

Cogent, Inc.  
Form 10-K  
March 22, 2005  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

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(Mark One)

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

For the fiscal year ended December 31, 2004

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 000-50947

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# COGENT, INC.

(Exact name of registrant as specified in its charter)

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<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>95-4305768</b> (I.R.S. Employer Identification No.)
<b>209 Fair Oaks Avenue</b> <b>South Pasadena, California</b> (Address of principal executive offices)	<b>91030</b> (Zip Code)

**Registrant's telephone number, including area code: (626) 799-8090**

**Securities registered pursuant to Section 12(b) of the Act:**

**None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock**

**(Title of Class)**

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The registrant's common stock was not publicly traded as of the last business day of the most recently completed second fiscal quarter.

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The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of March 16, 2005 was \$561,409,020.\*

The number of shares outstanding of the registrant's common stock was 82,024,040 as of March 16, 2005.

\* Excludes shares of common stock held by executive officers, directors and stockholders whose ownership exceeds 5% of the shares outstanding at March 16, 2005. This calculation does not reflect a determination that such persons are affiliates for any other purposes.

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**Table of Contents**

**COGENT, INC.**

**Form 10-K**

**For the Fiscal Year Ended December 31, 2004**

**Table of Contents**

	<b>Page</b>
<b>PART I</b>	
Item 1 <u>Business</u>	1
Item 2 <u>Properties</u>	27
Item 3 <u>Legal Proceedings</u>	28
Item 4 <u>Submission of Matters to a Vote of Security Holders</u>	28
<b>PART II</b>	
Item 5 <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	29
Item 6 <u>Selected Consolidated Financial Data</u>	31
Item 7 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
Item 7A <u>Quantitative and Qualitative Disclosures About Market Risk</u>	46
Item 8 <u>Financial Statements and Supplementary Data</u>	46
Item 9 <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosures</u>	46
Item 9A <u>Controls and Procedures</u>	46
<b>PART III</b>	
Item 10 <u>Directors and Executive Officers of the Registrant</u>	47
Item 11 <u>Executive Compensation</u>	49
Item 12 <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	51
Item 13 <u>Certain Relationships and Related Transactions</u>	52
Item 14 <u>Principal Accountant Fees and Services</u>	54
<b>PART IV</b>	
Item 15 <u>Exhibits, Financial Statement Schedules</u>	55
<b>Signatures</b>	

We have common law trademark rights in and U.S. trademark applications pending for Cogent Systems, BioGate, Live-ID and PMA. Each trademark, trade name or service mark of another company appearing in this Annual Report on Form 10-K belongs to its holder, and does not belong to us.

**Table of Contents**

**PART I**

**Item 1. Business**

This Annual Report (including the following section regarding Management's Discussion and Analysis of Financial Condition and Results of Operations) contains forward-looking statements regarding our business, financial condition, results of operations and prospects. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Annual Report. Additionally, statements concerning future matters such as the development of new products, sales levels, expense levels and other statements regarding matters that are not historical are forward-looking statements.

Although forward-looking statements in this Annual Report reflect the good faith judgment of our management, such statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties and actual results and outcomes may differ materially from the results and outcomes discussed in or anticipated by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include without limitation those discussed under the heading Risk Factors below, as well as those discussed elsewhere in this Annual Report. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report. We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report. Readers are urged to carefully review and consider the various disclosures made in this Annual Report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects.

We were incorporated in California in April 1990 and reincorporated in Delaware in May 2004.

**Overview**

We are a leading provider of Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. Our AFIS solutions enable customers to capture fingerprint images electronically, encode fingerprints into searchable files and accurately compare a set of fingerprints to a database of potentially millions of fingerprints in seconds. For over fifteen years, we have researched, designed and developed fingerprint biometric technologies that incorporate advanced concepts in fluid dynamics, neural networks, image enhancement, data mining and massively parallel processing. Our proprietary software algorithms, together with optimized hardware, enable our customers to cost-effectively achieve what we believe to be industry-leading accuracy rates and performance. We support the latest standards in fingerprint biometrics and have based our systems on cost-effective, industry-standard hardware and software platforms. We are focused on enabling our customers to expand the capabilities of their systems as their biometrics needs evolve.

**Industry Background**

*Authentication and Identification of Individuals Plays an Important Role in Society*

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Effectively authenticating and identifying individuals is critical to the safety and integrity of transactions, communications, travel and life in today's society. Security breaches and frauds resulting from failures in authentication and identification systems can cause economic harm and loss of life. As a result of growing public awareness of security and economic risks, people are becoming increasingly willing to submit to security checks and other identity verification procedures. Authentication of an individual's identity is necessary when governments, law enforcement agencies and other organizations need to confirm that an individual is who he claims to be. This necessity arises, for example, when a traveler enters a foreign country, a suspect is arrested, an

## **Table of Contents**

individual withdraws money from an ATM, a consumer purchases an item on the Internet, a citizen votes or an employee seeks access to a restricted area. To authenticate the individual's claimed identity in these types of scenarios, organizations traditionally implement processes to examine the individual's credentials, such as signatures, drivers' licenses, passports, access cards, PINs or passwords. If the authentication process indicates that the credentials are invalid or if there are no credentials to examine, such as when an unknown person leaves evidence fingerprints, known as latents, at a crime scene, organizations frequently initiate an identification process to determine the individual's identity.

### ***Traditional Authentication and Identification Processes are Inadequate***

Traditional processes for authenticating and identifying individuals have inherent weaknesses. Criminals and imposters can easily compromise these processes by falsifying credentials by forging a signature, altering a photograph on a driver's license or passport or stealing a physical access card. Imposters can use the compromised credentials to gain unauthorized access to physical locations, such as buildings and airplanes, and to confidential information, such as medical data and financial records, and cause significant harm. Traditional authentication and identification methodologies can also be cumbersome and inefficient to use. Individuals are required to remember several passwords and PINs for the multitude of access, credit and membership cards they carry. The costs incurred by organizations to administer these traditional processes can be significant.

### ***Evolution of Biometric Authentication and Identification Processes***

The inadequacies of traditional authentication and identification processes, coupled with more stringent security requirements and an increasingly global economy and mobile population, have in recent years contributed to the increased focus on the development of biometrics. Biometrics is the automated use of unique physiological characteristics of individuals, such as fingerprints, palm prints, faces or irises, to determine or verify an individual's identity. The individual's biometric characteristic is captured and encoded and then compared against previously encoded biometric data stored in an electronic database to determine or verify the individual's identity. Because biometrics technology utilizes an unchanging, unique characteristic of a person that cannot be lost, stolen, shared or forgotten, it has the capability to be more accurate, convenient and cost-effective than traditional methodologies.

Fingerprints have been, and we believe will continue to be, the most widely used biometric because they are relatively simple to capture, either voluntarily or from latents at crime scenes, are relatively non-intrusive and benefit from a substantial existing infrastructure that employs fingerprints for identification. Governments and law enforcement agencies around the world have already created vast databases of fingerprints and the American National Standard Institute and the National Institute of Standards and Technology have standardized a common format, called ANSI/NIST, that is used to describe, classify and share fingerprints. According to the FBI, its criminal database alone contains the fingerprints of approximately 47 million individuals. In addition, the United States Department of Homeland Security projects that its database will contain the fingerprints of approximately 43 million individuals by the end of 2005. Other organizations throughout the world, including foreign governments and law enforcement agencies, other U.S. government agencies such as the National Association of Securities Dealers and the Department of State, and the approximately 15,000 state and local law enforcement agencies in the United States, also have established large fingerprint databases, and these databases are continuing to grow.

### ***Automated Fingerprint Identification Systems***

The most pervasive, large-scale fingerprint biometrics technology implementations today are AFIS. AFIS are typically used to compare one person's fingerprints against a large database of fingerprints. This is known as one-to-many matching. The technology for AFIS was originally developed by the FBI and Scotland Yard to facilitate criminal investigations, and AFIS have achieved widespread acceptance within national,

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state and local law enforcement agencies globally. AFIS are comprised of fingerprint input scanning devices and software and



**Table of Contents**

computers that encode, process and store electronic versions of fingerprints. Originally, the fingerprint input devices were scanners that uploaded rolled fingerprint images obtained by rolling all ten inked fingers, known as tenprints, from nail to nail on cards or from latents obtained at crime scenes. Today, electronic fingerprint scanners, known as live-scans, are also available to directly capture flat fingerprint images by pressing the finger onto an input device and submitting the fingerprints to an AFIS. After the fingerprints of the subject are captured, the AFIS encodes the unique features associated with fingerprint ridge endings or bifurcations, known as minutiae, into a data set that is submitted for matching. Most commonly, existing fingerprint biometric systems classify, or bin, the stored fingerprints using basic criteria such as loops and whorls. Using this approach, the search program disregards those portions of the database that are inconsistent with the classification of the subject's fingerprints and only searches the relevant portions of the database.

AFIS deployments range widely in size, cost and complexity. In a local law enforcement deployment, the AFIS may be entirely contained within a single facility, with one or more fingerprint input devices attached to local computers, networked to a low-cost, small scale system capable of searching up to tens of thousands of records. As AFIS grow larger, they may consist of hundreds of fingerprint acquisition stations throughout a state or country and employ dedicated networks for transmission of biometric data and dozens of dedicated computers.

The diagram below represents a typical, full scale AFIS architecture:

***Significant Growth Expected in the AFIS Market***

The widespread deployment of AFIS and the development of biometric technologies to support the AFIS market have been among the biggest contributors to the growth of the biometrics industry. This growth is being

## **Table of Contents**

driven in part by the events of September 11, 2001 and subsequent terrorist attacks, the resultant increase in the worldwide demand for elevated security measures and a general increase in willingness for people to submit to security checks and other identity verification procedures. In response to this demand, significant legislation in the United States has been passed mandating increased spending on security measures. Governments worldwide are establishing agencies and departments focused on security, such as the formation of the Department of Homeland Security, or DHS, which integrated numerous existing agencies and formed a single department with the mission of protecting the United States against terrorism. Governments have also announced initiatives mandating heightened security measures and recommending or requiring the use of biometrics technology as part of the overall security solution. As a result, government agencies have indicated that they will make significant investments in information technology, including biometrics, to fulfill their missions.

The AFIS market is also poised for growth in its core law enforcement sector. Many of the approximately 15,000 state and local law enforcement agencies in the United States utilize AFIS solutions. Many of these law enforcement agencies are upgrading their AFIS based on the development of technology that enables new AFIS capabilities, such as 1,000 pixels per inch (ppi) resolution instead of the conventional 500 ppi resolution for better image quality. Many law enforcement agencies are also seeking to make their AFIS web-enabled and to enable their AFIS to search fingerprints using both flat and rolled methods and to search palm prints. We believe law enforcement agencies not currently using AFIS solutions are also likely to deploy such solutions to achieve faster response times and increased accuracy than they are achieving through existing methods.

### ***Significant Growth Expected in the Market for Other Fingerprint Biometrics Products and Solutions***

In addition to AFIS, the market for other fingerprint biometrics solutions is expected to increase. Advances in AFIS technology and widespread deployment of AFIS are resulting in both increased public awareness and acceptance of biometrics solutions and the establishment of an infrastructure that we believe will expedite the adoption of other fingerprint biometrics solutions. As a result of the advances necessitated by the development of the AFIS market, fingerprint biometrics solutions have become much more sophisticated and capable of application in a number of other environments. Several initiatives requiring increased spending on other fingerprint biometrics solutions have already begun. For example, numerous foreign jurisdictions around the world have begun to establish national identification card programs, which will require the issuance of smart ID cards with embedded fingerprint information for each citizen. Foreign jurisdictions such as Hong Kong, Italy, the U.K. and Thailand have implemented or are in the process of implementing national identification card programs. Moreover, consumers have also begun to embrace biometrics authentication, particularly for the purposes of providing increased security on laptops, cell phones and other smart handheld devices that are beginning to store increasing amounts of personal information.

### ***Governments, Law Enforcement Agencies and Other Organizations Face Challenges in Implementing Successful Fingerprint Biometrics Solutions***

To satisfy the evolving needs of the AFIS market and the emerging market for other fingerprint biometrics solutions, vendors must deliver systems that achieve increasingly high levels of both accuracy and performance in a cost-effective and scalable manner. Many existing solutions are challenged in their ability to meet these needs because they are limited by the following problems:

*Inaccuracy.* Accuracy rates of AFIS solutions are measured in two ways: detection failure rates and false positive rates. Detection failures occur when an AFIS fails to match a submitted fingerprint against a matching fingerprint in the database. A false positive occurs when a fingerprint is incorrectly matched to a fingerprint in the database. Many AFIS solutions have a high detection failure rate, particularly when tenprints are not available, due to the use of binning and a limited ability to use fingerprints with poor image quality. Classification binning relies heavily on data supplied by a full tenprint, and errors made in the binning process can also cause detection failures. Classification errors are particularly problematic for systems that attempt to search flat fingerprints because they are frequently binned differently from rolled fingerprints, even when the prints belong to the same person. Because the quality



## **Table of Contents**

of fingerprint images stored in various databases is highly variable, existing AFIS have difficulty matching against poorer quality images. This makes it difficult for existing systems to effectively match against digitized versions of older fingerprint cards, poorer quality latents taken at crime scenes and fingerprints that were improperly taken at law enforcement or government agencies.

*Performance Constraints.* To address heightened security requirements, organizations are beginning to perform biometric authentication checks in areas of high traffic, such as election polls, airports, embassies or state/country borders, where it is impracticable to capture full tenprints. In these environments, fast capture and response times are required, and it is frequently impractical to collect full tenprints or high quality images. Moreover, many AFIS use binning to try to expedite response times, but AFIS that use binning are ineffective at delivering accurate search results in a timely manner when the subject submits less than a full tenprint, as binning under such circumstances eliminates much less of the database and necessitates a broader and more time-consuming search.

*High Costs and Lack of Linear Scalability and Flexibility.* In addition, integration of these biometric products and solutions with existing networks and infrastructure can be costly and complex. As databases and the number of searches grow, governments, law enforcement agencies and other organizations need flexible systems that can be scaled in a linear and cost-effective manner. Using most existing fingerprint biometrics solutions, governments, law enforcement agencies and other organizations have had to purchase multiple costly servers to assemble the requisite processing power to achieve acceptable response times and accuracy rates, and these large server deployments are complex and costly to manage on an ongoing basis.

The constraints and shortcomings of many existing fingerprint biometrics solutions have inhibited the rate of deployment outside of traditional law enforcement environments. These constraints have become more pronounced as a result of the increased focus on security and protection from terrorism, as well as increased attention to economic losses from fraudulent activity, the rising costs of administering and the cumbersome nature of using traditional authentication and identification methodologies. These needs create a significant opportunity for a vendor that can leverage the technology developed in large AFIS deployments to provide accurate, rapid, scalable, flexible and cost-effective fingerprint biometric solutions to both the existing AFIS and the emerging other fingerprint biometrics solutions markets.

## **Our Solution**

We are a leading provider of advanced AFIS and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. For over fifteen years, we have researched, designed, developed and marketed advanced fingerprint biometric technologies and integrated solutions. We believe our proprietary software algorithms, together with optimized hardware, enable our customers to cost-effectively deploy AFIS solutions that consistently deliver industry leading accuracy rates and performance. Our solutions are designed to be scalable, enabling customers to seamlessly expand the capabilities of their AFIS, and flexible, enabling customers to deploy our AFIS in a variety of operating systems and hardware configurations. As a result, we provide a complete AFIS solution that enables customers to achieve a low total cost of ownership both upon initial deployment and throughout its entire lifecycle. Key benefits of our solutions include:

*End-to-End Solution and Services Capability.* We have designed and developed a fully integrated AFIS solution comprised of our proprietary fingerprint biometric software, together with optimized hardware and professional services. We offer all of the elements a customer needs to deploy fingerprint biometric solutions, including:

*Search and Retrieval Software.* At the core of our solutions are our proprietary search algorithms that accelerate the matching process while maintaining accuracy. This software can run on standard hardware, but in larger deployments our customers typically run it on servers that we enhance with our Programmable Matching Accelerator, or PMA, boards that are optimized for rapid searches. The



## Table of Contents

combination of powerful searching software and optimized hardware processing speeds enables us to deliver fingerprint biometrics solutions that can meet the most demanding requirements of governments, law enforcement agencies and other organizations.

*Capture Devices.* We offer several types of capture devices that enable our customers to obtain and process either flat or rolled fingerprints in a wide variety of places without ink, such as police stations, airports and immigration offices. All of our live-scan devices run our proprietary Image Flow software, which employs advanced algorithms to improve feature extraction from the fingerprint images, thereby enhancing search accuracy. We also offer portable devices that enable customers to obtain and process fingerprints remotely. Our live-scan devices provide real-time image previews on screen for improved quality control and reduced processing time.

*Systems Integration Services.* Our service abilities enable us to deliver full end-to-end solutions regardless of the operating or network environment and to design custom interfaces to existing systems. Our highly trained and skilled engineering professionals have extensive expertise in designing and deploying AFIS and other biometrics solutions that are integrated with our customers existing systems. Because our core intellectual property resides in our software capabilities, we can cost-effectively bundle our software with optimized off-the-shelf hardware components to create solutions for our customers that deliver the performance capabilities they demand. Moreover, our solutions implement standards-based approaches that simplify integration and support.

*High Accuracy Rates.* We believe our solutions enable our AFIS customers to search large databases with industry leading accuracy and performance. A key factor in our ability to achieve these accuracy rates is our approach of searching the entire database rather than using binning like most other AFIS. As a result, our solutions do not suffer from binning errors, and we can more effectively search both flat and rolled prints, which leads to increased accuracy. Moreover, because our software reflects our fifteen years of research and development on neural network, fluid dynamics and advanced image processing principles, we are able to extract more minutiae from lower quality fingerprints to minimize detection failures and false positives.

*High Performance.* Our solutions deliver high performance and enable rapid response times when searching large databases while still maintaining a high degree of accuracy. Our PMA servers accelerate the processing capability of standard server architectures and can compare over one million fingerprints per second per PMA server. We achieve this performance level by implementing our advanced search algorithms and our proprietary Data Flow technology, which enables massively parallel processing on our PMA servers to eliminate the need for binning. Because we do not need to bin, our solutions can rapidly search based on any number of prints. Furthermore, our PMA servers can be easily clustered together, which enables customers to employ multiple servers in an integrated solution and achieve throughput levels that scale with their needs. Our rapid response times enable our customers to deploy our systems in high traffic areas where real-time authentication or identification based on two flat prints is critical.

*Significant Cost Savings and Linear Scalability and Flexibility.* The power, linear scalability and flexibility of our solutions can result in significant cost savings to our customers. The power of our solutions reduces our customers' initial costs and related ongoing maintenance and administrative costs because one of our PMA servers running our software can typically accomplish the equivalent processing of multiple Windows, UNIX or Linux servers working with other existing AFIS solutions. In addition, our solutions enable our customers to expand their systems smoothly and economically as their processing needs grow and as their systems evolve because they can incrementally purchase additional PMA servers which can be easily connected to one another, or rack mounted, to linearly scale matching throughput and support system growth as their databases grow and the number of required searches increases. Moreover, all of our current products are backwards compatible with earlier versions, enabling our customers to integrate our solutions with their existing network and infrastructure and easily and cost-effectively upgrade their systems as we develop new generations of our technology. Furthermore, our solutions are flexible and work effectively in heterogeneous network environments that include multiple hardware systems and operating systems such as Windows, UNIX and Linux. As a result, we believe the total cost of ownership of our solutions is lower than the cost of competing solutions.

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## **Table of Contents**

### **Products and Services**

We offer biometrics solutions to the government sector, which consists of federal, state, local and foreign governments and agencies, including immigration/border control agencies, electoral commissions, law enforcement agencies and the market for other fingerprint biometric solutions, which are emerging applications primarily for the commercial sector. Our products for the government sector are principally AFIS solutions, and our products for the commercial sector, which generated less than 1% of our revenues for 2004, are other fingerprint biometric solutions principally based on our proprietary application specific integrated circuit, or ASIC, technology. At the core of each of our products is our proprietary Image Flow Processing, Data Flow Computing and Information Fusion software.

#### ***AFIS Solutions***

We offer a variety of products and services designed to enable customers to deploy cost-effective, accurate and high performance AFIS solutions. We offer our PMA servers bundled with our proprietary software to perform the searching and matching functions that are central to an AFIS, as well as live-scan fingerprint capture devices. We also deliver design and integration services and necessary computing and equipment infrastructure to enable deployment into diverse and heterogeneous environments. Our customers typically deploy our AFIS solutions in either traditional AFIS environments, such as law enforcement, where we market our solution as Cogent Automated Fingerprint Identification System, or CAFIS, or in live production environments, such as border crossings, where we market our solution as Cogent Live-ID.

We offer two primary AFIS solutions, each of which incorporates our PMAs and our live-scan devices:

*Cogent Automated Fingerprint Identification System (CAFIS).* CAFIS is our full-function, networked AFIS solution for local, regional and national systems. While each CAFIS deployment is unique to the customer due to its specific design and integration requirements, all such deployments employ our proprietary software, and the larger deployments rely significantly on our PMA servers. We believe that CAFIS is one of the most accurate systems in the world for twoprint, tenprint, latent and palm print searches.

CAFIS can be integrated with external AFIS, live-scan systems, hand-held wireless devices, secure web-based Internet solutions and other information systems. CAFIS features a modular and expandable architecture that can be scaled to meet any agency's database size, throughput and integration requirements. CAFIS can quickly and accurately search databases of enrolled subjects, with multiple records per subject in image resolutions of both 500 ppi and 1,000 ppi. Any number of modular elements can be incorporated into CAFIS, including PMA servers, workstations, live-scans and wireless handheld computers. For agencies with modest throughput requirements, systems can be configured using an NT or UNIX-based transaction server hosting our Image Flow, Data Flow and Information Fusion software. For local agencies, we provide an affordable AFIS solution on a stand-alone workstation that incorporates much of the tenprint and latent functionality and all the accuracy of large-scale AFIS systems. This workstation can scale to support larger-scale systems as agency needs change. CAFIS can be configured with a number of built-in safeguards that ensure service resiliency, while providing safety of information through its fault tolerant architecture, disk mirroring, automated database backup and disaster recovery options. It is also capable of integrating other authentication and identification solutions, such as facial recognition and smart cards.

