 30, 2005 and 20% and 45% respectively, in the comparable 2004 periods. The three-month period ended September 30, 2005 versus the prior year period was favorably impacted by higher sales volume and the concomitant absorption of fixed costs.

Research and development expenses for the three and nine-month periods ended September 30, 2005 increased approximately $.1 million (23%) and $.4 million (23%), respectively, from the comparable 2004 periods due to higher material costs and increased personnel costs due to increased salaries and headcount.

Selling, general and administrative expenses increased approxomately $35,000 (4%) and $.2 million (8%) for the three and nine-month periods ended September 30, 2005 versus the prior year periods due to higher professional fees, travel expense and personnel costs.

Other income, net increased due to higher interest earned on cash balances and marketable securities due to higher balances and interest rates.

Liquidity and Sources of Capital

Net cash provided by continuing operations for the nine months ended September 30, 2005 was $2.2 million versus the cash used of $.2 million in the 2004 period. In the 2005 period, the positive cash flow from operations was primarily due to the reduction of accounts receivable by $2.8 and increase in prepaid revenue of $2.0 million, offset, in part, by a loss from operations and net increase in marketable securities.

Working capital and the ratio of current assets to current liabilities were $9.3 million and 2.7:1 at September 30, 2005 compared to $13.1 million and 5.5:1 at December 31, 2004.

During the remainder of 2005, the Company may repurchase up to an additional 253,792 shares of its common stock and anticipates purchasing $.5 million of equipment and using $1,250,000 for the cash portion of a recently announced acquisition. Management believes that its cash and cash equivalents and marketable securities will be sufficient to meet these needs in 2005.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company does not use derivative financial instruments. The Company has Marketable Securities, which are exposed to changes in interest rates. Due to the term of these securities and/or their variable rate provisions, a change in interest rates should not have a material impact on their value.

Exchange rate fluctuations will impact the results of discontinued operations and the net assets of discontinued operations. The UK pound was stronger against the US dollar during the nine-month period ended September 30, 2005 as compared to the comparable period of 2004, so the losses of the UK distributorship operations were translated into more dollars than they would have in the 2004 periods. The relative value of the UK pound to US dollar decreased by 5% from December 31, 2004 to September 30, 2005. At September 30, 2005, the discontinued operations had net assets of $.7 million. The Company does not hedge this foreign currency net asset exposure.

Item 4. Controls and Procedures

Cognitronics Corporation's management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective as of the end of the period covered by this report in ensuring that all material information required to be disclosed in this quarterly report and all information required to be disclosed by the Company under the Securities Exchange Act of 1934 has been made known to them in a timely fashion. During the three months ended September 30, 2005, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls for financial reporting.

PART II

Item 6. Exhibits

(a) Index to Exhibits

Exhibit	
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COGNITRONICS CORPORATION
Registrant

Date: November 14, 2005

By /s/ Garrett Sullivan
Garrett Sullivan, Treasurer
and Chief Financial Officer