*Cogent Live-ID.* Our Live-ID AFIS solution enables our customers to rapidly identify individuals who submit their fingerprints for border crossings, background checks, fraud prevention, criminal investigation, document identification, voting stations and other activities where security is a concern. Live-ID has been deployed in many demanding environments, including the US-VISIT program. As a result of our powerful searching and matching technology and the improved feature extraction from our image capture technology, Live-ID provides a rapid and efficient identification solution using only two flat fingerprints. Our Live-ID system can be configured to run on hand-held devices,

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notebook computers, stand-alone workstations and enterprise systems serving users in a vast network of sites. Live-ID can be implemented on platforms operating under



## **Table of Contents**

UNIX, Windows and Linux, enabling users to submit search transactions and receive results with a standard web browser. Live-ID can also be used in non-governmental environments to provide authentication of an individual's identity for a variety of transactions, including e-commerce applications.

Live-ID implements our Data Flow matching technology to accurately search entire databases containing up to millions of records in a matter of seconds. Our Information Fusion technology makes it possible to combine identification systems so that Live-ID can search databases of digital photographs, signatures and demographic data simultaneously.

## ***AFIS Products***

We offer two key products in our AFIS solutions deployments:

*Programmable Matching Accelerator Servers.* Our proprietary PMA server is a high-speed image matching server at the core of a customer's AFIS or Live-ID system that can support search speeds of up to one million print comparisons per second per server. These speeds, which are made possible by the integration of our proprietary software with our advanced design PMAs, are necessary to adequately address the needs of customers that require real-time identification results when searching databases containing thousands to millions of records.

Our PMAs are modular units that enable customers to linearly increase matching throughput to support system and database growth by rack-mounting multiple PMA servers. PMA servers are comprised of up to eighteen of our PMA boards integrated with a commercially available server that has a high-speed input/output processor board and multiple random access memory drives. Our PMA boards use field programmable gate array integrated circuits optimized to run our proprietary software, rather than costly general purpose microprocessors or inflexible ASICs. As a result, we can cost-effectively program our PMA servers to perform a variety of matching tasks for fingerprints and palm prints. Our PMA boards also provide redundancy because the PMA boards house mirrored databases in on-board random access memory that contain files used by the system to generate fingerprint matches. The mirrored configuration and speed of the random access memory allow the system to perform simultaneous search transactions at very high speeds while still maintaining the reliability of the system.

*Live-scan Systems.* We offer a suite of live-scan systems running our proprietary software that improve minutiae feature extraction during the capture and encoding of fingerprint and palm print data. These systems can capture rolled or flat fingerprints and palm prints of a subject in an easy-to-learn and inkless manner. Using our software, these products enable real-time previewing, which helps the operator to place, guide and align the fingers and palms correctly, and provide immediate feedback, including error messages, if prints are not captured at an acceptable quality. These features improve the efficiency of the fingerprint capture process and enhance the effectiveness of the matching process by capturing and submitting high quality fingerprints to the AFIS or Live-ID system more quickly than live-scan devices that utilize other software programs. Scanning resolution meets ANSI/NIST and Federal Bureau of Investigation standards, and the scanner is certified to meet and exceed Federal Bureau of Investigation requirements. All data formatting is done with Federal Bureau of Investigation certified compression algorithms. Textual and graphic information is displayed in a single monitor, with a graphic user interface and on-screen buttons and zoom features. Our live-scan product suite is designed to enable integration within larger AFIS and booking management systems, including CAFIS, Live-ID and legacy AFIS solutions.

Our live-scan booking station is an advanced live-scan system designed to withstand extreme working conditions such as those present in jails and prisons. The system features a high-security glass front and a ruggedized cabinet. We also offer a desktop live-scan system and a portable live-scan system.

*AFIS Services*

*Design, Integration and Training.* We offer design and integration services and training that complement our AFIS product solutions. At the commencement of a large CAFIS or Live-ID deployment, we establish

## **Table of Contents**

project management teams that utilize a formal project management development process to meet the customer's desired performance objectives. We develop and deliver customized solutions to governments, law enforcement agencies and other organizations that require integration with existing information systems that interface with external AFIS systems. We also work with major systems integrators in providing tailored solutions. After installation, we conduct performance tests to validate performance objectives. We also offer tailored training plans that include classes, on-the-job training and in-house seminars. As part of our training services, we provide customized user guides along with manuals.

*Outsourced Live-ID Biometric Processing Services.* We provide a fully outsourced Live-ID service on a hosted application service business model. Systems are housed and maintained in a secure data center at our headquarters. The data center is equipped with high-speed, fault-tolerant Cogent PMA matchers and enterprise servers. Customers using this service can offer fingerprint matching services for applications such as background checks without investing in an entire AFIS infrastructure and pay on a transaction basis.

## ***ASIC Applications***

Our proprietary ASIC is designed to perform biometric image processing and matching for both fingerprints and facial images for the commercial sector. Based on an ARM940 microprocessor core, our proprietary ASIC incorporates a powerful two-dimensional digital signal processing engine and supports memory bus interfaces with synchronous dynamic random access memory, read-only memory, flash memory and static random access memory devices. Our proprietary ASIC is typically delivered as part of our proprietary Identification Module, which is a stand-alone image processing and biometric matching unit designed for applications requiring biometric identification and authentication. To provide maximum flexibility for integrating the Identification Module with a variety of user applications, the module supports a number of fingerprint sensor options, including silicon sensors and optical sensors and communication interface options, as well as magnetic stripe card, contact smart card and contactless smart card readers. We generated less than 1% of our revenues from sales of our ASIC or ASIC applications in 2004.

The Identification Module supports both one-to-one authentication and one-to-many identification applications. Host application systems can manage the Identification Module through common communication protocols, such as Ethernet. We also offer an original equipment manufacturer, or OEM, development kit for application development and integration. This kit comes with a variety of tools and options to provide high degrees of flexibility and customization for a wide range of applications.

Examples of applications powered by our proprietary ASIC are:

*BioGate.* BioGate is a physical access control system that provides a sophisticated, accurate and customizable biometrics solution to support a variety of access control environments. This system can replace existing access card systems with an easy-to-use system that controls access by requiring that an individual seeking entry submit to a finger scan to confirm his right to access a restricted area. Featuring our matching software, a 500 ppi resolution silicon fingerprint sensor and a contact smart card reader or optional magnetic stripe card reader, BioGate provides a high level of accuracy and speed. BioGate can increase security while making the access control system more convenient for authorized personnel.

*National Identification Card Programs.* Many governments worldwide, such as Hong Kong, Italy, the United Kingdom and Thailand, have implemented or are considering implementing national identification card programs. Many of these programs involve enrolling citizens in a database and issuing each citizen an identification card, some of which are smart cards that contain a chip, such as our proprietary ASIC, that has a digital template of fingerprints embedded in it. This information can be accessed and matched against a real-time scan of a citizen's finger to enable real-time authentication of the citizen's identity for a variety of purposes. Our proprietary ASIC is currently used in the Hong Kong Smart

Identity Card Program.

*MobileIDENT.* MobileIDENT integrates our proprietary ASIC with a forensic quality fingerprint sensor (500 ppi resolution), a digital camera, a smart card reader and a Windows mobile-based Pocket PC to create a

## **Table of Contents**

handheld AFIS that can locally store and search fingerprints on our proprietary ASIC chip. MobileIDENT can also communicate with a central AFIS search engine with results returned to the MobileIDENT. In addition, MobileIDENT supports match-on-card authentication whereby a captured fingerprint is compared to fingerprint minutiae stored on a smart card. MobileIDENT enables law enforcement officers to make rapid and effective identifications and authentications at ports of entry and exit, at sporting events, for roadside vehicle checks, for major public events and at any remote location where timely identification or authentication checks may be required.

## **Technology**

We developed our proprietary technology through an extensive research and development program focused on innovative algorithms for image processing and biometric identification. These highly complex matching algorithms are the core of our technology, and we have optimized the hardware deployed in our customers' systems to run these algorithms efficiently. Our engineers have extensive expertise in matching algorithms, image enhancement, image compression, fuzzy mathematics, morphology, neural networks, security, encryption, communications, data mining and data fusion. By leveraging this expertise over our fourteen year history, we have developed advanced algorithms for statistical pattern recognition, structural pattern recognition, random process modeling and error and distortion modeling.

*Image Flow Technology.* Our Image Flow software utilizes fluid dynamics principles to perform real-time identification and classification of minutia and other irregularities that define the unique biometric features. Since fingerprints have a natural graphical flow embodied in the ridges in human fingers, our Image Flow software enables our algorithms to identify the patterns of a fingerprint similar to the surface appearances associated with fluid flow. This enables us to employ mathematical modeling, using the principles of fluid dynamics, for enhancing poor fingerprints lifted from crime scenes or less than optimal images. Utilizing ridge pattern information in a fingerprint image, our Image Flow algorithms capture the flow information via partial differential equations, solve the numerical equations, and provide accurate feature data associated with the fingerprint image. By analytically modeling these natural flows, which are unique to each individual, our software can establish a positive identity using a variety of biometrics, including fingerprints, palm prints, and facial images. Our image processing software operates throughout our AFIS solutions to enable more detailed feature extraction to improve the accuracy of searches and descriptive function modeling to improve the speed of searches.

*Data Flow Technology.* Utilizing innovative hyper-pipeline and massively parallel computing architectures, our Data Flow super computing technology provides an in-depth analysis of the similarity of natural object characteristics to accurately and automatically identify matching characteristics. This technology enables very high-speed computation, and it is scalable to run on hand-held computers, desktop computers and enterprise servers. Our Data Flow technology utilizes parallel processing techniques to deliver high throughput by conducting parallel database searches while expending minimal time per comparison. The Data Flow technology implements a design paradigm that features a dataflow computing architecture based upon the Single Instruction Multiple Data, or SIMD, dataflow computer model. The SIMD model packs multiple data elements into a single register and performs the same calculation on all of them at the same time, and computational accelerators move performance bottlenecks from the processor into the processor's memory hierarchy. This technology enables us to optimize both our accuracy and transaction throughput by capitalizing on the fact that all the fingerprints in the database can be accessed in parallel. We have also developed advanced wavelet compression and coding design technologies to enhance system speed.

The design of our PMA boards also manifests our Data Flow technology. The PMA board design features extremely high input/output bandwidth to process the database using a massively parallel and hyper-pipeline architecture implemented on a single card that plugs into a standard interface on a commercially available server. Our PMA servers have been designed to support the high-speed capabilities of the Data Flow algorithms and provide scalable matching units that can individually perform one million fingerprint comparisons per second.

**Table of Contents**

For every transaction, our PMA server initializes the search engine by loading the search fingerprint minutiae data to the search engine. The PMA server continues sending the fingerprint minutiae data to the data pipe of the search engine while the search engine data pipe is not full.

*Information Fusion Technology.* Our Information Fusion technology integrates data mining and data fusion technologies with biometric identification to enable the transformation of raw data into business information. To meet customer requirements, AFIS and other fingerprint biometrics systems must integrate with larger communications and information systems. Our Information Fusion technology improves the accuracy of our solutions by utilizing sophisticated fusion algorithms to combine biometric data from multiple sources and multiple algorithms.

Our Information Fusion technology includes system integration tools and techniques to integrate information from disparate information systems, such as intelligence systems, criminal history systems and border crossing systems. This technology includes advanced workflow and state transition modeling architectures that we use to develop custom workflows and seamless integration of data in customers' information systems. Rather than maintaining multiple versions of our software for a variety of applications and customers, our Information Fusion software requires only one master version that is both dynamically and statically configured based on each customer's requirements. Information Fusion facilitates the rapid development of extension modules for individual customer deployments to address specific needs, and we can frequently use the functionality developed for one customer in future customer deployments. This technology also provides an efficient framework for providing customer support of delivered systems, which can reduce customers' maintenance costs and increase system reliability. The ability to provide integration across local, state, national and international systems is a key advantage for governments and law enforcement agencies in implementing heightened security procedures.

**Customers**

We have established relationships with governments, law enforcement agencies and other organizations worldwide. The following is a representative list of our customers and end-users:

<u>National</u>	<u>State/Local</u>	
Bureau of Alcohol, Tobacco, Firearms and Explosives	State of Connecticut	Sheriff Criminalistic Lab Northeast Offices, Johnson County, Kansas
Department of Homeland Security (US-VISIT)	State of Florida Department of Highway Safety and Motor Vehicles	City of Austin, Texas
U.S. Citizenship and Immigration Services Identification System (IDENT)	County of Marin, California	County of Stanislaus, California
U.S. Department of Justice, Federal Bureau of Investigations (FBI)	Ohio Bureau of Criminal Investigation and Identification (OBCII)	County of San Joaquin, California
	Los Angeles County Sheriff's Department	City of Ontario, California

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Federal Bureau of Prisons

State of Rhode Island

11

**Table of Contents**

	<b>International</b>	<b>Other</b>
Algeria Gendarmerie Nationale	Ekonomika State Enterprise of Moscow	Hewlett-Packard
Bulgarian National Police	Turkish Gendarmerie	National Association of Securities Dealers, Inc.
Chilean National Police	Control Data (Thailand) Ltd.	Airline Reporting Corporation
National Electoral Council in the Republic of Venezuela	Royal Brunei Police Force	
U.K. National Automated Fingerprint Identification System (NAFIS)	National Database & Registration Authority, Pakistan	
Hong Kong Smart Identity Card Program	Secretary of State of the Office of Security, Honduras	
Italian National Police	Electoral Office of Jamaica	
European Commission	Royal Cayman Islands Police Services	
Singapore National Police	Trinidad and Tobago Population Registration System	
City of Winnepeg, Manitoba		
Ministry of Interior of the Slovak Republic		

In 2004, we derived 44% and 38%, respectively, of our revenues from the sale of our solutions to various agencies of the DHS and the National Electoral Council in the Republic of Venezuela.

**Sales and Marketing**



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We market our AFIS solutions and other fingerprint biometrics solutions directly to end-users and indirectly through prime contractors. We market our proprietary ASIC device indirectly through OEMs, resellers and distributors. As of December 31, 2004, we employed 12 individuals who were involved in our sales and marketing efforts.

Sales efforts for our AFIS and other government related fingerprint biometrics solutions are predominantly focused on establishing and maintaining new and existing relationships with defense and IT solutions companies that typically serve as prime contractors on government projects. We also market our AFIS and other government related fingerprint biometrics solutions directly to end customers if the project is focused primarily on a biometrics implementation. For large AFIS deployments, a government entity typically issues a request for proposal, or RFP. In the RFP, the entity will usually provide the project's specifications and performance requirements, and then solicit proposals from prospective prime contractors who are on the approved vendor list. Because we are one of four vendors that offer AFIS solutions, we are typically included in any U.S. or international RFP that is open for competitive bidding. We enhance our opportunities for being selected as a prime or subcontractor by utilizing references from our existing customers, usually bidding on a fixed price basis and employing consultants who have strong relationships in our international markets. We assemble a multi-disciplined project management team to draft the proposal, or to assist with drafting if we are the subcontractor, negotiate the actual contract and deploy the solution. Once our solution has been deployed, the project management team educates our customer on the use of our AFIS and other biometrics solutions. The project management team is also frequently involved in upgrading our customers to more comprehensive solutions as their needs grow. In addition, when competing for local, state and international contracts from governments and law enforcements agencies, we seek to team with local systems integrators in the jurisdiction in which the contract is to be performed.

Our sales efforts for our proprietary ASIC device are focused on OEMs, resellers and distributors. We attempt to identify markets that would benefit from biometrics, such as the market for corporate and personal

## **Table of Contents**

security, and then partner with leading vendors in those areas. We frequently rely on references from our existing AFIS customers to obtain new commercial customers. As we expand our presence in the commercial market, we intend to increase our sales force.

As part of our general sales and marketing efforts we have also established the Cogent User Group. The main purpose of this group is to provide feedback on existing solutions, identify needs for new products and identify new desirable capabilities for both existing and new solutions. We have an annual user conference where members can provide feedback on our solutions and products. We utilize the information gathered from members of the Cogent User Group and the information gathered from clients by our project management teams to better enable us to create and deliver to our customers timely upgrades and new solutions that meet evolving customer needs.

## **Manufacturing and Suppliers**

For our PMA servers, we conduct finish assembly operations, quality assurance, manufacturing engineering, documentation control and integration at our headquarters facility in South Pasadena, California. We acquire the servers from commercial suppliers such as IBM and Hewlett-Packard. We outsource the assembly of our PMA boards to contract manufacturers to reduce fixed costs and to provide flexibility in meeting market demands. We directly purchase the components of our PMA boards, including printed circuit boards, field programmable gate arrays and memory integrated circuits, and our contract manufacturers assemble them to our specifications. The contract manufacturers deliver the assembled PMA boards to us, and we perform finish assembly procedures before testing and integrating the final products into the commercial servers with software and manuals in our South Pasadena, California facility.

Samsung Semiconductor, Inc. fabricates our proprietary ASIC wafers in Asia. Various subcontractors perform assembly, packaging and testing of our ASICs, allowing us to purchase and receive only finished ASIC product. We maintain a manufacturing facility in Shenzhen, China where we manufacture and assemble consumer and commercial products that incorporate our proprietary ASIC. Approximately 23 employees oversee the manufacturing process, and we have a quality assurance strategy in place that provides quality control audits from these employees. Certain components of our products that are manufactured in Shenzhen are outsourced to contract partners, none of which are sole source suppliers. We also store and distribute our inventory of consumer and commercial products from the Shenzhen facility. All design, engineering, customization and development of these products is done at our facility in South Pasadena.

Most component parts used in our products are standard off-the-shelf items, which are, or can be, purchased from two or more sources. In addition to Samsung, IBM and Hewlett-Packard, we utilize products from suppliers such as Sun Microsystems and Dell Computer, which provide computer workstations, Smith Heimann Biometrics, Identix and CrossMatch, which provide live-scans, Oracle, Informix, Sybase and Microsoft, who supply database software and Atmel, which supplies sensors. We select suppliers on the basis of functionality, manufacturing capacity, quality and cost. Whenever possible and practicable, we strive to have at least two manufacturing locations for each product. Nevertheless, our reliance on third-party manufacturers involves risks, including possible limitations on availability of products due to market abnormalities, unavailability of, or delays in obtaining access to, certain product technologies and the absence of complete control over delivery schedules, manufacturing yields, and total production costs. The inability of our suppliers to deliver products of acceptable quality and in a timely manner or our inability to procure adequate supplies of our products could disrupt our ability to meet customer demands or reduce our gross margins.

## **Strategic Relationships**

Our strategic relationships are an important part of our sales and marketing strategy. We have established strategic relationships with commercial entities such as IBM, Hewlett-Packard, Fujitsu and Sun Microsystems. We are committed to working with our strategic partners to

enhance our solutions and increase the value our

## **Table of Contents**

customers receive. Our relationships with our strategic partners range from situations in which our technology is embedded within a partner's products and deployed as part of its solution to cooperation arrangements where we work with a partner to increase the interoperability of our offerings for our customers.

### **Customer Service**

We believe that customer service is critical to our success, and we have committed significant resources to this function. Our contracts provide for telephone, web-based or email support and occasionally on-site support. Our systems are configured for remote access, allowing us to solve most problems remotely and without customer involvement. We also maintain a customer support database that allows us to both resolve problems and prevent recurrences of prior problems.

### **Competition**

The market for biometric solutions is highly competitive, rapidly evolving and fragmented, and subject to changing technology, shifting customer needs and frequent introductions of new products and services. A significant number of established companies have developed or are developing and marketing software and hardware for biometric products and applications that currently compete or will compete directly with our offerings. Our offerings also compete with non-biometric technologies such as public key infrastructure solutions, smart card security solutions, and traditional key, card, surveillance and password systems. Many of our competitors have significantly more financial and other resources than we do. We believe that additional competitors will continue to enter the biometrics market and become significant long-term competitors, and that, as a result, competition will increase in the near term. We sometimes compete with third parties who are also our suppliers or prime contractors. Companies competing with us may introduce products that are competitively priced, have increased performance or functionality or incorporate technological advances not yet developed or implemented by us. Our current principal competitors include:

diversified technology providers, such as NEC, Sagem Morpho, Inc. (a wholly owned subsidiary of Sagem) and Motorola, Inc. (through its Printrak International division) that offer integrated AFIS solutions to government and law enforcement agencies;

companies that are AFIS component providers, such as Identix;

prime government contractors such as Northrop Grumman, that develop integrated information technology products and services that include biometrics-related solutions that are frequently delivered in partnership with diversified technology providers and biometrics-focused companies; and

companies focused on other fingerprint biometrics solutions, such as BioScript and Dermalog.

We believe the principal competitive factors in the market for complete AFIS solutions include the following:

accuracy of matching;

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speed of matching;

total cost of system ownership, including initial costs and ongoing maintenance and support;

customization;

scalability that enables rapid and accurate matching in extremely large databases; and

quality of service and support.

We believe the principal competitive factors in the market for other fingerprint biometric solutions include the following:

degree of security provided;

## **Table of Contents**

ease of use;

functionality;

price;

size; and

reliability.

We believe that we compete favorably with our competitors in both of the above markets on the basis of the aforementioned factors. Our ability to remain competitive will depend to a great extent upon our ongoing performance in the areas of product development and customer support.

## **Backlog**

We record an item as backlog when we receive a contract, purchase order or other notification indicating the number of units to be purchased, the purchase price, specifications and other customary terms and conditions. Our backlog includes deferred revenue reflected on our consolidated balance sheet. There can be no assurance that any of the contracts comprising our backlog presented in this Annual Report will result in actual revenue in any particular periods or that the actual revenue from such contracts will equal our backlog estimates. Furthermore, there can be no assurance that any contract included in our estimated backlog that actually generates revenue will be profitable. These estimates are based on our experience under such contracts and similar contracts and may not be accurate. As of December 31, 2004 and 2003, our total backlog was approximately \$127 million and \$47 million, respectively.

We cannot assure you that we will realize revenue from all our backlog or as to timing thereof. In 2004, we derived 32.2% of our revenues for the sale of our solutions either directly or indirectly to U.S. government agencies pursuant to government contracts. Many of these contracts are subject to re-negotiation, budget constraints and termination at the option of the customer. In addition, a significant portion of our revenue is not recognized upon shipment, but is recognized only upon customer acceptance of our systems or over the term of our contracts under the percentage-of-completion method.

## **Research and Development**

We engage in substantial research and development to advance our core products and develop new products. We conduct research on algorithm development, hardware development, system engineering and architecture, industry standards, technology integration, user productivity features and performance enhancement. We also invest substantial resources in commercializing the technology that we develop in our research and development efforts into products that meet the needs of our customers. We have found that while there are unique features to each client engagement, there is often a degree of commonality. 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. Our research and development expense was \$6.9 million in 2004, \$5.7 million in 2003 and \$4.6 million in 2002.

**Intellectual Property**

Our success will depend in part on our ability to protect our intellectual property. The core technology used in our products and solutions is not the subject of any patent or copyright protection. We rely on a portfolio of intellectual property rights, both foreign and domestic, including trade secrets, trademarks, contractual provisions, patent applications and licenses to protect our intellectual property. Our pending trademark applications relate to Cogent Systems, BioGate, Live-ID and PMA. Our two pending patent applications relate to our Data Flow and Information Fusion technology.

## **Table of Contents**

If we fail to protect our intellectual property rights adequately, our competitors might gain access to our technology, and our business would thus be harmed. In addition, defending our intellectual property rights might entail significant expense. Any of our trademarks or other intellectual property rights may be challenged by others or invalidated through administrative processes or litigation. We currently have no issued patents and may be unable to obtain patent protection in the future. In addition, if any patents are issued in the future, they may not provide us with any competitive advantages, or may be challenged by third parties. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. Effective patent, trademark, copyright and trade secret protection may not be available to us in every country where we market our solutions. The laws of some foreign countries may not be as protective of intellectual property rights as those in the United States, and domestic and international mechanisms for enforcement of intellectual property rights in those countries may be inadequate. Accordingly, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property or otherwise gaining access to our technology.

We may be required to expend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any such litigation, whether or not it is ultimately resolved in our favor, would result in significant expense to us and divert the efforts of our technical and management personnel.

As the number of entrants into our market increases, the possibility of an intellectual property claim against us grows. Our technologies may not be able to withstand any third-party claims against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to litigate or settle, and could divert management attention from executing our business plan. In addition, we may be required to indemnify our customers for third-party intellectual property infringement claims, which would increase the cost to us of an advance ruling in such a claim. An adverse determination could also prevent us from offering our service to others.

We generally enter into confidentiality agreements with our employees, vendors, industry partners and customers. Furthermore, we generally control access to and distribution of our documentation and other proprietary information. Despite this protection, unauthorized parties may copy aspects of our current or future software products or obtain and use information that we regard as proprietary, and such unauthorized use could harm our business.

## **Employees**

As of March 1, 2005, we employed 137 full-time employees, including 61 in research and development, 49 in operations and engineering services, 12 in sales and marketing and 15 in general and administration. We have never had any work stoppage and none of our employees are represented by a labor organization or are party to any collective bargaining arrangements. We consider our employee relations to be good.

## **Available Information**

We file reports with the Securities and Exchange Commission ( SEC ). We make available on our website under Investor Relations/SEC Filings, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. Our website address is [www.cogentsystems.com](http://www.cogentsystems.com). You can also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain additional information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site ([www.sec.gov](http://www.sec.gov)) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us.





**Table of Contents**

**RISK FACTORS**

*You should consider each of the following factors as well as the other information in this Annual Report in evaluating our business and our prospects. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impair our business operations. If any of the following risks actually occur, our business and financial results could be harmed. In that case, the trading price of our common stock could decline. You should also refer to the other information set forth in this Annual Report, including our financial statements and the related notes.*

***Our business could be adversely affected by significant changes in the contracting or fiscal policies of governments and governmental entities.***

We derive substantially all of our revenues from contracts with international, federal, state and local governments and government agencies, and subcontracts under federal government prime contracts, and we believe that the success and growth of our business will continue to depend on our successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could directly affect our financial performance. Among the factors that could adversely affect our business are:

changes in fiscal policies or decreases in available government funding;

changes in government programs or applicable requirements;

the adoption of new laws or regulations or changes to existing laws or regulations;

changes in political or social attitudes with respect to security and defense issues;

potential delays or changes in the government appropriations process; and

delays in the payment of our invoices by government payment offices.

These and other factors could cause governments and governmental agencies, or prime contractors that use us as a subcontractor, to reduce their purchases under existing contracts, to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which could have an adverse effect on our business, financial condition and results of operations. Many of our government customers are subject to stringent budgetary constraints.

***In 2003 and 2004, we derived 64% and 71%, respectively, of our revenues from a limited number of customers.***

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In each fiscal period we have derived, and we believe that in each future fiscal period we will continue to derive, a significant portion of our revenues from a limited number of customers. We had four customers that collectively accounted for 64% of revenues in 2003. In 2004, we had three customers that collectively accounted for 71% of revenues for that period. The success of our business is substantially dependent on the continuation of our relationships with, and additional sales to, these significant customers. In addition, our business is dependent upon entering into relationships with additional significant customers. To the extent that any significant customer reduces or delays its purchases from us or terminates its relationship with us, our revenues would decline significantly and our financial condition and results of operations would suffer substantially. None of our customers is obligated to purchase additional solutions from us. As a result, the amount of revenue that we derive from a specific customer may vary from period to period, and a significant customer in one period may not be a significant customer in any subsequent period.

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**Table of Contents**

*In 2003 and 2004, we derived 75% and 44%, respectively, of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our earnings and revenues.*

Our performance in any one reporting period is not necessarily indicative of future operating performance because of our reliance on a small number of customers, the majority of which are government entities. Government contracts frequently include provisions that are not standard in private commercial transactions. For example, government contracts may include bonding requirements and provisions permitting the purchasing agency to cancel or delay the contract without penalty in certain circumstances. Many of our government customer contracts have these provisions.

In addition, government contracts are frequently awarded only after formal competitive bidding processes, which have been and may continue to be protracted, and typically impose provisions that permit cancellation in the event that necessary funds are unavailable to the public agency. In many cases, unsuccessful bidders for government agency contracts are provided the opportunity to formally protest certain contract awards through various agency, administrative and judicial channels. The protest process may substantially delay a successful bidder's contract performance, result in cancellation of the contract award entirely and distract management. We may not be awarded contracts for which we bid, and substantial delays or cancellation of purchases may even follow our successful bids as a result of such protests.

In addition, local government agency contracts may be contingent upon availability of matching funds from federal or state entities. Also, law enforcement and other government agencies are subject to political, budgetary, purchasing and delivery constraints which may cause our quarterly and annual revenues and operating results to fluctuate in a manner that is difficult to predict.

*If the biometrics market does not experience significant growth or if our products do not achieve broad acceptance both domestically and internationally, we will not be able to achieve our anticipated level of growth.*

Our revenues are derived from sales of our biometrics solutions. We cannot accurately predict the future growth rate or the size of the biometrics market. The expansion of the biometrics market and the market for our biometrics solutions depends on a number of factors, such as:

the cost, performance and reliability of our solutions and the products and services offered by our competitors;

customers' perceptions regarding the benefits of biometrics solutions;

the development and growth of demand for biometric solutions in markets outside of government and law enforcement;

public perceptions regarding the intrusiveness of these solutions and the manner in which organizations use the biometric information collected;

public perceptions regarding the confidentiality of private information;

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proposed or enacted legislation related to privacy of information;

customers' satisfaction with biometrics solutions; and

marketing efforts and publicity regarding biometrics solutions.

Even if biometrics solutions gain wide market acceptance, our solutions may not adequately address market requirements and may not continue to gain market acceptance. If biometrics solutions generally or our solutions specifically do not gain wide market acceptance, we may not be able to achieve our anticipated level of growth and our revenues and results of operations would suffer.

## **Table of Contents**

*Our financial results often vary significantly from quarter to quarter and may be negatively affected by a number of factors.*

Since individual orders can represent a meaningful percentage of our revenues and net income in any single quarter, the deferral or cancellation of or failure to close a single order in a quarter can result in a revenue and net income shortfall that results in our failing to meet securities analysts' expectations for that period. We base our current and future expense levels on our internal operating plans and sales forecasts, and our operating costs are to a large extent fixed. As a result, we may not be able to sufficiently reduce our costs in any quarter to adequately compensate for an unexpected near-term shortfall in revenues, and even a small shortfall could disproportionately and adversely affect financial results for that quarter.

In addition, our financial results may fluctuate from quarter to quarter and be negatively affected by a number of factors, including the following:

the lack or reduction of government funding and the political, budgetary and purchasing constraints of our government agency customers;

the size and timing of our receipt of customer orders;

significant fluctuation in demand for our solutions;

price reductions or adjustments, new competitors, or the introduction of enhanced solutions from new or existing competitors;

cancellations, delays or contract amendments by government agency customers;

protests of federal, state or local government contract awards by competitors;

unforeseen legal expenses, including litigation and/or administrative protest costs;

expenses related to acquisitions or mergers;

potential effects of providing services as a prime contractor that may not carry gross margins as high as those of our core solutions;

impairment charges arising out of our assessments of goodwill and intangibles; and

other one-time financial charges.

*We face intense competition from other biometrics solutions providers, including diversified technology providers, alternative solutions providers and providers of biometric products.*

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A significant number of established companies have developed or are developing and marketing software and hardware for fingerprint biometrics products and applications that currently compete with or will compete directly with our offerings. Our offerings also compete with non-biometric technologies such as public key infrastructure solutions, smart card security solutions and traditional key, card surveillance and password systems. We believe that additional competitors will enter the biometrics market and become significant long-term competitors, and that, as a result, competition will increase. In certain instances, we compete with third parties who are also our suppliers or prime contractors. Companies competing with us may introduce solutions that are competitively priced, have increased performance or functionality or incorporate technological advances we have not yet developed or implemented. Our current principal competitors include:

diversified technology providers such as NEC, Sagem SA (through its wholly owned subsidiary Sagem Morpho) and Motorola, Inc. (through its Printrak International division) that offer integrated AFIS solutions to government and law enforcement agencies;

companies that are AFIS component providers, such as Identix;

prime government contractors, such as Northrop Grumman, that develop integrated information technology products and services that include biometrics-related solutions that are frequently delivered in partnership with diversified technology providers and biometrics-focused companies; and

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**Table of Contents**

companies focused on other fingerprint biometric solutions, such as BioScript and Dermalog.

We expect competition to intensify in the near term in the biometrics market. Many current and potential competitors have substantially greater financial, marketing, research and manufacturing resources than we have. To compete effectively in this environment, we must continually develop and market new and enhanced solutions and technologies at competitive prices and must have the resources available to invest in significant research and development activities. Our failure to compete successfully could cause our revenues and market share to decline.

***If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business.***

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports or prevent fraud, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. Prior to commencement of our preparations for our initial public offering, we operated primarily on a cash accounting basis consistent with our status as a privately held S Corporation, and did not maintain a system of internal controls that was adequate for a public company. As a result, we have in the past discovered, and may in the future discover, areas in our internal controls that need improvement. For example, in connection with the audit of our financial statements for the three years ended December 31, 2003, in May 2004 our independent registered public accounting firm ( independent auditors ) reported to our audit committee several matters that were reportable conditions and material weaknesses in our internal controls as defined in standards established by the American Institute of Certified Public Accountants. In general, reportable conditions are significant deficiencies in our internal controls that, in our auditor's judgment, could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. A material weakness is a reportable condition in which our internal controls do not reduce to a low level the risk that undetected misstatements caused by error or fraud may occur in amounts that are material to our audited financial statements. In 2004, we devoted significant resources to remediate and improve our internal controls. We believe that these efforts have remediated the concerns that gave rise to the reportable conditions and material weaknesses and our independent registered auditors did not identify any reportable conditions or material weaknesses in connection with their audit of our financial statements for the the year ended December 31, 2004. However, we cannot be certain that our controls over our financial processes and reporting will continue to be adequate in the future. Any failure of our internal controls over financial reporting, could cause us to fail to meet our reporting obligations.

***We are subject to extensive government regulation, and our failure to comply with applicable regulations could subject us to penalties that may restrict our ability to conduct our business.***

We are affected by and must comply with various government regulations that impact our operating costs, profit margins and the internal organization and operation of our business. Furthermore, we may be audited to assure our compliance with these requirements. Our failure to comply with applicable regulations, rules and approvals could result in the imposition of penalties, the loss of our government contracts or our disqualification as a U.S. government contractor, all of which could adversely affect our business, financial condition and results of operations.

Among the most significant regulations affecting our business are:

the Federal Acquisition Regulations, or the FAR, and agency regulations supplemental to the FAR, which comprehensively regulate the formation and administration of, and performance under government contracts;



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the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;

**Table of Contents**

the Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under cost-based government contracts;

the Foreign Corrupt Practices Act; and

laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

These regulations affect how our customers and we can do business and, in some instances, impose added costs on our business. Any changes in applicable laws and regulations could restrict our ability to conduct our business. Any failure by us to comply with applicable laws and regulations could result in contract termination, price or fee reductions or suspension or debarment from contracting with the federal government generally.

***Our lengthy and variable sales cycle will make it difficult to predict financial results.***

Our AFIS solutions often require a lengthy sales cycle ranging from several months to sometimes over a year before we can receive approvals for purchase. The length of the sales cycle depends on the size and complexity of the solution, the customer's in-depth evaluation of our solutions and a competitive bidding process. As a result, we may incur substantial expense before we earn associated revenues, since a significant portion of our operating expenses is relatively fixed. The lengthy sales cycles of our solutions make forecasting the volume and timing of sales difficult. In addition, the delays inherent in lengthy sales cycles raise additional risks that customers may cancel contracts or change their minds. If customer cancellations occur, they could result in the loss of anticipated sales without allowing us sufficient time to reduce our operating expenses.

***Security breaches in systems that we sell or maintain could result in the disclosure of sensitive government information or private personal information that could result in the loss of clients and negative publicity.***

Many of the systems we sell manage private personal information and protect information involved in sensitive government functions. A security breach in one of these systems could cause serious harm to our business as a result of negative publicity and could prevent us from having further access to such systems or other similarly sensitive areas for other governmental clients.

As part of our service offerings, we agree from time to time to maintain and operate a portion of the AFIS systems of our customers on an outsourced application hosting basis. Our ability to continue this service is subject to a number of risks. For example, our systems may be vulnerable to physical or electronic break-ins and service disruptions that could lead to interruptions, delays, loss of data or the inability to process user requests. If any such compromise of our security were to occur, it could be very expensive to cure, could damage our reputation and could discourage potential customers from using our services. Although we have not experienced attempted break-ins, we may experience such attempts in the future. Our systems may also be affected by outages, delays and other difficulties. Our insurance coverage may be insufficient to cover losses and liabilities that may result from such events.

***If we are unable to continue to obtain U.S. government authorization regarding the export of our products, or if current or future export laws limit or otherwise restrict our business, we could be prohibited from shipping our products to certain countries, which could cause our business, financial condition and results of operations to suffer.***

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We must comply with U.S. laws regulating the export of our products. In some cases, explicit authorization from the U.S. government is needed to export our products. The export regimes and the governing policies applicable to our business are subject to changes. We cannot assure you that such export authorizations will be available to us or for our products in the future. In some cases where we act as a subcontractor, we rely upon the compliance activities of our prime contractors, and we cannot assure you that they have taken or will take all measures necessary to comply with applicable export laws. If we or our prime contractor partners cannot obtain

## **Table of Contents**

required government approvals under applicable regulations, we may not be able to sell our products in certain international jurisdictions.

*Failure to properly manage projects may result in costs or claims, and our financial results could be adversely affected.*

Deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the projects and deploy appropriate resources, including our own project managers and third party subcontractors, in a timely manner. Any defects or errors or failures to meet clients' expectations could result in reputational damage or even claims for substantial monetary damages against us. In addition, we sometimes guarantee customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit from a particular project. Moreover, 82% of our revenues in 2003 and 79% of our revenues for in 2004 were derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

*The biometrics industry is characterized by rapid technological change and evolving industry standards, which could render our existing solutions obsolete.*

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing solutions in order to address the changing and sophisticated needs of the marketplace. Frequently, technical development programs in the biometrics industry require assessments to be made of the future direction of technology, which is inherently difficult to predict. Delays in introducing new products and enhancements, the failure to choose correctly among technical alternatives or the failure to offer innovative products or enhancements at competitive prices may cause customers to forego purchases of our solutions and purchase our competitors' solutions. We may not have adequate resources available to us or may not adequately keep pace with appropriate requirements in order to effectively compete in the marketplace.

*We are dependent on our management team, particularly Ming Hsieh, our founder and Chief Executive Officer, and the loss of any key member of our team may impair our ability to operate effectively and may harm our business.*

Our success depends largely upon the continued services of our executive officers and other key personnel, particularly Ming Hsieh, our founder and Chief Executive Officer. The relationships that our key managers have cultivated with our customers makes us particularly dependent upon their continued employment with us. We are also substantially dependent on the continued services of our existing engineering and project management personnel because of the highly technical nature of our solutions. We do not have employment agreements with any of our executive officers or key personnel obligating them to provide us with continued services and therefore, they could terminate their employment with us at any time without penalty. We do not maintain key person life insurance policies on any of our employees. The loss of one or more members of our management team could seriously harm our business.

*Our strategy to increase our sales of other fingerprint biometrics products and solutions may not be successful.*

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Historically, our business and products have been focused on the government and law enforcement markets. In 2003 and in 2004, sales to customers in these markets accounted for 96% and 99%, respectively, of our

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**Table of Contents**

revenues. A key component of our strategy is to develop and grow our sales of other fingerprint biometrics solutions. The market for these solutions is at an early stage of development compared to the market for law enforcement and other government sector biometrics products. We cannot assure you that other fingerprint biometrics products and solutions will gain wide market acceptance, that this market will develop and grow as we expect, that we will successfully develop products for this market or that we will have the same success in this market as we have had in the government and law enforcement markets. In addition, we cannot assure you that our strategy of expanding our business to cover biometric solutions and products based on biometrics other than fingerprints will be successful.

***Termination of all or some of our backlog of orders could negatively affect our sales.***

We record an item as backlog when we receive a contract, purchase order or other notification indicating the specific products and/or services to be purchased, the purchase price, specifications and other customary terms and conditions. Our backlog includes deferred revenue reflected on our consolidated balance sheet. There can be no assurance that any of the contracts comprising our backlog presented in this Annual Report will result in actual revenue in any particular periods or that the actual revenue from such contracts will equal our backlog estimates. Furthermore, there can be no assurance that any contract included in our estimated backlog that actually generates revenue will be profitable. These estimates are based on our experience under such contracts and similar contracts and may not be accurate. As of December 31, 2004 and 2003, our total backlog was approximately \$127 million and \$47 million, respectively.

***Loss of limited source suppliers may result in delays or additional expenses.***

We obtain hardware components and complete products from a limited group of suppliers, and we do not have any long term agreements with any of these suppliers obligating them to continue to sell components or products to us. Our reliance on them involves significant risks, including reduced control over quality, price, and delivery schedules. Moreover, any financial instability of our manufacturers or contractors could result in our having to find new suppliers. We may experience significant delays in manufacturing and shipping our products to customers if we lose these sources or if the supplies from these sources are delayed, or are of poor quality or supplied in insufficient amounts. As a result, we may be required to incur additional development, manufacturing and other costs to establish alternative sources of supply. It may take several months to locate alternative suppliers, if required, or to re-tool our products to accommodate components from different suppliers. We cannot predict if we will be able to obtain replacement components within the time frames we require at an affordable cost, or at all. Any delays resulting from suppliers failing to deliver components or products on a timely basis, in sufficient quantities and of sufficient quality or any significant increase in the price of components from existing or alternative suppliers could disrupt our ability to meet customer demands or reduce our gross margins.

***Our business could be adversely affected by negative audits by government agencies, and we could be required to reimburse the U.S. government for costs that we have expended on our contracts, and our ability to compete successfully for future contracts could be materially impaired.***

Government agencies may audit us as part of their routine audits and investigations of government contracts. As part of an audit, these agencies may review our performance on contracts, cost structures and compliance with applicable laws, regulations and standards. These agencies may also review the adequacy of, and our compliance with, our internal control systems and policies, including our purchasing, property, estimating, compensation and management information systems. If any of our costs are found to be improperly allocated to a specific contract, the costs may not be reimbursed and any costs already reimbursed for such contract may have to be refunded. An audit could materially affect our competitive position and result in a material adjustment to our financial results or statement of operations. If a government agency audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with the federal government. In addition, we could suffer serious reputational



## **Table of Contents**

harm if allegations of impropriety were made against us. While we have never had a negative audit by a governmental agency, we cannot assure you that one will not occur. If we were suspended or debarred from contracting with the federal government generally, or if our reputation or relationships with government agencies were impaired, or if the government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenues and prospects would be materially harmed.

***Any failure to protect our intellectual property rights could impair our ability to protect our proprietary technology which could have a material adverse effect on our business, financial condition and results of operations, and on our ability to compete effectively.***

The core technology used in our products and solutions is not the subject of any patent protection, and we may be unable to obtain patent protection in the future. We rely primarily on trade secrets and confidentiality procedures to protect our proprietary technology. Despite our efforts, these measures can only provide limited protection. Unauthorized third parties may try to copy or reverse engineer portions of our products or otherwise obtain and use our intellectual property. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business would thus be harmed. In addition, defending our intellectual property rights may entail significant expense. Any of our trademarks or other intellectual property rights may be challenged by others or invalidated through administrative processes or litigation. In addition, if any patents are issued to us in the future, they may not provide us with any competitive advantages, or may be challenged by third parties. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. Effective patent, trademark, copyright and trade secret protection may not be available to us in every country in which we market our solutions. The laws of some foreign countries may not be as protective of intellectual property rights as those in the United States, and domestic and international mechanisms for enforcement of intellectual property rights may be inadequate. Accordingly, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property or otherwise gaining access to our technology.

We may be required to expend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any such litigation, whether or not it is ultimately resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

***We may be sued by third parties for alleged infringement of their proprietary rights.***

As the size of our market increases, the likelihood of an intellectual property claim against us increases. Our technologies may not be able to withstand third-party claims against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to litigate or settle, and could divert management attention away from the execution of our business plan. In addition, we may be required to indemnify our customers for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also prevent us from offering our solutions to others.

***Ming Hsieh controls a majority of our outstanding stock, and this may delay or prevent a change of control of our company or adversely affect our stock price.***

Ming Hsieh, our Chief Executive Officer, controls 73% of our outstanding common stock. As a result, he is able to exercise control over matters requiring stockholder approval, such as the election of directors and the approval of significant corporate transactions. These types of transactions include transactions involving an actual or potential change of control of our company or other transactions that the non-controlling stockholders may deem to be in their best interests and in which such stockholders could receive a premium for their shares. We are a controlled



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company under the Nasdaq corporate governance rules, and therefore we are entitled to exemptions from certain of the Nasdaq corporate governance rules. These requirements are generally intended to

## **Table of Contents**

increase the likelihood that boards will make decisions in the best interests of stockholders. Specifically, we are not required to have a majority of our directors be independent or to have compensation, nominating and corporate governance committees comprised solely of independent directors. We do not intend to avail ourselves of the controlled company exemptions, but our intentions may change and in such event, if our stockholders' interests differed from those of Mr. Hsieh, our stockholders would not be afforded the protections of these Nasdaq corporate governance requirements.

***Because competition for highly qualified project managers and technical personnel is intense, we may not be able to attract and retain the managers we need to support our planned growth.***

To execute our growth plan, we must attract and retain highly qualified project managers. Competition for hiring these managers is intense, especially with regard to engineers with high levels of experience in designing, developing and integrating biometrics solutions. We may not be successful in attracting and retaining qualified managers. Many of the companies with which we compete for hiring experienced managers have greater resources than we have. In addition, in making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider the value of the stock options they are to receive in connection with their employment. Significant volatility in the price of our stock may, therefore, adversely affect our ability to attract or retain key managers. Furthermore, proposed changes to accounting principles generally accepted in the United States relating to the expensing of stock options may discourage us from granting the sizes or types of stock options that job candidates may require to join our company. If we fail to attract new personnel or fail to retain and motivate our current managers, our business and future growth prospects could be severely harmed.

Competition for skilled personnel in our industry is intense and companies such as ours sometimes experience high attrition rates with regard to their skilled employees. In addition, we often must comply with provisions in federal government contracts that require employment of persons with specified levels of education and work experience. The loss of any significant number of our existing key technical personnel or our inability to attract and retain key technical employees in the future could have a material adverse effect on both our ability to win new business and our financial results.

***International uncertainties and fluctuations in the value of foreign currencies could harm our profitability.***

During each of the years ended December 31, 2003 and December 31, 2004, revenues outside of the Americas accounted for approximately 15% of our total revenues. We also currently have international operations, including offices in Austria, China and Taiwan. Our international revenues and operations are subject to a number of material risks, including, but not limited to:

difficulties in building and managing foreign operations;

regulatory uncertainties in foreign countries;

difficulties in enforcing agreements and collecting receivables through foreign legal systems and other relevant legal issues;

longer payment cycles;

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foreign and U.S. taxation issues;

potential weaknesses in foreign economies;

fluctuations in the value of foreign currencies;

general economic and political conditions in the markets in which we operate; and

unexpected domestic and international regulatory, economic or political changes.

## **Table of Contents**

Our sales, including sales to customers outside the United States, are primarily denominated in U.S. dollars, and therefore downward fluctuations in the value of foreign currencies relative to the U.S. dollar may make our solutions more expensive than local solutions in international locations. This would make our solutions less price competitive than local solutions, which could harm our business. We do not currently engage in currency hedging activities to limit the risks of currency fluctuations. Therefore, fluctuations in the value of foreign currencies could harm our profitability.

***If biometrics solutions and products based on biometrics other than fingerprints become predominant or more significant in the biometrics market, our business, financial condition and results of operations could suffer materially.***

Our current business and products are based primarily on fingerprint biometrics. It is possible that other biometrics solutions could become predominant or more significant in the future, such as biometrics based on face or iris recognition. In such event, we cannot assure you that we would be able to develop successful products and solutions based on these other biometrics or that any such products or solutions we develop would be as successful as our fingerprint biometric solutions.

***Our products and solutions could have unknown defects or errors, which may give rise to claims against us or divert application of our resources from other purposes.***

Products and solutions as complex as those we offer frequently develop or contain undetected defects or errors. Despite testing, defects or errors may arise in our existing or new products and solutions, which could result in loss of revenue or market share, failure to achieve market acceptance, diversion of development resources, injury to our reputation and increased service and maintenance costs. Defects or errors in our products and solutions might discourage customers from purchasing future products and services.

***Potential future acquisitions could be difficult to integrate, divert the attention of key management personnel, disrupt our business, dilute stockholder value and adversely affect our financial results.***

As part of our business strategy, we intend to consider acquisitions of companies, technologies and products that we feel could accelerate our ability to compete in our core markets or allow us to enter new markets. Acquisitions involve numerous risks, including:

difficulties in integrating operations, technologies, accounting and personnel;

difficulties in supporting and transitioning customers of our acquired companies;

diversion of financial and management resources from existing operations;

risks of entering new markets;

potential loss of key employees; and

inability to generate sufficient revenues to offset acquisition costs.

Acquisitions also frequently result in the recording of goodwill and other intangible assets which are subject to potential impairments in the future that could harm our financial results. In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted, which could affect the market price of our stock. As a result, if we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of any such acquisitions, and we may incur costs in excess of what we anticipate.

*Our charter documents and Delaware law may deter potential acquirers of our business and may thus depress our stock price.*

Our certificate of incorporation, as amended, and our bylaws, as amended, contain provisions that could delay or prevent a change of control of our company that our stockholders might consider favorable. In addition,

## **Table of Contents**

we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may discourage, delay or prevent certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our charter documents may make it more difficult for stockholders or potential acquirers to initiate actions that are opposed by the then-current board of directors, including delaying or impeding a merger, tender offer, or proxy contest or other change of control transaction involving our company. Any delay or prevention of a change of control transaction could cause stockholders to lose a substantial premium over the then current market price of their shares.

### ***The trading price of our common stock is volatile.***

The trading prices of the securities of technology companies have historically been highly volatile. Accordingly, the trading price of our common stock is likely to be subject to wide fluctuations. Factors affecting the trading price of our common stock may include:

variations in our financial results;

announcements of technological innovations, new solutions, strategic alliances or significant agreements by us or by our competitors;

recruitment or departure of key personnel;

changes in the estimates of our financial results or changes in the recommendations of any securities analysts that elect to follow our common stock; and

market conditions in our industry, the industries of our customers and the economy as a whole.

In addition, if the market for biometrics or other technology stocks or the stock market in general experiences continued or greater loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business or financial results. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

### ***Future sales of shares by existing stockholders could cause our stock price to decline.***

If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market after the 180-day or more contractual lock-up and other legal restrictions on resale lapse, the trading price of our common stock could decline.

After the lock-up agreements that were executed in connection with our initial public offering expire (180 days or more from September 23, 2004), all of our outstanding shares will be eligible for sale in the public market, but they will be subject to volume limitations under Rule 144 under the Securities Act. In addition, shares subject to outstanding options and rights under our 2000 Stock Option Plan, 2004 Equity Incentive Plan and 2004 Employee Stock Purchase Plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act of 1933, as amended, or the Securities Act.

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If these additional shares are sold, or if it is perceived that they will be sold in the public market, the trading price of our common stock could decline.

### **Item 2. Properties**

Our corporate headquarters occupy approximately 20,074 square feet in South Pasadena, California in a building we purchased in 1997. We also lease properties in Reston, Virginia, Dublin, Ohio, London, U.K., Vienna, Austria and Taipei, Taiwan for use as local project management and business development offices. The size and location of these properties changes from time to time based on business requirements. We lease a manufacturing facility in Shenzhen, China. We believe our space is adequate for current needs and that suitable additional or substitute space will be available to accommodate the foreseeable expansion of our operations.

**Table of Contents**

**Item 3. Legal Proceedings**

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.



**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

Our common stock has been traded on the Nasdaq National Market under the symbol "COGT" since September 24, 2004. Prior to that time, there was no public market for our common stock. The following table sets forth the range of high and low sales prices on the National Market of the common stock for the periods indicated, as reported by Nasdaq.

	<u>Common Stock Price</u>	
	<u>High (\$)</u>	<u>Low (\$)</u>
Fiscal Year 2004		
Third Quarter 2004 (from September 24, 2004)	19.03	15.50
Fourth Quarter 2004	38.25	17.61

As of March 16, 2005, there were 40 holders of record of our common stock. On March 16, 2005, the last sale price reported on the Nasdaq National Market for our common stock was \$25.50 per share.

As an S Corporation prior to September 22, 2004, we historically paid dividends to our stockholders. We declared a final dividend of \$65.5 million to our existing stockholder that was paid after completion of our initial public offering. We anticipate that any future earnings will be retained to finance continuing development of our business. Accordingly, we do not anticipate paying dividends on our common stock in the foreseeable future. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend upon our results of operation, financial condition and other factors as the board of directors, in its discretion, deems relevant.

The Securities and Exchange Commission declared our registration statement, which we filed on Form S-1 (Registration No. 333-115535) under the Securities Act of 1933 in connection with the initial public offering of our common stock, effective on September 23, 2004. The sale of shares of our common stock, including the sale of 2,700,000 shares pursuant to the exercise of the over-allotment option by the underwriters, resulted in aggregate gross proceeds of \$248.4 million, \$17.4 million of which we applied to underwriting discounts and commissions and approximately \$2.4 million of which we applied to related costs. As a result, we received approximately \$228.6 million of the offering proceeds.

As of December 31, 2004, we had used approximately \$65.5 million of the net proceeds of the offering to fund the final dividend of our undistributed accumulated S Corporation earnings to our stockholder of record prior to our initial public offering. We had also used approximately \$17.9 million to fund operating expenses.

The underwriting syndicate was managed by Morgan Stanley & Co. Incorporated, J.P. Morgan Securities Inc., Bear, Stearns & Co. Inc., SG Cowen & Co., LLC and Needham & Company, Inc. The offering terminated after the sale of all of the shares of our common stock that we registered under our registration statement on Form S-1.

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The offering commenced on September 23, 2004, and was completed on September 29, 2004, at a price to the public of \$12.00 per share. The underwriters exercised the over-allotment option effective as of September 24, 2004 and the offering terminated as of September 29, 2004 with the sale of all securities registered.

The following sales of unregistered securities occurred during the period covered by this Annual Report.

On various dates, we issued options to approximately six employees to purchase up to an aggregate total of 11,500 shares of our common stock under our 2004 Equity Incentive Plan. The exercise prices per share ranged from \$18.01 to \$34.43. No consideration was paid to us by any recipient of any of the foregoing options for the

**Table of Contents**

grant of such options. In addition, three option holders exercised options for an aggregate of 14,290 shares and we received an aggregate of \$4,467 upon the exercise of such options. There were no underwriters employed in connection with these transactions. The sales and issuances of securities listed above were deemed to be exempt from registration under the Securities Act of 1933, as amended (the Securities Act ) by virtue of Rule 701 promulgated under Section 3(b) of the Securities Act as transactions pursuant to compensation benefit plans and contracts relating to compensation.

**Equity Compensation Plans Information**

Information about our equity compensation plans at December 31, 2004 that were either approved or not approved by our stockholders was as follows:

<b>Plan Category</b>	<b>Number of Shares to be Issued Upon Exercise of Outstanding Options</b>	<b>Weighted Average Exercise Price of Outstanding Options</b>	<b>Number of Shares Remaining Available for Future Issuance(b)</b>
Equity compensation plans approved by our stockholders(a)	8,631,000	\$ 0.38	6,062,000
Equity compensation plans not approved by our stockholders			

- (a) Includes our 2000 Stock Option Plan, our 2004 Equity Incentive Plan and our 2004 Employee Stock Purchase Plan. However, no future grants may be made under our 2000 Stock Option Plan.
- (b) Includes 2,000,000 shares reserved for issuance under our 2004 Employee Stock Purchase Plan.

**Table of Contents****Item 6. Selected Consolidated Financial Data**

The following selected consolidated financial data should be read together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this Annual Report. The selected consolidated balance sheet data as of December 31, 2002, 2003 and 2004 and the selected consolidated statement of operations data for each of the three years in the period ended December 31, 2004, have been derived from our audited consolidated financial statements, which are included elsewhere in this Annual Report. The selected consolidated balance sheet data as of December 31, 2001 and selected consolidated statement of operations data for the year then ended have been derived from our audited consolidated financial statements not included in this Annual Report. The selected consolidated balance sheet data as of December 31, 2000 and the selected consolidated statement of operations data for the year then ended have been derived from unaudited consolidated financial statements not included in this Annual Report. Historical results are not necessarily indicative of the results to be expected in the future.

	Year Ended December 31,				
	2000	2001	2002	2003	2004
<b>Statements of Operations Data:</b>					
Revenues:					
Product revenues	\$ *	\$ 8,716	\$ 10,450	\$ 24,911	\$ 74,698
Maintenance and services revenues	*	4,352	5,907	7,268	12,990
<b>Total revenues</b>	<b>14,120</b>	<b>13,068</b>	<b>16,357</b>	<b>32,179</b>	<b>87,688</b>
Cost of revenues:					
Cost of product revenues(1)	*	3,520	3,841	7,881	25,551
Cost of maintenance and services revenues(1)	*	1,015	1,128	2,051	3,607
Amortization of deferred stock-based compensation	*			305	669
<b>Total cost of revenues</b>	<b>4,815</b>	<b>4,535</b>	<b>4,969</b>	<b>10,237</b>	<b>29,827</b>
<b>Gross profit</b>	<b>9,305</b>	<b>8,533</b>	<b>11,388</b>	<b>21,942</b>	<b>57,861</b>
Operating expenses:					
Research and development(1)	3,194	4,270	4,551	5,687	6,890
Selling and marketing(1)	4,991	1,886	2,135	2,752	3,826
General and administrative(1)	*	2,904	2,152	1,986	3,976
Amortization of deferred stock-based compensation	*	13	10	1,142	9,759
<b>Total operating expenses</b>	<b>8,185</b>	<b>9,073</b>	<b>8,848</b>	<b>11,567</b>	<b>24,451</b>
Income (loss) before income taxes	1,120	(540)	2,540	10,375	33,410
Other income (expense):					
Interest income	138	189	69	120	1,144
Other, net(2)	7,117	15	19	(48)	1,599
<b>Total other income</b>	<b>7,255</b>	<b>204</b>	<b>88</b>	<b>72</b>	<b>2,743</b>
Income (loss) before income taxes	8,375	(336)	2,628	10,447	36,153
Income taxes	18	(32)	35	577	(6,428)
Equity in losses of investee		(107)	(314)	(246)	

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Impairment of equity investment				(435)	
Net income (loss)	\$ 8,357	\$ (411)	\$ 2,279	\$ 9,189	\$ 42,581

**Table of Contents**

	Year Ended December 31,				
	2000	2001	2002	2003	2004
<b>Net income (loss) per share(3):</b>					
Basic	\$ 0.14	\$ (0.01)	\$ 0.04	\$ 0.15	\$ 0.65
Diluted	\$ 0.14	\$ (0.01)	\$ 0.04	\$ 0.14	\$ 0.56
<b>Weighted average number of shares used in per share calculations:</b>					
Basic	60,000	60,000	60,000	60,000	65,617
Diluted	60,000	60,000	63,723	67,853	75,817
<b>Pro forma net income data(4):</b>					
Income (loss) before income taxes, as reported		\$ (336)	\$ 2,628	\$ 10,447	\$ 36,153
Pro forma provision (credit) for income taxes		(564)	636	4,123	14,837
Pro forma net income		\$ 228	\$ 1,992	\$ 6,324	\$ 21,316
<b>Pro forma net income per share</b>					
Basic			\$ 0.03	\$ 0.11	\$ 0.32
Diluted			\$ 0.03	\$ 0.09	\$ 0.28
<b>Pro forma weighted average number shares used in pro forma share calculations</b>					
Basic			60,000	60,000	65,617
Diluted			63,723	67,853	75,817

	Year Ended December 31,				
	2000	2001	2002	2003	2004
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 2,074	\$ 1,111	\$ 1,522	\$ 17,457	\$ 27,004
Working capital	8,080	4,602	9,606	22,997	187,546
Total debt					
Total assets	16,229	14,732	22,223	37,655	300,894
Deferred revenue	940	1,129	6,162	15,264	68,429
Total stockholders' equity	14,743	11,980	12,367	19,716	222,064

\* During the year ended December 31, 2000, we did not separately record product revenues and maintenance and services revenues or the related costs of product revenues and costs of maintenance and services revenues. In addition, during that period we recorded our selling and marketing and general and administrative expenses as a single expense category which we have presented as selling and marketing expenses in this table.

(1) Excludes amortization of stock-based compensation expense as follows:

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	Year Ended December 31,				
	2000	2001	2002	2003	2004
Cost of product revenues	\$	\$	\$	\$ 100	\$ 172
Cost of maintenance and services revenues				205	497
Research and development				663	1,413
Selling and marketing		13	10	421	1,558
General and administrative				58	6,788
	\$	\$ 13	\$ 10	\$ 1,447	\$ 10,428

- (2) Other, net of \$7.1 million for the year ended December 31, 2000 relates primarily to the proceeds we received from the settlement of a lawsuit in June 2000.
- (3) See Note 1 to our consolidated financial statements for an explanation of the determination of the number of shares used to compute basic and diluted per share amounts.
- (4) Prior to the termination of our S Corporation status, we were exempt from paying federal income taxes and have paid certain state income taxes at a reduced rate because of our S Corporation status. Our S Corporation status terminated effective September 22, 2004. Pro forma net income (loss) data reflects the income tax expense (credit) that would have been recorded had we not been exempt from paying taxes under the S Corporation election.

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## **Table of Contents**

### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion of our financial condition and results of operations should be read together with the financial statements and related notes that are included elsewhere in this Annual Report. This discussion may contain forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under "Risk Factors" or in other parts of this Annual Report.*

#### **Overview**

We are a leading provider of advanced Automated Fingerprint Identification Systems, or 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. We experienced a significant increase in our revenues and net income in 2004 as the market for our AFIS and other fingerprint biometric solutions expanded primarily due to increased demand by the Department of Homeland Security (DHS) as well as the National Electoral Council of Venezuela for our AFIS solutions. There can be no assurance that our revenues or net income will continue to grow at the same rates as in the past or at the rate we expect or that we will achieve similar results in future periods.

#### **Sources of Revenue**

*Revenues.* We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator, or PMA, servers and other AFIS equipment, including work stations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. To a lesser extent, we generate product revenues from sales of our proprietary biometrics application specific integrated circuit, or ASIC, and biometrics products that incorporate our ASIC. Revenues from sales of our ASIC and products that incorporate our ASIC have historically been immaterial and accounted for less than 1% of our total revenue in both 2003 and 2004. 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. For larger AFIS deployments, the maintenance period is frequently longer than 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





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## **Table of Contents**

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.

Our growth in revenues since the fourth quarter of 2003 is due principally to increased demand by the DHS and by the National Electoral Council in the Republic of Venezuela (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 used our solutions for national elections. We anticipate that both of these customers will account for a significant portion of our revenues in 2005 and thereafter. We do not have any long-term contracts with the DHS or the CNE for the sale of our products, and our future sales to the DHS and CNE 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 CNE could cause our revenues to fall short of our expectations.

We also expect to experience increased demand from a number of other governments as they deploy AFIS solutions in elections and at points of entry and exit, including borders, seaports and airports. Notwithstanding our expectations regarding demand for these solutions, 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 and at points of entry and exit 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 in some cases, customizing AFIS solutions and the costs associated with manufacturing, assembling and testing our AFIS solutions. A substantial portion of these costs is comprised of the costs of 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, payments to contract manufacturers that perform assembly functions and payments to subcontractors. Cost of maintenance and services revenues consists of customer support costs, training and professional service expenses, including compensation. Cost of revenues also includes amortization of deferred stock-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 our resale of third party hardware included in our AFIS solutions. Other 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, 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. We are committed to the continued development of new and enhanced technologies to meet the evolving needs of our customers, and we

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## **Table of Contents**

expect we will be required to increase our research and development expenses in absolute dollars in the future. Research and development expenses do not include amortization of deferred stock-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. We expect that our sales and marketing expenses will increase in absolute dollars. Sales and marketing expenses do not include amortization of deferred stock-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. We expect our general and administrative expenses to increase in absolute dollars as we employ additional personnel and incur additional costs related to the growth of our business and our operation as a public company. General and administrative expenses do not include amortization of deferred stock-based compensation allocable to personnel performing general and administrative services.

*Amortization of Deferred Stock-Based Compensation.* In connection with the grant of stock options during the years ended December 31, 2004 and 2003, we recorded \$17.9 million and \$4.4 million in deferred stock-based compensation within stockholders' equity, respectively. These options were considered compensatory because the deemed fair value of the underlying common stock for financial reporting purposes was greater than the exercise prices determined by the board of directors on the date of grant. The determination of the fair value prior to our initial public offering of the underlying shares of common stock involved subjective judgment and the consideration of a variety of factors, including our historical and anticipated operating results and the earnings and revenue multiples implicit in the trading prices of securities of comparable companies. Because there was no public market for our common stock prior to our initial public offering, the amount of the compensatory charge for the period prior to our initial public offering is not based on an objective measure such as the trading price of our common stock. For the years ended December 31, 2004 and 2003, we recognized expense for amortization of deferred stock compensation of \$10.4 million and \$1.4 million, respectively. As of December 31, 2004, we had an aggregate of \$9.8 million of deferred stock-based compensation remaining to be amortized. This deferred compensation balance is expected to be amortized as follows: \$5.8 million in 2005; \$2.9 million in 2006; \$1.0 million in 2007; and \$62,000 in 2008. We are amortizing the deferred compensation on an accelerated basis over the vesting period of the related options, which is generally four years. The amount of stock-based compensation amortization actually recognized in future periods could decrease if options for which accrued but unvested deferred compensation has been recorded are forfeited. The amount of stock based compensation which we recognize will be impacted beginning in our quarter ending September 30, 2005 by Statement of Financial Accounting Standards ( SFAS ) 123 (Revised 2004)-Share Based Payment (SFAS 123R). See Recent Accounting Pronouncements.

### **Prior S Corporation Status**

In 1992, we elected to be treated for federal and certain state income tax purposes as an S Corporation under Subchapter S of the Internal Revenue Code of 1986, as amended, or the Code, and comparable state laws. As a result, our earnings since such initial election and through September 21, 2004, were included in the taxable income of our stockholders for federal and certain state income tax purposes, and we were subject only to reduced amounts of state income tax on such earnings. By reason of our treatment as an S Corporation for federal and state income tax purposes, since 1992 we have paid dividends to our stockholders. We terminated our S Corporation status effective September 22, 2004, and beginning on that date we have been treated for federal and state income tax purposes as a C Corporation under Subchapter C of the Code and, as a result, are subject to state and federal income taxes.

We declared as a dividend to our stockholder the undistributed balance of our federal tax-exempt earnings and taxable earnings included or includable in the taxable income of our stockholders as a result of our



## **Table of Contents**

S Corporation status through December 31, 2003. We also declared a dividend to our stockholder in the same manner and at the same time our estimate of such amounts for the period beginning on January 1, 2004 and ending on the day before we terminated our S Corporation election (September 22, 2004). The total final dividend was \$65.5 million.

We have entered into a tax matters agreement with our stockholder pursuant to which we have agreed, among other things, to indemnify the stockholder and the stockholder has agreed to indemnify us against certain income tax consequences which may occur if a taxing authority increases our income for tax periods prior to or after the termination of our S election, as applicable, but only to the extent of the actual tax benefit, if any, to the indemnifying party attributable to the circumstances resulting in additional tax to the indemnified party. The stockholder has further agreed to indemnify us for any tax liability resulting from our failure to qualify as an S Corporation at the initial election or at any time prior to the anticipated termination of our S Corporation status in connection with this offering. For information concerning the tax matters agreement, see [Certain Relationships and Related Party Transactions Tax Matters Agreement](#).

All pro forma income taxes and pro forma net income data reflect adjustments for federal and state income taxes as if we had been taxed as a C Corporation rather than an S Corporation.

## **Application of Critical Accounting Policies**

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 United States of America. 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, inventories, investments, income taxes, 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 policies 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;

accounting for taxes; and

accounting for stock-based compensation.

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*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 SFAS No. 13 Accounting for Leases and accounts for the

## **Table of Contents**

remaining elements in the arrangement in accordance with SOP 97-2. 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 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 vendor-specific objective evidence of fair value, or VSOE, is 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 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.

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, 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 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.

Revenue associated with the sale of our ASIC applications 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. We recognize revenue in this manner upon shipment of our BioGate and MobileIdent products. The amount of these revenues has historically not been significant.

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) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

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

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reference to substantive maintenance renewal provisions contained in a particular arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. 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



## **Table of Contents**

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, collection of the resulting receivable is probable and VSOE of the fair value of any undelivered element exists.

*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 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.

*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.

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*Commitments and Contingencies.* We periodically 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

**Table of Contents**

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.

*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 December 31, 2004, our net deferred tax assets were approximately \$14.3 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.

*Accounting for Stock-Based Compensation.* We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations, and comply with the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. Under APB Opinion No. 25, compensation cost, if any, is recognized over the respective vesting period based on the difference between the deemed fair value of our common stock and the exercise price on the date of grant. The determination of the volatility, expected term and other assumptions used to determine the fair value of stock options granted under SFAS 123 for footnote disclosure purposes involves subjective judgment and the consideration of a variety of factors, including our historical stock price, option exercise activity to date and the review of assumptions used by comparable companies. We have recorded compensation charges for issuances of stock awards where the exercise price was less than the deemed fair value of the underlying stock for financial accounting purposes. See Costs of Revenues and Operating Expenses Amortization of Deferred Stock-Based Compensation.

We account for stock options issued to non-employees, in which goods or services are the consideration received for the equity instruments issued, in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

**Table of Contents****Results of Operations**

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

	Year Ended December 31,		
	2002	2003	2004
<b>Consolidated Statements of Operations Data:</b>			
Revenues:			
Product revenues	63.9%	77.4%	85.2%
Maintenance and services revenues	36.1	22.6	14.8
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Cost of revenues:			
Cost of product revenues	23.5	24.5	29.1
Cost of maintenance and services revenue	6.9	6.4	4.1
Amortization of deferred stock-based compensation		0.9	0.8
<b>Total cost of revenues</b>	<b>30.4</b>	<b>31.8</b>	<b>34.0</b>
<b>Gross profit</b>	<b>69.6</b>	<b>68.2</b>	<b>66.0</b>
Operating expenses:			
Research and development	27.8	17.7	7.9
Selling and marketing	13.1	8.6	4.4
General and administrative	13.2	6.2	4.5
Amortization of deferred stock-based compensation	0.1	3.5	11.1
<b>Total operating expenses</b>	<b>54.2</b>	<b>36.0</b>	<b>27.9</b>
Income from operations	15.4	32.2	38.1
Income before income taxes	14.1	30.3	41.2
Income tax provision (benefit)	0.2	1.8	(7.3)
<b>Net income</b>	<b>13.9%</b>	<b>28.6%</b>	<b>48.6%</b>
<b>Pro forma net income (loss) data:</b>			
Pro forma provision (credit) for net income taxes	3.9%	12.8%	16.9%
<b>Pro forma net income</b>	<b>10.3%</b>	<b>17.5%</b>	<b>24.3%</b>

**Comparison of Results for the Years Ended December 31, 2004 and 2003**

*Revenues.* Revenues were \$87.7 million for the year ended December 31, 2004 compared to \$32.2 million for the year ended December 31, 2003. This substantial increase in revenues resulted from a number of factors which are driving the growth in the market for AFIS solutions. These factors include recent legislation passed in the United States and in many foreign jurisdictions mandating the implementation of

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fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics, recent terrorist attacks and increased demand in the civil sector, particularly for voting applications. Product revenues were \$74.7 million for the year ended December 31, 2004 compared to \$24.9 million for the year ended December 31, 2003. The \$49.8 million increase in product revenues resulted primarily from AFIS solutions delivered to the National Electoral Council ( CNE ) in Venezuela, solutions sold to the DHS for the US-VISIT program, an AFIS solution sold to a customer in Algeria as well as sales to a number of other domestic and international customers. During the year ended December 31, 2004, we recognized revenue of approximately \$33 million for AFIS solutions delivered to the CNE in Venezuela. In the third quarter of 2004, we entered into a \$54 million contract with the CNE for the deployment and sale of an automated fingerprint identification and voter authentication/matching system for use in the Venezuela national and regional elections. Revenue recorded related to this contract totaled \$26.4 million in fiscal 2004 with the remaining \$27.6 million

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**Table of Contents**

recorded in deferred revenue to be recognized ratably over the remaining portion of the one year maintenance period. In the fourth quarter of 2004, we entered into a \$20.2 million contract with the CNE for the deployment and sale of a new automated fingerprint identification and voter authentication/matching system for use in the Venezuelan Regional Elections. Revenue recorded on this contract totaled \$6.5 million in fiscal 2004 with the remaining \$13.7 million recorded in deferred revenue to be recognized ratably over the remaining portion of the one year maintenance period. Product sales to the DHS for the US-VISIT program in the year ended December 31, 2004 totaled \$19.7 million compared to \$15.8 million during the year ended December 31, 2003. In 2004, we also entered into a contract with a value of approximately \$10 million for the development and implementation of a automated palm and fingerprint identification system for a customer in Algeria. During the year ended December 31, 2004, we recorded revenue of approximately \$6.5 million related to this contract which is being accounted for using the percentage of completion method. Maintenance and services revenues increased by 78.7% to \$13.0 million for the year ended December 31, 2004 from \$7.3 million for the year ended December 31, 2003. The \$5.7 million increase was due to an increase in maintenance revenues and engineering services associated with higher product sales and increased support provided to the DHS. Maintenance and services revenues as a percentage of total revenues declined from period to period due to the increase in product revenues in the year ended December 31, 2004.

*Gross Profit.* Gross profit as a percentage of revenues was 66.0% for the year ended December 31, 2004 compared to 68.2% for the year ended December 31, 2003. Amortization of deferred stock-based compensation included in cost of revenues increased to \$669,000 for the year ended December 31, 2004 from \$305,000 for the year ended December 31, 2003, which accounted for approximately one percentage point of revenues for these respective periods. Product gross margins were 65.6% for the year ended December 31, 2004 compared to 68.0% for the year ended December 31, 2003. The portion of deferred stock-based compensation included in cost of revenues related to product cost of revenues was \$172,000 and \$100,000 for the years ended December 31, 2004 and 2003, respectively, which reduced product gross margins by less than one percentage point for these respective periods. The decrease in product gross margins was primarily due to lower gross margins associated with our significant AFIS installations, particularly the CNE contract, resulting from the resale of third party hardware which was partially offset by the allocation of fixed overhead costs over a higher revenue base. Costs of product revenues increased to \$25.6 million for the year ended December 31, 2004 from \$7.9 million for the year ended December 31, 2003. Maintenance and services gross margins were 68.4% for the year ended December 31, 2004 compared to 69.0% for the year ended December 31, 2003. The portion of deferred stock-based compensation included in cost of revenues related to maintenance and services cost of revenues was \$497,000 and \$205,000 for the years ended December 31, 2004 and 2003, respectively, which reduced maintenance and service margins by approximately four and three percentage points for these respective periods. Costs of maintenance and service revenues increased to \$3.6 million for the year ended December 31, 2004 from \$2.1 million for the year ended December 31, 2003.

*Research and Development.* Research and development expenses increased to \$6.9 million, or 7.9% of revenues, for the year ended December 31, 2004 compared to \$5.7 million, or 17.7% of revenues for the year ended December 31, 2003. The increase was primarily due to an increase in research and development compensation expense of \$772,000 which was primarily attributable to an increase in research and development personnel to support development efforts for the year ended December 31, 2004 compared to December 31, 2003. Additionally, outside development costs totaling approximately \$288,000 also contributed to the increase in research and development expenses in fiscal 2004.

*Selling and Marketing.* Selling and marketing expenses increased to \$3.8 million, or 4.4% of revenues, for the year ended December 31, 2004 from \$2.8 million, or 8.6% of revenues, for the year ended December 31, 2003. The increase in absolute dollars was primarily due to an increase in selling and marketing compensation expense of \$504,000, which was primarily due to an increase in sales and marketing personnel to support our expanded customer base. Additionally, a \$186,000 increase in trade show, promotional and conference expenses and a \$132,000 increase in travel costs also contributed to the increase in selling and marketing expenses.

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**Table of Contents**

*General and Administrative.* General and administrative expenses increased to \$4.0 million, or 4.5% of revenues, for the year ended December 31, 2004 compared to \$2.0 million, or 6.2% of revenues, for the year ended December 31, 2003. The increase in absolute dollars was primarily attributable to increased outside legal and accounting fees of \$762,000 and a net increase in compensation expense of \$345,000 related to an increase in general and administrative personnel, including the addition of a Chief Financial Officer, a Corporate Controller and a Director of Financial Planning and Analysis. Various costs, such as insurance and franchise taxes, board of directors fees and investor relations consulting fees associated with our growth and transition to a public company resulted in an increase in general and administrative expenses of \$492,000.

*Interest Income.* We earned interest income of \$1.1 million during the year ended December 31, 2004 compared to \$120,000 during the year ended December 31, 2003. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds raised of approximately \$228.6 million from our initial public offering and cash generated from operations partially offset by cash distributions to our stockholders.

*Other, net.* During the year ended December 31, 2004, we recorded other income of \$1.6 million related to a \$362,000 dividend declared and paid on our 10% ownership interest in Beijing Jinchun Ciccone Security Printing Company as well as from a \$1.2 million pre-tax gain on the sale of such investment in the fourth quarter of 2004.

*Loss from Equity Investment.* In fiscal year 2003, we conducted an impairment analysis of our equity investment in Kinetic Science, Inc. and recorded an impairment charge during 2003 of \$435,000 which represented the entire remaining carrying value of the investment. During the year ended December 31, 2003, we also recorded losses from our equity investment in KSI of \$246,000.

*Income Tax Provision (Benefit).* We recognized a net income tax benefit of \$6.4 million during the year ended December 31, 2004 primarily as a result of the termination of our S Corporation status and the related recognition of previously unrecognized net deferred tax assets in the quarter ended September 30, 2004 partially offset by the income tax expense recorded as a C Corporation beginning on September 23, 2004. During the year ended December 31, 2003, we recorded an income tax provision of \$577,000 due to the net income incurred in the period and based on our tax rate as an S Corporation.

**Comparison of Years Ended December 31, 2003 and 2002**

*Revenues.* Revenues were \$32.2 million for 2003 compared to \$16.4 million for 2002, an increase of 96%. This substantial increase in revenues has resulted from a number of factors which are driving the growth in the market for AFIS solutions. These factors include recent legislation passed in the United States and in many foreign jurisdictions mandating the implementation of fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics as well as recent terrorist attacks. Product revenues were \$24.9 million for 2003 compared to \$10.5 million for 2002. The \$14.5 million increase in product revenues resulted primarily from an increase in solutions sold to the DHS, most of which occurred in the fourth quarter of 2003. We recorded product sales of \$15.8 million to the DHS for the US-VISIT program during the year ended December 31, 2003 compared to \$3.2 million during the year ended December 31, 2002. Maintenance and services revenues were \$7.3 million for 2003 compared to \$5.9 million in 2002. The \$1.4 million increase was due to maintenance revenue associated with 2003 product sales and an increase in time and materials service revenues of \$820,000. Because we recorded 62% of our annual revenue in the fourth quarter of 2003 principally due to increased product shipments and because maintenance and service revenues are recognized over time following product shipment, maintenance and services revenues as a percentage of total revenues declined from 36% in 2002 to 23% in 2003.

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*Gross Profit.* Gross profit as a percentage of revenues was 68% and 70% in 2003 and 2002, respectively. Product gross margins were 68% in 2003 compared to 63% in 2002. The increase was due to increased shipments of PMA servers, which carry higher gross margins than our other products, in 2003 compared to 2002. Sales of our PMA servers totaled \$15.4 million during the year ended December 31, 2003 compared to \$1.0 million



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**Table of Contents**

during the year ended December 31, 2002. Costs of product revenues increased to \$7.9 million in 2003 from \$3.8 million in 2002. Maintenance and services gross margins were 72% in 2003 compared to 81% in 2002. The decrease was due to an increase in services revenue of \$953,000 from 2002 to 2003, which carries lower gross margins than maintenance revenue. Costs of maintenance and service revenues increased to \$2.1 million in 2003 from \$1.1 million in 2002. Amortization of deferred stock-based compensation increased to \$305,000 in 2003 from \$0 in 2002.

*Research and Development.* Research and development expenses increased to \$5.7 million, or 18% of revenues, for 2003 compared to \$4.6 million, or 28% of revenues for 2002. The increase in absolute dollars was primarily due to an increase in research and development compensation expense of \$709,000, which was primarily related to an increase in research and development personnel from 33 in 2002 to 44 in 2003. Additionally, research and development expenses related to our Shenzhen facility increased by \$240,000. Operations at our Shenzhen facility began in late 2002 and therefore, 2003 marked the first full year of operation.

*Selling and Marketing.* Selling and marketing expenses increased to \$2.8 million, or 9% of revenues, for 2003 compared to \$2.1 million, or 13% of revenues for 2002. The increase in absolute dollars was primarily attributable to an increase in selling and marketing compensation expense of \$457,000, combined with an increase in conference, promotion and tradeshow expenses of \$69,000.

*General and Administrative.* General and administrative expenses decreased to \$2.0 million, or 6% of revenues, for 2003 compared to \$2.2 million, or 13% of revenues for 2002. The decrease was primarily attributable to a \$400,000 decrease in executive bonus costs which totaled \$100,000 in 2003 compared to \$500,000 in 2002, partially offset by \$45,000 of increased costs for insurance and other general items. In 2002, the executive bonuses were paid to members of management who were also our S corporation shareholders at the time. The bonuses were paid in addition to any S corporation dividends and were in recognition of the relative contributions of the stockholders which differed from their ownership positions.

*Interest Income.* We earned interest income of \$120,000 in 2003 compared to \$69,000 in 2002. The higher interest income resulted from higher cash balances.

*Investment Impairment Loss and Loss from Equity Investment.* We recorded losses from our equity investment in Kinetic Science, Inc., or KSI, of \$246,000 in 2003 compared to \$314,000 in 2002 as a result of lower recorded losses of KSI in 2003 compared to 2002. We conducted an impairment analysis of KSI in 2003 and recorded an impairment charge during 2003 of \$435,000 which represented the entire remaining carrying value of the investment. See Note 4 to our consolidated financial statements.

**Liquidity and Capital Resources**

Since inception, we have financed our operations by generating cash from operations. As of December 31, 2004, we had \$27.0 million in cash and cash equivalents and \$195.7 million in investments in marketable securities.

We derive cash from operations primarily from cash collected on product sales and maintenance contract sales. Net cash generated by operating activities was \$58.4 million and \$19.8 million in the years ended December 31, 2004 and 2003, respectively. The increase in cash provided by operating activities was primarily due to net income of \$42.6 million adjusted for non-cash reconciling items, the most significant of which were amortization of deferred stock-based compensation of \$10.4 million and deferred income taxes of \$13.8 million. Cash provided by operating activities during the year ended December 31, 2004 was also significantly impacted by increases in deferred revenues of \$53.1 million and

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income taxes payable of \$5.2 million partially offset by increases in inventory and contract related costs of \$31.2 million and billed and unbilled accounts receivable of \$9.6 million. Net cash generated by operating activities was \$19.8 and \$3.0 million, respectively, in the years ended December 31, 2003 and 2002. The increase in cash generated by operations between the periods principally reflects the increase in both net income and deferred revenues between the periods.

**Table of Contents**

Net cash used in investing activities was \$197.8 million, \$0.6 million and \$0.7 million, respectively, in the years ended December 31, 2004, 2003 and 2002. The increase in cash used in investing activities in 2004 from 2003 relates primarily to the investment of the Company's initial public offering proceeds in marketable securities. Investing activities for all periods consisted of capital expenditures, which consist primarily of computer equipment for our engineering and service departments.

Cash provided by (used in) financing activities was \$149.1 million, (\$3.3) million and (\$2.0) million, respectively, in the years ended December 31, 2004, 2003 and 2002. Cash provided by financing activities in 2004 relates to the Company's initial public offering, which generated proceeds of \$228.6 million, net of issuance costs. Cash used in financing activities consisted solely of cash dividends to our stockholders primarily to fund such stockholders' tax liabilities related to our S Corporation earnings, of which the dividends amounted to \$2.0 million, \$3.3 million and \$79.6 million for the years ended December 31, 2002, 2003 and 2004, respectively.

We currently have no material cash commitments, except our normal recurring trade payables, expense accruals and operating leases, all of which are currently expected to be funded through existing working capital and future cash flows from operations. We believe that our cash and cash equivalent balances will be sufficient to satisfy our cash requirements for at least the next twelve months. Although we cannot accurately anticipate the effect of inflation or foreign exchange markets on our operations, we do not believe these external economic forces have had, or are likely in the foreseeable future to have, a material impact on our results of operations.

At December 31, 2004, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose, or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have material relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed in this Annual Report.

At December 31, 2004, our outstanding contractual cash commitments were limited to our non-cancelable operating lease obligations as follows:

<b>Contractual Obligations</b>	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 Years</b>
	(in thousands)				
Non-cancelable operating lease obligations	\$ 950	\$ 204	\$ 591	\$ 155	\$

**Recent Accounting Pronouncements**

In November 2002, the FASB's Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of Issue No. 00-21 did not have a material effect on the Company's consolidated financial position or results of operations.

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In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives ) and for hedging activities under SFAS No. 133. This statement is effective for contracts entered into or modified after June 30, 2003. The adoption of SFAS No. 149 did not have an impact on the Company's consolidated financial position and results of operations.

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**Table of Contents**

In August 2003, the FASB's Emerging Issues Task Force issued EITF 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*. The consensus addresses whether non-software deliverables included in an arrangement that contains software that is more than incidental to the products or services as a whole are included within the scope of SOP 97-2. The EITF reached a consensus that non-software deliverables, including non-related equipment, for which a software deliverable is essential to its functionality, would be considered software-related, and therefore, included within the scope of SOP 97-2. Unrelated hardware where the software deliverables are not essential to the unrelated hardware's functionality would not be within the scope of SOP 97-2. The adoption of EITF 03-5 did not have a material impact on the Company's consolidated financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. This statement establishes how a company classifies and measures certain financial instruments with characteristics of both liabilities and equity, including redeemable preferred stock. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period commencing July 1, 2003. Adoption of this statement did not have a material impact on the Company's consolidated financial position and results of operations.

In July 2004, the Emerging Issues Task Force (EITF) published its consensus on Issue No. 03-01, *The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments*. EITF Issue No. 03-01 addresses the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of Statement of Financial Accounting Standards (SFAS) No. 115, certain debt and equity securities within the scope of SFAS No. 124, and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting. In September 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) Issue 03-1-1, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1*, which delays the effective date for the recognition and measurement guidance in EITF Issue No. 03-1. In addition, the FASB has issued a proposed FSP to consider whether further application guidance is necessary for securities analyzed for impairment under EITF Issue No. 03-1. The Company continues to assess the potential impact that the adoption of the proposed FSP could have on its financial statements.

In December 2004, the FASB issued SFAS 123 (Revised 2004)-Share Based Payment (SFAS 123R). SFAS 123R requires that the Company record stock option expense in its financial statements based on a fair value methodology beginning no later than the first fiscal quarter beginning after June 15, 2005, the Company's third quarter of fiscal year 2005. The Company is evaluating the impact of the new standard and the method and timing of adoption. Although the Company has not completed its analysis, it is anticipated that the expense related to stock options will increase under the new pronouncement, however, it cannot be quantified at this time.

In December 2004, the FASB issued FASB Staff Position (FSP) Financial Accounting Standard (FAS) 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (the Act)*. This Act provides tax relief to U.S. domestic manufacturers for certain qualifying activities. The FSP states that the manufacturers' deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 rather than a tax rate reduction. Also in December 2004, the FASB issued FSP FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*, addressing accounting and disclosure guidance relating to a Company's repatriation program. Management is currently evaluating the impact of this and any other changes made by the Act and, as such, the effects of such changes cannot be quantified at this time.

## **Table of Contents**

### **Item 7A. Quantitative and Qualitative Disclosure about Market Risk**

Although we currently bill for our products and services mostly in U.S. dollars, our financial results could be affected by factors such as changes in foreign currency rates or weak economic conditions in foreign markets. A strengthening of the dollar could make our products and services less competitive in foreign markets and therefore could reduce our revenues. We are billed by and pay substantially all of our vendors in U.S. dollars. In the future, an increased portion of our revenues and costs may be denominated in foreign currencies. To date, exchange rate fluctuations have had little impact on our operating results. We do not enter into derivative instrument transactions for trading or speculative purposes.

Fixed income securities are subject to interest rate risk. The fair value of our investment portfolio would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investment portfolio. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk.

### **Item 8. Financial Statements and Supplementary Data**

Our consolidated financial statements at December 31, 2004 and 2003 and the Report of Deloitte & Touche LLP, Independent Registered Public Accounting Firm, are included in this Annual Report on Form 10-K.

### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A. Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) under the Exchange Act, we conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon the foregoing evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the fiscal period covered by this report.

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There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to have a materially affect, our internal controls over financial reporting.

**Table of Contents****PART III****Item 10. Directors and Executive Officers of the Registrant**

The following table provides the name, age, position(s) and a brief account of the business experience of each of our directors and executive officers as of December 31, 2004:

<u>Name</u>	<u>Age</u>	<u>Position(s)</u>
Ming Hsieh	49	President, Chief Executive Officer and Chairman of the Board of Directors
Paul Kim	37	Chief Financial Officer
Michael Hollowich	58	Executive Vice President, Operations
James Jasinski	55	Executive Vice President, Federal and State Systems
John Bolger(1)	58	Director
John P. Stenbit(1)	64	Director
Kenneth R. Thornton(1)	63	Director

(1) Member of audit, compensation and nominating and corporate governance committees

*Ming Hsieh* has served as our Chief Executive Officer, President and Chairman of the Board of Directors since founding Cogent in 1990. Mr. Hsieh is responsible for our executive management and his responsibilities include long-range planning and corporate growth, as well as developing and implementing company policies, procedures and philosophy. Prior to founding Cogent, Mr. Hsieh founded and was Vice President of AMAX Technology from 1987 to 1990. Prior to that, Mr. Hsieh was a research and development engineer at International Rectifier from 1985 to 1987. Mr. Hsieh received a B.S.E.E. from University of Southern California in 1983 and an M.S.E.E. from University of Southern California in 1984.

*Paul Kim* has served as our Chief Financial Officer since January 2004. Prior to that, Mr. Kim was the Chief Financial Officer of JNI Corporation, a storage area network technology company, from September 2002 until December 2003. From October 1999 to August 2002, Mr. Kim was Vice President, Finance and Corporate Controller of JNI. Prior to joining JNI, he served as Vice President of Finance and Administration for Datafusion Inc., a privately held software development company, from January 1998 until October 1999. From April 1996 to January 1998, Mr. Kim was the Corporate Controller for Interlink Computer Sciences, Inc., a public enterprise software company. From January 1990 to April 1996, Mr. Kim worked for Coopers and Lybrand L.L.P., leaving as an audit manager. Mr. Kim received a B.A. in economics from the University of California at Berkeley in 1989 and is a Certified Public Accountant.

*Michael Hollowich* joined Cogent in February 2001. He currently serves as Executive Vice President, Operations. Mr. Hollowich is responsible for internal operations related to new project management and user support, as well as qualification of new business targets and preparation of proposals. Prior to joining us, Mr. Hollowich served at TRW (Northrup Grumman) from April 1969 to February 2001, where he held senior business development and project management positions including project director for the United Kingdom's National Automated Fingerprint Identification System as well as the project manager for the NASA Spacelab Payload Integration project. While at TRW, Mr. Hollowich worked overseas on projects in the United Kingdom, Germany, Belgium and Denmark. Mr. Hollowich received a B.S. degree from the University of California at Los Angeles in April 1969.



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*James Jasinski* joined Cogent in May 2002. He currently serves as Executive Vice President Federal and State Systems. Mr. Jasinski is responsible for support of existing clients at the federal and state levels, development of new business opportunities, and establishment of new project offices as needed for the management of new contracts. He also manages our Reston, Virginia, Ohio and London offices. Prior to joining us, Mr. Jasinski was a Vice President for DynCorp Systems and Solutions from December 2000 to May 2002. From May 1978 through December 2000, Mr. Jasinski worked at the Federal Bureau of Investigation. Mr. Jasinski received a Juris Doctor degree from Union University, Albany Law School in 1976 and a Bachelor of Arts degree from State University of New York at Buffalo in 1973.

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## **Table of Contents**

*John Bolger* has served as a director since March 2004. Mr. Bolger is a retired Vice President of Finance and Administration of Cisco Systems, Inc., a manufacturer of computer networking systems. Mr. Bolger is currently a private investor and has served as a director of Integrated Device Technology, Inc. since 1993, Wind River Systems, Inc. since 2000, Mission West Properties, Inc. since 1998 and Micromuse, Inc. since 2004, all of which are public companies. Mr. Bolger earned a B.A. from the University of Massachusetts and an M.B.A. from Harvard University. He is a Certified Public Accountant.

*John P. Stenbit* has served as a director since April 2004. Mr. Stenbit participated as a member of Secretary Rumsfeld's staff in conjunction with the transformation of the entire Department of Defense during his two terms of service from September 1973 to April 1977. Mr. Stenbit served as the Assistant Secretary of Defense Networks and Information Integration (NII), previously known as Command, Control, Communications, and Intelligence (C3I), at the Pentagon from August 2001 to March 2004. Mr. Stenbit also worked at TRW, Inc. from September 1968 to August 1973, and from May 1977 to April 2001, most recently as an executive vice president. Mr. Stenbit has chaired advisory committees for the Administrator of the Federal Aviation Administration, as well as served as a member of advisory committees on information security, strategic systems, telecommunications, submarines, and future warfare defense communications. Mr. Stenbit earned a bachelors degree in Engineering in 1961 and masters degree in Electrical Engineering in 1962 from the California Institute of Technology in Pasadena, California and attended the Technische Hogeschool in the Netherlands from 1962 to 1963 and 1965 to 1967. Mr. Stenbit was a Fulbright Fellow from 1962 to 1963 and an Aerospace Corporation Fellow from 1965 to 1967. He is presently a member of the National Academy of Engineering, Tau Beta Pi, and a recipient of Secretary of Defense Medals for both Distinguished and Outstanding Public Service.

*Kenneth Thornton* has served as a director since June 2004. Mr. Thornton worked for International Business Machines (IBM) from November 1967 until April 2001 when he retired as General Manager Worldwide Public Sector. Mr. Thornton has served as a director of CyberSource Corporation since April 2001, First Genetic Trust Corporation since December 2002, Hire Networks corporation since November 2001, Infodata Systems since July 2004 and the National Symphony Orchestra since July 2000. In addition, Mr. Thornton has served on the Advisory Board of the U.S. Postal Service since January 1998 and CrossMatch Technologies since November 2003. Mr. Thornton received his B.S. in Business Administration from Barton College in 1964.

## **Executive Officers and Directors**

Currently, all of our directors hold office until the next annual meeting of our stockholders and until their successors have been duly elected and qualified. Our officers are elected and serve at the discretion of our board of directors.

Ming Hsieh, our President, Chief Executive Officer and Chairman of the Board of Directors, and James Xie, our Vice President System Integration, are brothers. There are no other family relationships among any of our directors and executive officers.

## **Board Committees**

Our board of directors has established three standing committees: an audit committee; a compensation committee; and a nominating and corporate governance committee.

*Audit Committee.* The audit committee oversees, reviews and evaluates our financial statements, accounting and financial reporting processes, internal control functions and the audits of our financial statements. The audit committee is responsible for the appointment, compensation,

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retention and oversight of our independent registered public accounting firm. The members of our audit committee are John Bolger, John P. Stenbit and Kenneth R. Thornton.

**Table of Contents**

*Compensation Committee.* The compensation committee reviews and makes recommendations to our board of directors concerning the compensation and benefits of our executive officers and directors, administers our stock option and employee benefits plans, and reviews general policy relating to compensation and benefits. The members of our compensation committee are John Bolger, John P. Stenbit and Kenneth R. Thornton.

*Nominating and Corporate Governance Committee.* The nominating and corporate governance committee identifies prospective board candidates, recommends nominees for election to our board of directors, develops and recommends board member selection criteria, considers committee member qualification, recommends corporate governance principles to our board of directors, and provides oversight in the evaluation of our board of directors and each committee. The members of our nominating and corporate governance committee are John Bolger, John P. Stenbit and Kenneth R. Thornton.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires our executive officers, directors and persons who beneficially own more than 10% of our common stock to file initial reports ownership and reports of changes in ownership with the SEC. Such persons are required by SEC regulations to furnish us with copies of all Section 16(a) forms filed by such person.

Based solely on our review of such forms furnished to us and written representations from such reporting persons, we believe that all filing requirements applicable to our executive officers, directors and more than 10% stockholders were complied with.

**Code of Ethics**

The Board of Directors has adopted a Code of Ethics that applies to all of our employees, officers and directors. The Code of Ethics is available at the Company's website at [www.cogentsystems.com/investors/](http://www.cogentsystems.com/investors/).

**Item 11. Executive Compensation**

The following table summarizes the compensation paid to or earned by our Chief Executive Officer and our other three most highly compensated executive officers whose total annual salary and bonus during the fiscal year ended December 31, 2004 exceeded \$100,000:

**Summary Compensation Table**

Name and Principal Position	Fiscal Year	<u>Annual Compensation</u>	Long-Term Compensation Awards	All Other Compensation(2)
<u>Table of Contents</u>				<u>92</u>

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		<u>Salary</u>	<u>Bonus(1)</u>	<u>Number of Securities Underlying Options</u>	
Ming Hsieh,					
	2004	\$ 259,921	\$ 70,000		\$ 9,988
President and Chief Executive Officer	2003	\$ 170,000	\$ 100,000		\$ 6,000
Paul Kim,	2004	\$ 205,524	\$ 70,000	950,000	\$
Chief Financial Officer(3)					
Michael Hollowich,	2004	\$ 175,556	\$ 70,000	140,000	\$ 7,367
	2003	\$ 164,583	\$ 100,000	100,000	\$ 6,000
Executive Vice President, Operations					
James Jasinski,	2004	\$ 176,000	\$ 70,000	140,000	\$ 7,380
	2003	\$ 165,334	\$ 100,000	120,000	\$ 6,000
Executive Vice President, Federal and State Systems					

- (1) Bonuses are paid in the year in which they are earned.  
(2) Includes contributions made by us to our 401(k) plan on behalf of the named individuals.  
(3) Mr. Kim was appointed our Chief Financial Officer on January 5, 2004.

**Table of Contents****Option Grants in Last Fiscal Year**

The following table sets forth certain information with respect to stock options granted to the individuals named in the Summary Compensation Table during the fiscal year ended December 31, 2004, including the potential realizable value over the ten-year term of the options, based on assumed rates of stock appreciation of 5% and 10%, compounded annually, minus the applicable per share exercise price. These assumed rates of appreciation are mandated by the rules of the Securities and Exchange Commission and do not represent our estimate or projection of our future common stock price. There can be no assurance that any of the values in the table will be achieved. Actual gains, if any, on stock option exercises will be dependent on the future performance of our common stock and overall stock market conditions.

In the fiscal year ended December 31, 2004, we granted options to purchase up to an aggregate of 2,682,000 shares of our common stock to employees, directors and consultants. All options are fully vested within four years. The percentage of total options granted is based upon an aggregate of 2,682,000 options granted during 2004.

Name	Individual Grants				Potential Realizable	
	Number of Shares Underlying Options Granted	% of Total Options Granted to Employees In Last Fiscal Year	Exercise Price Per Share	Expiration Date	Value at Assumed Annual Rates of Stock Price Appreciation for Option	
					Term	
					5%	10%
Ming Hsieh						
Paul Kim	950,000	35%	\$ 1.00	1/05/2014	\$ 47,684,140	\$ 72,971,660
Michael Hollowich	40,000	1%	\$ 1.00	1/01/2014	\$ 2,007,753	\$ 3,072,491
Michael Hollowich	100,000	4%	\$ 4.50	6/22/2014	\$ 4,795,807	\$ 7,711,020
James Jasinski	40,000	1%	\$ 1.00	1/01/2014	\$ 2,007,753	\$ 3,072,491
James Jasinski	100,000	4%	\$ 4.50	6/22/2014	\$ 4,795,807	\$ 7,711,020

**Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values**

The following table sets forth for the individuals named in the Summary Compensation Table their option exercises for the fiscal year ended December 31, 2004, and exercisable and unexercisable options held by them as of December 31, 2004.

The Value of Unexercised In-the-Money Options at December 31, 2004 is calculated based on the difference between the \$ 33.00, the closing price of our common stock on the Nasdaq National Market on December 31, 2004, and the exercise price for the shares underlying the option, multiplied by the number of shares issuable upon exercise of the option. All options were granted under our 2000 Stock Option Plan.

Name	Number of Shares Acquired On	Value Realized	Number of Shares Underlying Unexercised Options At	Value of Unexercised In-the-Money Options at December 31, 2004
------	------------------------------	----------------	--	--

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<u>Exercise</u>	<u>December 31, 2004</u>			
	<u>Exercisable</u>	<u>Unexercisable</u>	<u>Exercisable</u>	<u>Unexercisable</u>
Ming Hsieh				
Paul Kim	237,500	712,500	\$ 7,600,000	\$ 22,800,000
Michael Hollowich	132,500	207,500	\$ 4,308,938	\$ 6,310,063
James Jasinski	102,500	237,500	\$ 3,313,125	\$ 7,278,875

## **Table of Contents**

### **Employment Agreements and Change in Control Agreements**

We have an employment agreement with Paul Kim, entered into on January 5, 2004, under which Mr. Kim is entitled to an annual salary of \$208,000, with a one-time initial bonus of \$20,000. On January 5, 2004, Mr. Kim was also granted an option to purchase up to 950,000 shares at an exercise price of \$1.00 per share, with 237,500 shares vesting on April 5, 2004, 178,124 shares vesting on January 5, 2005, and 44,532 shares vesting on each subsequent calendar quarter thereafter. In the event of a change of control, all unvested shares will immediately vest. In the event of termination for cause following a change of control, Mr. Kim may be eligible for severance pay of up to one year of his annual salary.

We have employment agreements with our Executive Vice President, Federal and State Systems, Michael Hollowich and our Executive Vice President, Operations, James Jasinski. Each of these agreements provides for a fixed base annual salary that is subject to normal periodic review for increases by our board or directors, and each of these agreements may be terminated at will by either the employee or us.

### **Compensation Committee Interlocks and Insider Participation**

None of the members of the compensation committee is or has ever been one of our officers or employees. No interlocking relationship exists between our board of directors or compensation committee and the board of directors or compensation committee of any other entity, nor has any interlocking relationship existed in the past. For information concerning transactions between us and Messrs. Bolger, Thornton and Stenbit, or their affiliates, see Certain Relationships and Related Party Transactions.

### **Director Compensation**

Each of our non-employee directors is paid \$20,000 annually and is reimbursed for reasonable expenses incurred in connection with performance of their duties as directors. Upon their election to our board of directors, each of our non-employee directors is granted an initial option to purchase up to 40,000 shares of our common stock at the then fair market value pursuant to the terms of our 2004 Equity Incentive Plan. In addition, each non-employee director is automatically granted an option to purchase up to 10,000 shares of our common stock if he or she remains on the board of directors on the date of each annual meeting of stockholders (unless he or she joined our board of directors within six months of such meeting). Each non-employee director also receives cash compensation of \$2,000 for attendance of each board meeting. Additionally, the chairperson of each of the audit committee and the compensation committee receives \$2,500 and \$1,500, respectively, and members of the audit committee and compensation committee (not including chairpersons) receive \$1,500, and \$1,000, respectively, for attendance at each meeting of such committees.

### **Item 12. Security Ownership of Certain Beneficial Owners and Management**

The following table sets forth information concerning the beneficial ownership of the shares of our common stock as of March 16, 2005, by:

each person we know to be the beneficial owner of 5% or more of the outstanding shares of our common stock;



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each executive officer listed in the Summary Compensation Table;

each of our directors; and

all of our executive officers and directors as a group.

**Table of Contents**

Except in cases where community property laws apply or as indicated in the footnotes to this table, we believe that each stockholder identified in the table possesses sole voting and investment power with respect to all shares of our common stock shown as beneficially owned by such stockholder. The address of the individuals listed below is the address appearing on the cover of this Annual Report.

Name or Group of Beneficial Owners	Shares Beneficially Owned	
	Number	Percent
<b>Named Executive Officers:</b>		
Ming Hsieh(2)	60,000,000	73%
Paul Kim(3)	460,155	*
Michael Hollowich(4)	163,750	*
James Jasinski(5)	140,000	*
<b>Directors:</b>		
John Bolger(6)	23,000	*
John P. Stenbit(7)	10,000	*
Kenneth R. Thornton	5,000	*
<b>Executive officers and directors as a group (7 persons)(8)</b>	<b>60,801,905</b>	<b>74.1%</b>

\* Represents less than 1%.

- (1) Applicable percentage ownership is based on shares of our common stock outstanding as of March 16, 2005. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission, based on factors including voting and investment power with respect to shares, subject to the applicable community property laws. Shares of our common stock subject to options currently exercisable, or exercisable within 60 days after March 16, 2005, are deemed outstanding for the purpose of computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage ownership of any other person.
- (2) Includes 3,000,000 shares held by Ming Hsieh as trustee of the Ming Hsieh Annuity Trust No. 1 dated May 11, 2004, and 3,000,000 shares held by the spouse of Mr. Hsieh, Fang Liu Hsieh, as trustee of the Fang Liu Hsieh Annuity Trust No. 1 dated May 12, 2004.
- (3) Consists of 460,155 shares issuable upon the exercise of options that are exercisable within 60 days after March 16, 2005.
- (4) Consists of 163,750 shares issuable upon the exercise of options that are exercisable within 60 days after March 16, 2005.
- (5) Consists of 140,000 shares issuable upon the exercise of options that are exercisable within 60 days after March 16, 2005.
- (6) Includes 20,000 shares issuable upon the exercise of options that are exercisable within 60 days after March 16, 2005.
- (7) Consists of 10,000 shares issuable upon the exercise of options that are exercisable within 60 days after March 16, 2005.
- (8) Includes an aggregate of 793,905 shares issuable upon the exercise of options granted to our executive officers and directors that are exercisable within 60 days after March 16, 2005.

**Item 13. Certain Relationships and Related Transactions**

Since January 1, 2001, there has not been, nor is there currently proposed, any transaction or series of similar transactions to which we were or are a party in which the amount involved exceeds \$60,000 and in which any director, executive officer or beneficial holder of more than 5% of any class of our voting securities or members of such person's immediate family had or will have a direct or indirect material interest other than the transactions described below. All future transactions between us and any of our directors, executive officers or related parties will be subject to the review and approval of our audit committee.

## **Table of Contents**

### **Indemnification Agreements**

We have entered into indemnification agreements with each of our executive officers and directors containing provisions that may require us to, among other things, indemnify those executive officers and directors against certain liabilities that may arise by reasons of their status or service as executive officers or directors. The agreements also provide for us to advance to the executive officers and directors expenses that they expect to incur as a result of any proceeding against them as to which they could be indemnified. We also intend to execute such agreements with our future executive officers and directors.

### **Stock Option Grants**

Certain stock option grants to our directors and executive officers are described in this Annual Report under the captions "Management Director Compensation" and "Management Option Grants in Last Fiscal Year."

### **Stock Sale Agreement**

On December 31, 2003, we entered into a Stock Sale Agreement with Ming Hsieh, our President and Chief Executive Officer, and Archie Yew, our former Vice President-Finance whereby Mr. Yew sold 20,000,040 shares of our common stock to Mr. Hsieh. Mr. Hsieh made an initial payment to Mr. Yew in the amount of \$6,292,150 on January 21, 2004, which was funded by a dividend paid by us to Mr. Hsieh. Mr. Hsieh issued a Promissory Note to Mr. Yew for an aggregate amount equal to (i) \$2,813,778 plus interest on such amount at 6% per annum, plus (ii) an amount equal to Mr. Yew's tax liability on the aggregate payment of \$9,105,928, plus (iii) an additional amount equal to the taxes Mr. Yew is required to pay in connection with our earnings as an S Corporation while Mr. Yew was a stockholder. The amounts described in clauses (i) and (iii) were paid in July 2004 and the amount in clause (ii) was paid in March 2005 by Mr. Hsieh, and the Promissory Note was cancelled.

Pursuant to the Stock Sale Agreement, we agreed to indemnify, hold harmless and insure Mr. Yew against all losses, liabilities or expenses which he shall incur arising out of his actions taken as an officer, director or employee of ours, provided such actions were in good faith or at the direction of any other officer of ours. Mr. Yew agreed to indemnify and hold harmless, to the extent not covered by insurance, us and our officers, directors and employees against all losses, liabilities or expenses incurred as a result of Mr. Yew's actions as an officer, director or employee, to the extent such actions were outside the scope of his duties or in bad faith.

### **Tax Matters Agreement**

On May 12, 2004, we entered into a Tax Matters Agreement with our stockholder, Ming Hsieh. The Tax Matters Agreement was amended in September 2004. Under the amended agreement, we agreed to declare a dividend to Mr. Hsieh in an amount not to exceed \$85.0 million. The final amount of \$65.5 million was calculated as described in Item 7, under "Prior S Corporation Status." We also agreed to not file an amended income tax return or change any election or accounting method if such filing or change would increase any tax liability of Mr. Hsieh for any tax period. Mr. Hsieh and we agreed that we would file all appropriate tax returns related to our prior fiscal years as an S Corporation or in connection with the termination of our status as an S Corporation. The amended Tax Matters Agreement also provides for certain allocations of responsibility for taxes for the periods prior to the termination of our status as an S Corporation and after such termination.

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We agreed to indemnify and hold harmless Mr. Hsieh for any tax liabilities incurred by him in connection with changes to our taxable income as a result of an increase in or change in character of our taxable income during the period in which we were an S Corporation. Further, we agreed to indemnify Mr. Hsieh for professional fees or other costs reasonably incurred in the course of his defense of his income tax returns for the years in which he was reporting corporate income as a result of the S Corporation election. Our obligation to indemnify Mr. Hsieh is limited to the amount of our actual tax savings in connection with such increases or changes with respect to our taxable income.

Pursuant to the amended Tax Matters Agreement, Mr. Hsieh agreed to indemnify and hold us harmless for any tax liability resulting from our failing to qualify as an S Corporation at the initial election or at any time prior to the termination of our S Corporation status. Mr. Hsieh has also agreed to indemnify us against certain

**Table of Contents**

increases in our tax liabilities related to periods prior to the termination of our S Corporation election, but Mr. Hsieh's obligation to indemnify us for these liabilities is limited to the amount of his actual tax savings attributable to the circumstances giving rise to the increase in our tax liability.

**Dividends**

During the years ended December 31, 2002, 2003 and 2004, we declared S Corporation dividends of approximately \$1,957,000, \$3,334,000 and \$79,625,000 respectively, of which the amounts indicated below were paid to the following holders of our common stock:

Name of Stockholder	Year Ended December 31,		
	2002	2003	2004
	(in thousands)		
Ming Hsieh	\$ 1,304	\$ 2,222	\$ 68,720
Archie Yew	\$ 653	\$ 1,112	\$ 10,905

**Item 14. Principal Accounting Fees and Services**

Our consolidated financial statements as of December 31, 2001 and for the years ended December 31, 2000 and 2001 were previously audited by KPMG LLP, certified public accountants. KPMG LLP resigned in January 2004 and the Company engaged Deloitte & Touche LLP in April 2004 to audit our consolidated financial statements as of December 31, 2001, 2002 and 2003 and for the years ended December 31, 2001, 2002 and 2003. Our board of directors approved the appointment of Deloitte & Touche LLP as our independent registered public accounting firm in April 2004.

The following table sets forth the aggregate fees billed to us for the fiscal years ended 2003 and 2004 by KPMG LLP and Deloitte & Touche LLP:

	KPMG LLP		Deloitte & Touche LLP	
	2004	2003	2004	2003
Audit Fees(1)	\$ 0	\$ 99,148	Audit Fees(3)	\$ 1,175,876
Audit-Related Fees(2)	0	13,769	Audit-Related Fees(4)	0
Tax Fees	0	0	Tax Fees	0
All Other Fees	0	0	All Other Fees	0

- (1) Consist of fees billed for professional services rendered for the audit of our consolidated annual financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by our independent registered public accounting firm in connection with statutory and regulatory filings or engagements.
- (2)

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Audit-Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our consolidated financial statements and are not reported under Audit Fees. None of these fees or services were pre-approved by our audit committee.

- (3) Audit Fees consist of fees billed for professional services rendered for the audit of our consolidated annual financial statements and review of the interim consolidated financial statements included in quarterly reports, billing for professional services performed in connection with our initial public offering in September 2004 and services that are normally provided by our independent registered public accounting firm in connection with statutory and regulatory filings or engagements.
- (4) Audit-Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our consolidated financial statements and are not reported under Audit Fees.

Our audit committee's policy is to pre-approve all audit and permissible non-audit services provided by our independent auditors. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services. The independent auditor and management are required to periodically report to the audit committee regarding the extent of services provided by the independent auditor in accordance with this pre-approval.

**Table of Contents****PART IV****Item 15. Exhibits, Financial Statement Schedules**

The following documents are filed as part of this report:

	<b>Page</b>
	<b>Number</b>
(a) Financial Statements:	
<u>(1) Report of Independent Registered Public Accounting Firm</u>	F-1
<u>Consolidated Balance Sheets at December 31, 2004 and 2003</u>	F-2
<u>Consolidated Statements of Operations for Fiscal 2004, 2003 and 2002</u>	F-3
<u>Consolidated Statements of Stockholders' Equity for Fiscal 2004, 2003 and 2002</u>	F-4
<u>Consolidated Statements of Cash Flows for Fiscal 2004, 2003 and 2002</u>	F-5
<u>Notes to Consolidated Financial Statements</u>	F-6
<u>(2) Schedule II - Valuation and Qualifying Accounts</u>	S-1

Financial statement schedules other than those listed above have been omitted because they are either not required, not applicable or the information is otherwise included.

(b) Exhibits:

Exhibits.

<b><u>Exhibit</u></b>	<b><u>Description of Documents</u></b>
<b><u>Number</u></b>	
3.1(1)	Amended and Restated Certificate of Incorporation of the registrant
3.2(2)	Bylaws of the registrant
4.1(5)	Specimen Common Stock Certificate
10.1(2)#	Form of Indemnity Agreement for directors and executive officers
10.2(3)#	2000 Stock Option Plan and forms of Incentive Stock Option Agreement and Nonqualified Stock Option Agreement thereunder
10.3(2)#	2004 Equity Incentive Plan and forms of Stock Option Agreements thereunder
10.4(2)#	2004 Employee Stock Purchase Plan and form of subscription agreement thereunder
10.5(2)#	Employment Agreement by and between the registrant and Paul Kim, dated January 5, 2004

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- 10.6(2)# Employment Agreement by and between the registrant and Michael Hollowich, dated February 19, 2001
- 10.7(2)# Employment Agreement by and between the registrant and James Jasinski, dated May 9, 2002
- 10.9(3) Automated Fingerprint Matcher Systems Equipment and Services Blanket Purchase Agreement (BPA), dated July 11, 2002 by and between the registrant and INS Headquarters Procurement Division
- 10.10(2) Tax Matters Agreement among the registrant, Ming Hsieh, Fang Liu Hsieh, Trustee of the Fang Liu Hsieh Annuity Trust No. 1 dated May 12, 2004, and Ming Hsieh, Trustee of the Ming Hsieh Annuity Trust No. 1 dated May 11, 2004
- 10.11(3) Stock Sale Agreement, by and among the registrant, Ming Hsieh and Archie Yew, dated December 31, 2003



**Table of Contents**

<b>Exhibit Number</b>	<b>Description of Documents</b>
10.12(4)	Amended and Restated Tax Matters Agreement among the registrant, Ming Hsieh, Fang Liu-Hsieh, trustee of the Fang Liu Hsieh Annuity Trust No. 1 dated May 12, 2004, and Ming Hsieh, Trustee of the Ming Hsieh Annuity Trust No. 1 dated May 12, 2004
23.1	Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 promulgated under the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 promulgated under the Securities Exchange Act of 1934
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- (1) Filed with a Current Report on Form 8-K dated November 1, 2004.  
 (2) Filed with initial Registration Statement on Form S-1 (File No. 333-115535) dated May 14, 2004.  
 (3) Filed with Amendment No. 1 to the Registration Statement on Form S-1 (File No. 333-115535) dated June 29, 2004.  
 (4) Filed with Amendment No. 3 to the Registration Statement on Form S-1 (File No. 333-115535) dated September 8, 2004.  
 (5) Filed with Amendment No. 4 to the Registration Statement on Form S-1 (File No. 333-115535) dated September 23, 2004.  
 # Indicates management contract or compensatory plan.

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM**

To the board of directors and stockholders of

Cogent, Inc.:

South Pasadena, California

We have audited the accompanying consolidated balance sheets of Cogent, Inc. and subsidiaries (the Company) as of December 31, 2003 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index in Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Cogent, Inc. and subsidiaries at December 31, 2003 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche LLP

Los Angeles, California

March 21, 2005

F-1

**Table of Contents****COGENT, INC.****CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except share data)

	<b>December 31, 2003</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 17,457	\$ 27,004
Investments in marketable securities		167,202
Billed accounts receivable, net of allowance for doubtful accounts of \$229 and \$150 at December 31, 2004 and 2003, respectively	6,271	14,761
Unbilled accounts receivable	306	1,308
Inventory and contract related costs	3,550	35,854
Prepaid expenses and other current assets	267	741
Deferred income taxes	163	10,744
<b>Total current assets</b>	<b>28,014</b>	<b>257,614</b>
Investments in marketable securities		28,517
Inventory and contract related costs	2,769	2,126
Property and equipment, net	5,696	8,478
Restricted cash		561
Deferred income taxes	376	3,568
Other assets	800	30
<b>Total assets</b>	<b>\$ 37,655</b>	<b>\$ 300,894</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,572	\$ 2,790
Accrued expenses	172	1,480
Income taxes payable	931	6,131
Deferred revenues	5,111	59,667
<b>Total current liabilities</b>	<b>7,786</b>	<b>70,068</b>
Deferred revenues	10,153	8,762
Commitments and contingent liabilities		
Stockholders' equity:		
Common stock, \$0.001 par value; 250,000,000 shares authorized; 80,788,040 and 60,000,000 shares issued and outstanding at December 31, 2004 and 2003, respectively	120	120
Additional paid-in capital	5,394	251,871
Deferred stock-based compensation	(2,924)	(9,831)
Retained earnings (deficit)	17,049	(19,995)
Accumulated other comprehensive income (loss)	77	(101)
<b>Total stockholders' equity</b>	<b>19,716</b>	<b>222,064</b>

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Total liabilities and stockholders' equity	<u>\$ 37,655</u>	<u>\$ 300,894</u>
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See accompanying notes to consolidated financial statements.

F-2

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

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Revenues:</b>			
Product revenues	\$ 10,450	\$ 24,911	\$ 74,698
Maintenance and services revenues	5,907	7,268	12,990
<b>Total revenues</b>	<b>16,357</b>	<b>32,179</b>	<b>87,688</b>
<b>Cost of revenues:</b>			
Cost of product revenues(1)	3,841	7,881	25,551
Cost of maintenance and services revenues(1)	1,128	2,051	3,607
Amortization of deferred stock-based compensation		305	669
<b>Total cost of revenues</b>	<b>4,969</b>	<b>10,237</b>	<b>29,827</b>
<b>Gross profit</b>	<b>11,388</b>	<b>21,942</b>	<b>57,861</b>
<b>Operating expenses:</b>			
Research and development(1)	4,551	5,687	6,890
Selling and marketing(1)	2,135	2,752	3,826
General and administrative(1)	2,152	1,986	3,976
Amortization of deferred stock-based compensation	10	1,142	9,759
<b>Total operating expenses</b>	<b>8,848</b>	<b>11,567</b>	<b>24,451</b>
Operating income	2,540	10,375	33,410
<b>Other income:</b>			
Interest income	69	120	1,144
Other, net	19	(48)	1,599
<b>Total other income</b>	<b>88</b>	<b>72</b>	<b>2,743</b>
Income before income taxes	2,628	10,447	36,153
Income tax provision (benefit)	35	577	(6,428)
Equity in losses of investee	(314)	(246)	
Impairment of equity investment		(435)	
<b>Net income</b>	<b>\$ 2,279</b>	<b>\$ 9,189</b>	<b>\$ 42,581</b>
Basic net income per share	\$ 0.04	\$ 0.15	\$ 0.65
Diluted net income per share	\$ 0.04	\$ 0.14	\$ 0.56

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Shares used in computing basic net income per share	60,000	60,000	65,617
Shares used in computing diluted net income per share	63,723	67,853	75,817
Pro forma net income data (unaudited)			
Income before income taxes, as reported	\$ 2,628	\$ 10,447	\$ 36,153
Pro forma provision for income taxes	636	4,123	14,837
Pro forma net income	\$ 1,992	\$ 6,324	\$ 21,316
Pro forma net income per share (unaudited)			
Basic	\$ 0.03	\$ 0.11	\$ 0.32
Diluted	\$ 0.03	\$ 0.09	\$ 0.28
Pro forma weighted average number shares used in pro forma share calculations (unaudited)			
Basic	60,000	60,000	65,617
Diluted	63,723	67,853	75,817

(1) Excludes amortization of deferred stock-based compensation as follows:

Cost of product revenues	\$	\$ 100	\$ 172
Cost of maintenance and services revenues		205	497
Research and development expenses		663	1,413
Selling and marketing expenses	10	421	1,558
General and administrative expenses		58	6,788
	\$ 10	\$ 1,447	\$ 10,428

See accompanying notes to consolidated financial statements.

Table of Contents

## COGENT, INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(in thousands)

	Common Stock		Additional Paid in Capital	Deferred Stock-Based Compensation	Retained Earnings (Deficit)	Accumulated Other		Total Stockholders Equity
	Shares	Amount				Comprehensive Income (Loss)	Comprehensive Income (Loss)	
Balances at January 1, 2002	60,000	\$ 120	\$ 1,030	\$ (17)	\$ 10,872	\$ (25)	\$	\$ 11,980
Stockholders distributions					(1,957)			(1,957)
Stock-based compensation				10				10
Comprehensive income:								
Net income					2,279		2,279	2,279
Other comprehensive income						55	55	55
Comprehensive income							\$ 2,334	
Balances at December 31, 2002	60,000	120	1,030	(7)	11,194	30		12,367
Stockholders distributions					(3,334)			(3,334)
Deferred stock-based compensation			4,364	(4,364)				
Stock-based compensation				1,447				1,447
Comprehensive income:								
Net income					9,189		9,189	9,189
Other comprehensive income						47	47	47
Comprehensive income							\$ 9,236	
Balances at December 31, 2003	60,000	120	5,394	(2,924)	17,049	77		19,716
Stockholders distributions					(79,625)			(79,625)
Deferred stock-based compensation			17,862	(17,862)				
Stock-based compensation				10,888				10,888
Issuance of common stock in public offering, net of issuance costs	20,700		228,635					228,635
Stock options exercised	88		47					47
Cancellation of unvested stock options			(67)	67				
Comprehensive income:								
Net income					42,581		42,581	42,581
Other comprehensive loss						(178)	(178)	(178)
Comprehensive income							\$ 42,403	
Balances at December 31, 2004	80,788	\$ 120	\$ 251,871	\$ (9,831)	\$ (19,995)	\$ (101)		\$ 222,064

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See accompanying notes to consolidated financial statements.

F-4



**Table of Contents****COGENT, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Cash Flows from operating activities:</b>			
Net income	\$ 2,279	\$ 9,189	\$ 42,581
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sale of investment			(1,200)
Depreciation and amortization	589	703	1,279
Equity in losses of investee	314	246	
Impairment of equity investment		435	
Allowance for doubtful accounts	51	70	79
Amortization of deferred stock-based compensation	10	1,447	10,428
Amortization of bond premium on available for sale securities			34
Deferred income taxes	(12)	(477)	(13,773)
Changes in assets and liabilities:			
Billed accounts receivable	(4,047)	2,829	(8,561)
Unbilled accounts receivable	(16)	59	(1,002)
Inventory and contract related costs	(3,348)	(2,507)	(31,201)
Prepaid expenses and other current assets	2	(238)	(474)
Restricted cash			(561)
Income tax receivable	42		
Other assets			(30)
Accounts payable	2,157	(1,740)	1,141
Accrued expenses	265	(209)	1,307
Income taxes payable		932	5,200
Deferred revenues	4,683	9,100	53,165
<b>Net cash provided by operating activities</b>	<b>2,969</b>	<b>19,839</b>	<b>58,412</b>
<b>Cash Flows from investing activities:</b>			
Proceeds from sale of investment, net of transaction costs			2,000
Purchase of available-for-sale securities			(414,024)
Proceeds from sale of available-for-sale securities			218,271
Purchase of property and equipment	(656)	(617)	(4,060)
<b>Net cash used in investing activities</b>	<b>(656)</b>	<b>(617)</b>	<b>(197,813)</b>
<b>Cash Flows from financing activities:</b>			
Distributions to stockholders	(1,957)	(3,334)	(79,625)
Proceeds from the issuance of common stock, net of issuance costs incurred			228,635
Proceeds from the exercise of stock options			47
<b>Net cash provided by (used in) financing activities</b>	<b>(1,957)</b>	<b>(3,334)</b>	<b>149,057</b>

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Effect of exchange rate changes on cash	55	47	(109)
Net increase in cash and cash equivalents	411	15,935	9,547
Cash and cash equivalents, beginning of period	1,111	1,522	17,457
Cash and cash equivalents, end of period	\$ 1,522	\$ 17,457	\$ 27,004
<b>Supplemental disclosures of cash flow information</b>			
Cash received (paid) during the period for:			
Interest income	\$ 69	\$ 120	\$ 1,144
Income taxes	\$ (48)	\$ (124)	\$ (2,034)
<b>Non-cash financing activities:</b>			
Deferred stock-based compensation, net	\$	\$ 4,364	\$ 17,795
Capitalized deferred stock-based compensation (Inventory & contract related costs)	\$	\$	\$ 461
Conversion of property and equipment to inventories	\$	\$	\$ 1,092

See accompanying notes to consolidated financial statements.

F-5

**Table of Contents**

**COGENT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Description of the Business and Summary of Significant Accounting Policies**

***General***

Cogent, Inc. and subsidiaries ( Cogent ) 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, or PMA, servers and other AFIS equipment, including work stations and live-scans, bundled with our proprietary software, and other fingerprint biometrics products and solutions, to governments, law enforcement agencies and other organizations worldwide. Cogent also provides professional services and technical support and maintenance services to its customers.

***Principles of Consolidation***

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or ( GAAP ). The consolidated financial statements include the accounts of Cogent and its wholly owned subsidiaries. Cogent and its subsidiaries are collectively referred to herein as the Company. All significant intercompany accounts and transactions have been eliminated. The Company s investments in 20% to 50% owned companies in which it has the ability to exercise significant influence over operating and financial policies of the investee are accounted for using the equity method.

***Use of Estimates and Assumptions***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions for the reporting period and as of the financial statement date. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities, and the reported amounts of revenues and expenses. Actual results could differ from those estimates.

***Cash Equivalents***

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

***Restricted Cash***

In April 2004, the Company entered into a contract to provide an AFIS solution to a customer. The terms of the contract with this customer required that the Company issue a bank guarantee to assure its performance under the contract. The bank guarantee totaled \$1,400,000, and as of December 31, 2004, \$839,000 of the bank guarantee had expired. Cash collateralizing the remaining \$561,000 is held in an interest bearing restricted cash account and expires in December 2006.

***Investments in Marketable Securities***

The Company accounts for its 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*. Marketable securities are classified as available-for-sale securities and are accounted for at their fair value, and unrealized gains and losses on these securities are reported as other comprehensive income (loss). Management determines the appropriate classification of such securities at the time of purchase and reevaluates such classification as of each balance sheet date. When the fair value of an investment declines below its original cost, the Company considers all available evidence to evaluate whether the

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

decline is other-than-temporary. Among other things, the Company considers the duration and extent of the decline and economic factors influencing the markets. To date, the Company has had no such other-than-temporary declines below cost basis. The Company utilizes specific identification in computing realized gains and losses on the sale of investments.

***Fair Value of Financial Instruments***

The carrying amounts of cash equivalents, accounts receivable, and accounts payable approximate fair value because of the short-term maturities of these instruments.

***Accounts Receivable***

The Company generally bills its customers under its long term contracts pursuant to billing schedules contained in the contracts or, upon completion of agreed milestones or deliveries, with each milestone or delivery typically having a value specified in the contract. Unbilled accounts receivable comprise principally amounts of revenue recognized on contracts for which invoices have not been issued. It is expected that all unbilled accounts receivable balances will be billed in the next 12 months. Amounts billable under retainage provisions are billed to the customer upon contract completion and acceptance by the customer.

***Inventory and contract related costs***

Inventory and contract related costs consist of the following:

	As of December 31, 2003	As of December 31, 2004
	(in thousands)	
Materials and components	\$ 2,828	\$ 1,398
Inventory and costs related to long-term contracts		1,257
Deferred costs of revenue	3,491	35,325
	<u>\$ 6,319</u>	<u>\$ 37,980</u>

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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 cost of revenues at the time revenue is recognized. The long-term component of inventory and contract related costs of \$2,769,000 and \$2,126,000 as of December 31, 2003 and 2004, respectively, consists of deferred costs relating to contracts where revenue recognition is deferred beyond one year (see Note 5).

### ***Impairment of Long-Lived Assets***

The Company reviews its long-lived assets in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which provides guidance on the recognition and measurement of the impairment of long-lived assets to be held and used, and the measurement of long-lived assets to be disposed of by sale. Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

carrying amount of the assets to future net cash flows (undiscounted and without interest) expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

***Property and Equipment***

The cost of property and equipment, less applicable estimated residual values, is depreciated over their estimated useful lives, on the straight-line method, from the date the specific asset is completed, installed, and ready for normal use, as follows:

	<b>Useful Life</b>
Buildings	30
Building improvements	10
Furniture and other equipment	5
Computer equipment	3
Purchased software	3

***Concentrations of Credit Risk***

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents, investments in marketable securities and accounts receivable. The Company restricts investments in cash and cash equivalents and investments in marketable securities to financial institutions with high credit standing. At December 31, 2004 and 2003, the majority of the Company's cash and cash equivalents and investments in marketable securities were held at financial institutions located in California and New York. Accounts at these institutions are insured by the Federal Deposit Insurance Corporation up to \$100,000. Uninsured balances aggregate approximately \$222,910,000 (including foreign accounts) as of December 31, 2004. The Company performs periodic evaluations of the relative credit standing of financial institutions and limits the amount of risk by selecting financial institutions with a strong credit standing. The Company periodically performs credit evaluations of its customers and maintains reserves for potential losses on its accounts receivable.

***Revenue Recognition***

The Company generates revenues principally from sales of its AFIS solutions, which typically consist of PMA servers and other AFIS equipment, including workstations and live-scans, bundled with the Company's proprietary software. The Company's proprietary software is essential to the functionality of its AFIS solutions and other biometric products. The sales price of the Company's AFIS solutions generally

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includes one year of maintenance, which can be renewed. The Company also generates revenues under long-term contracts to provide customized systems as well as revenues derived from services performed under fixed-price and time-and-material agreements. To a lesser extent, the Company also generates revenues from sales of its proprietary biometrics application specific integrated circuit ( ASIC ) and biometrics products that incorporate its proprietary ASIC. The Company classifies the revenues generated by these activities as either product revenues, or as maintenance and services.

Because the Company s proprietary software is essential to the functionality of its AFIS solutions, the Company applies 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,

F-8



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**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the Company applies 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 Certain Production-Type Contracts. For arrangements that contain the lease of equipment, the Company accounts for the lease element in accordance with SFAS No. 13 Accounting for Leases and accounts for the remaining elements in the arrangement in accordance with SOP 97-2. While these statements govern the basis for revenue recognition, significant judgment and the use of estimates are required in connection with the determination of the amount of product, maintenance and service revenue as well as the amount of deferred revenue to be recognized in each accounting period. Material differences may result in the amount and timing of the Company's revenue for any period if actual results differ from management's judgments or estimates.

*Product revenue.* The timing of product revenue recognition is dependent on the nature of the product sold. Product arrangements comprising multiple deliverables including software, hardware, professional services, and maintenance are generally categorized into one of the following:

*AFIS solutions that do not require significant modification or customization of the Company's software:* Revenue associated with these arrangements, exclusive of amounts allocated to maintenance, for which the Company has vendor-specific objective evidence of fair value, or VSOE, is recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided that all other criteria for revenue recognition have been met. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

*AFIS solutions that require significant modification or customization of the Company's software:* Revenue associated with these arrangements is 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, 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. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period.

*ASIC applications and other biometric products:* Revenue associated with the sale of these applications and 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. The amount of these revenues has historically not been significant.

*AFIS solutions maintained on an outsourced application-hosting basis:* Revenue associated with these arrangements is recognized on a per transaction basis 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.

*Maintenance revenue.* 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 the arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. The Company considers 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.

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*Services revenue.* 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

F-9

**Table of Contents**

**COGENT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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 the U.S. government under time-and-materials arrangements. 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.

*Revenue Recognition Criteria.* The Company recognizes revenue when persuasive evidence of an arrangement exists, the element has been delivered, the fee is fixed or determinable, collection of the resulting receivable is probable, and VSOE of the fair value of any undelivered element exists. A discussion about these revenue recognition criteria and their applicability to the Company's transactions follows:

*Persuasive evidence of an arrangement:* The Company uses either contracts signed by both the customer and the Company or written purchase orders issued by the customer that legally bind the Company and the customer as evidence of an arrangement.

*Product delivery:* The Company deems delivery to have occurred when AFIS solutions are installed and, when required under the terms of the arrangement, when accepted by the customer. Shipments of ASICs 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:* The Company considers the fee to be fixed or determinable if the fee is not subject to refund or adjustment and the payment terms are within its normal established practices. If the fee is not fixed or determinable, the Company recognizes the revenue as amounts become due and payable.

*Collection is deemed probable:* The Company conducts 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 the Company expects that the customer will pay amounts under the arrangement as payments become due.

***Deferred Revenue***

Deferred revenue consists primarily of payments received in advance of revenue recognition from the sale of the Company's AFIS solutions including maintenance. Revenues from maintenance fees are recognized ratably over the term of the maintenance period.

***Major Customers***

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Revenues from sales to various agencies of the Department of Homeland Security ( DHS ), both directly and indirectly, were approximately 33.6%, 59.0% and 32.2% of total revenue for the years ended December 31, 2002, 2003 and 2004, respectively. Contract costs for revenues derived from the U.S. government are subject to audit and subsequent adjustment. Revenues are recorded in amounts based upon the Authorized Federal Supply Service Information Technology Schedule Pricelist negotiated between the Company and U.S. government. As of December 31, 2003 and 2004 amounts receivable from the DHS and from subcontracts with other U.S. government contractors were approximately 17.0% and 40.2%, respectively of total billed accounts receivable.

F-10

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table sets forth sales to customers, other than U.S. federal government agencies, comprising 10% or more of the Company's total revenue and billed accounts receivable balance for the periods indicated:

	Year ended December 31,		
	2002	2003	2004
<b>Revenues</b>			
Customer A	23%	*	*
Customer B	*	*	*
Customer C	*	*	38%
<b>Billed Accounts Receivable</b>			
Customer A	*	*	14%
Customer B	*	*	12%
Customer C	51%	32%	*
Customer D	*	23%	*
Customer E	*	*	10%

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

***Research and Development***

Research and development costs consist primarily of salaries and other personnel-related costs, bonuses, facility costs and third-party services. The Company maintains a research and development staff to enhance its products and to develop new products. In accordance with SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, software costs are expensed as incurred until technological feasibility of the software is determined and the recovery of the cost can reasonably be expected, after which any additional costs are capitalized. The Company has expensed all software development costs because the establishment of technological feasibility of products and their availability for sale have substantially coincided.

***Advertising Costs***

Advertising costs are expensed as incurred and were not significant for any period presented.

***Income Taxes***

Current income tax expense is the amount of income taxes expected to be payable for the current year. Deferred income tax assets and liabilities are computed annually for differences between the financial statement and income tax bases of assets and liabilities. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to reverse. If necessary, a valuation allowance is established to reduce deferred income tax assets to the amount expected to be realized.

*S Corporation Dividends*

The Company paid cash dividends of approximately \$1,957,000, \$3,334,000 and \$79,625,000 for the years ended December 31, 2002, 2003 and 2004, respectively, to its stockholders. Prior to the initial public offering, the Company declared a dividend of \$65,500,000 to its stockholder of record representing the estimated amount of undistributed cumulative income that had been taxed or is taxable to such stockholder through the date of termination of S Corporation election. Upon completion of the initial public offering, the Company paid \$65,500,000 of this dividend, which is included in the total cash dividends paid in 2004 of \$79,625,000.

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Stock Split***

The Company effected a two-for-one stock split on May 3, 2004. All references to number of shares and per share amounts have been restated to reflect the stock split.

***Foreign Currency Translation***

For foreign operations, the balance sheet accounts are translated at the year-end exchange rate, and income statement items are translated at the average exchange rate for the year. Resulting translation adjustments are recorded within accumulated other comprehensive income (loss). Assets and liabilities denominated in foreign currencies are re-measured at the balance sheet date. Resulting exchange rate gains or losses are included as a component of current period earnings.

***Net Income Per Share***

The Company calculates net income per share in accordance with SFAS No. 128, *Earnings Per Share*. Under SFAS No. 128, 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. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	<b>Years Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
	<b>(in thousands, except per share data)</b>		
<b>Numerator:</b>			
Income available to common stockholders	\$ 2,279	\$ 9,189	\$ 42,581
<b>Denominator:</b>			
Denominator for basic net income per share weighted average shares	60,000	60,000	65,617
Effect of dilutive securities:			
Stock options	3,723	7,853	10,200

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Dilutive potential common stock	3,723	7,853	10,200
	<u>          </u>	<u>          </u>	<u>          </u>
Denominator for diluted net income per share adjusted weighted average shares	63,723	67,853	75,817
	<u>          </u>	<u>          </u>	<u>          </u>
Basic net income per share	\$ 0.04	\$ 0.15	\$ 0.65
	<u>          </u>	<u>          </u>	<u>          </u>
Diluted net income per share	\$ 0.04	\$ 0.14	\$ 0.56
	<u>          </u>	<u>          </u>	<u>          </u>

*Pro Forma Net Income Per Share (unaudited)*

Pro forma net income reflects the income tax expense that would have been reported by the Company had it been subject to income taxes at the corporate level during all periods presented.

Pro forma net income per share is computed by dividing the pro forma net income available to common stockholders for the period by the weighted average number of shares of common shares and potentially dilutive common shares outstanding during the period.

*Commitments and Contingencies*

The Company periodically evaluates all pending or threatened contingencies and any commitments, if any, that are reasonably likely to have a material adverse effect on its operations or financial position. The Company



**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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.

**Accounting for Stock-Based Compensation**

The Company has two stock option plans, the 2000 Stock Option Plan and 2004 Equity Incentive Plan, which authorize the issuance of stock options, restricted stock and other stock-based incentives to employees, which are described more fully in Note 10. The Company accounts for these plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under APB Opinion No. 25, compensation for employee common stock option grants is calculated as the difference, if any, on the date of grant, between the fair value of the Company's common stock and the exercise price of the option. Stock-based compensation related to employee option grants is recorded on the grant date as deferred stock-based compensation, which is classified as a separate component of stockholders' equity, and is amortized to expense based on the multiple option model, which results in more compensation expense being attributed to an option's initial vesting periods when compared to the straight-line method. The Company accounts for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

In accordance with SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the following pro forma net income and earnings per share information is presented as if the Company accounted for stock-based compensation awarded under the stock incentive plans using the fair value method. Under the fair value method, the estimated fair value of stock incentive awards is charged against income using the multiple option model over the vesting period.

	Year Ended December 31,		
	2002	2003	2004
	(in thousands, except per share data)		
Net income as reported	\$ 2,279	\$ 9,189	\$ 42,581
Add: Total stock-based employee compensation expense included in reported net income net of related tax effects	10	1,447	8,347
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards net of the related tax effects	(454)	(1,901)	(9,755)

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Pro forma net income	<u>\$ 1,835</u>	<u>\$ 8,735</u>	<u>\$ 41,172</u>
Net Income per share			
Basic as reported	<u>\$ 0.04</u>	<u>\$ 0.15</u>	<u>\$ 0.65</u>
Basic pro forma	<u>\$ 0.03</u>	<u>\$ 0.15</u>	<u>\$ 0.63</u>
Diluted as reported	<u>\$ 0.04</u>	<u>\$ 0.14</u>	<u>\$ 0.56</u>
Diluted pro forma	<u>\$ 0.03</u>	<u>\$ 0.13</u>	<u>\$ 0.54</u>

F-13

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company used the Black-Scholes option-pricing model with the following weighted-average assumptions in determining the pro forma compensation costs:

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Risk-free interest rate	4.54%	2.66%	2.57%
Dividend yield	0.00%	0.00%	0.00%
Expected life (years)	5.0	4.25	3.07
Volatility	93%	91%	86%

The weighted-average estimated fair value of options granted was as follows:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Weighted average fair value	\$ 0.44	\$ 3.22	\$ 7.22

***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 and unrealized gains or losses on the Company's investments in marketable securities are included in accumulated other comprehensive income (loss).

The components of total comprehensive income (loss) are as follows:

<b>Year ended December 31,</b>	
<b>2003</b>	<b>2004</b>
(In thousands)	

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Net income	\$ 9,189	\$ 42,581
Other comprehensive income (loss):		
Change in unrealized gain (loss):		(142)
Change in foreign currency translation adjustment	47	(36)
	<u>          </u>	<u>          </u>
Total comprehensive income	<u>\$ 9,236</u>	<u>\$ 42,403</u>

### ***Recent Accounting Pronouncements***

In November 2002, the FASB's Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of Issue No. 00-21 did not have a material effect on the Company's consolidated financial position or results of operations.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives ) and for hedging activities under SFAS No. 133. This statement is effective for contracts entered into or modified after June 30, 2003. The adoption of SFAS No. 149 did not have an impact on the Company's consolidated financial position and results of operations.

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**Table of Contents**

**COGENT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In August 2003, the FASB's Emerging Issues Task Force issued EITF 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*. The consensus addresses whether non-software deliverables included in an arrangement that contains software that is more than incidental to the products or services as a whole are included within the scope of SOP 97-2. The EITF reached a consensus that non-software deliverables, including non-related equipment, for which a software deliverable is essential to its functionality, would be considered software-related, and therefore, included within the scope of SOP 97-2. Unrelated hardware where the software deliverables are not essential to the unrelated hardware's functionality would not be within the scope of SOP 97-2. The adoption of EITF 03-5 did not have a material impact on the Company's consolidated financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. This statement establishes how a company classifies and measures certain financial instruments with characteristics of both liabilities and equity, including redeemable preferred stock. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period commencing July 1, 2003. Adoption of this statement did not have a material impact on the Company's consolidated financial position and results of operations.

In July 2004, the Emerging Issues Task Force (EITF) published its consensus on Issue No. 03-01, *The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments*. EITF Issue No. 03-01 addresses the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of Statement of Financial Accounting Standards (SFAS) No. 115, certain debt and equity securities within the scope of SFAS No. 124, and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting. In September 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) Issue 03-1-1, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1*, which delays the effective date for the recognition and measurement guidance in EITF Issue No. 03-1. In addition, the FASB has issued a proposed FSP to consider whether further application guidance is necessary for securities analyzed for impairment under EITF Issue No. 03-1. The Company continues to assess the potential impact that the adoption of the proposed FSP could have on its financial statements.

In December 2004, the FASB issued SFAS 123 (Revised 2004)-Share Based Payment (SFAS 123R). SFAS 123R requires that the Company record stock option expense in its financial statements based on a fair value methodology beginning no later than the first fiscal quarter beginning after June 15, 2005, the Company's third quarter of fiscal year 2005. The Company is evaluating the impact of the new standard and the method and timing of adoption. Although the Company has not completed its analysis, it is anticipated that the expense related to stock options will increase under the new pronouncement, however, it cannot be quantified at this time.

In December 2004, the FASB issued FASB Staff Position (FSP) Financial Accounting Standard (FAS) 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (the Act)*. This Act provides tax relief to U.S. domestic manufacturers for certain qualifying activities. The FSP states that the manufacturers' deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 rather than a tax rate reduction. Also in December 2004, the FASB issued FSP FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*, addressing accounting and disclosure guidance relating to a Company's repatriation program. Management is currently evaluating the impact of this and any other changes made by the Act and, as such, the effects of such changes cannot be quantified at this time.



**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Reclassifications**

Certain prior year amounts have been reclassified to conform to the current year presentation. Equity in losses of investee of \$314,000 and \$246,000 for the years ended December 31, 2002 and 2003, respectively, was reclassified from other income to a separate line item after income taxes. Accordingly, the impairment of this investment of \$435,000 in the year ended December 31, 2003 was reclassified to a separate line item after income taxes. The related tax effect is not significant and there was no impact on any other financial statement line item in the prior years. The long-term component of inventory and contract related costs of \$2,769,000 as of December 31, 2003, was reclassified from inventory to non-current assets.

**Note 2. Fair Value of 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:

	<b>December 31, 2004</b>
	<b>(in thousands)</b>
<b>Type of Security:</b>	
Short-term instruments	\$ 24,368
Corporate debt securities with maturities of less than one year	58,962
Municipal securities with maturities of less than one year	75,460
U.S. government securities with maturities of less than one year	8,412
<b>Total short-term investments</b>	<b>\$ 167,202</b>
Corporate debt securities with maturities between one and three years	15,015
Municipal securities with maturities between one and three years	12,011
U.S. government securities with maturities between one and three years	1,491
<b>Total long-term investments</b>	<b>\$ 28,517</b>
	<b>\$ 195,719</b>

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. At December 31, 2004, the unrealized loss on available-for-sale securities totaled \$142,000. The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses are reported

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in other income and expense and were zero for 2004. The Company's short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper.

F-16



**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3. Property and Equipment**

Property and equipment consist of the following:

	As of December 31,	
	2003	2004
	(in thousands)	
Land	\$ 1,600	\$ 1,600
Building	3,294	3,294
Building improvements	601	719
Furniture and fixtures	890	193
Computer and other equipment	2,974	1,310
Purchased software	460	324
Equipment for lease		3,401
	9,819	10,841
Accumulated depreciation	(4,123)	(2,363)
Property and equipment, net	\$ 5,696	\$ 8,478

Depreciation and amortization expense related to property and equipment was \$589,000, \$703,000 and \$1,279,000 for the years ended December 31, 2002, 2003 and 2004, respectively. During the year ended December 31, 2004, the Company wrote-off the historical cost of fully depreciated property, plant and equipment totaling approximately \$3,047,000. In addition, during the year ended December 31, 2004, the Company transferred equipment held for lease with a net book value of \$1,092,000 to inventory as the Company has the positive intent to sell such items.

**Note 4. Investments**

In October 2004, the Company sold its 10% interest in Beijing Jinchun Ciccone Security Printing Company, Ltd. ( J&C ) for proceeds of approximately \$2,000,000, net of transaction costs, resulting in a gain of approximately \$1,200,000, which is included in other income in the accompanying consolidated statement of operations. Prior to the sale of its investment, the Company received a cash dividend in the amount of \$362,000, which is included in other income in the consolidated statement of operations for the year ended December 31, 2004. This investment was included in other assets on the consolidated balance sheet as of December 31, 2003.

In September 2001, the Company purchased a 39% ownership interest in Kinetic Science, Inc. ( Kinetic Science ) for \$1.1 million. The Company accounts for the investment under the equity method. The excess of the carrying amount of the Company's investment over its share of the net assets of the investee was approximately \$996,000 at the date of the investment. The excess was allocated to purchased technology and amortized over a five year period. At December 31, 2003, as a result of Kinetic Science's continued inability to introduce products based on its technology and its inability to raise additional capital required to further develop its technology, coupled with Kinetic Science's limited cash resources, the Company recognized an other than temporary impairment of the entire remaining carrying value of the investment amounting to \$435,000.

**Note 5. Deferred Revenues and Deferred Costs**

In the third quarter of 2004, the Company entered into contracts with a total value of approximately \$54 million with the National Electoral Council ( CNE ) of Venezuela. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contracts also provided for the short-term lease of equipment to be used by the CNE in

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**Table of Contents**

**COGENT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

connection with the August 15, 2004 Venezuela national election. Because VSOE of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component is being amortized over the life of the contracts. During the year ended December 31, 2004, the Company recognized approximately \$26.4 million of revenue representing both the estimated fair value of the lease component of the contracts as well as the ratable recognition of the total remaining value of the contracts over the one-year maintenance period. The estimated value of the lease component was approximately \$7.0 million and was based upon an independent valuation. The remaining \$27.6 million of the contract value is included in deferred revenue at December 31, 2004. Deferred costs related to this contract are included in inventory and contract related costs at December 31, 2004 and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In the fourth quarter of 2004, the Company entered into a contract with a total value of approximately \$20.2 million with the CNE of Venezuela. The contract also required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the October 31, 2004 Venezuela regional elections. Because VSOE of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component is being amortized over the life of the contracts. During the year ended December 31, 2004, the Company recognized approximately \$6.5 million of revenue representing both the estimated fair value of the lease component of the contracts as well as the ratable recognition of the total remaining value of the contract over the one-year maintenance period. The estimated value of the lease component was approximately \$3.7 million and was based upon an independent valuation. The remaining \$13.7 million of the contract value is included in deferred revenue at December 31, 2004. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately \$15 million with a domestic customer to provide a customized AFIS solution for which VSOE of the maintenance element did not exist. Revenue from this contract is being recognized ratably over the contractual maintenance period of five years, commencing upon the acceptance of the AFIS solution by the customer in October 2003. During the years ended December 31, 2003 and 2004, the Company recognized \$466,000 and \$2.8 million of revenue related to this contract. As of December 31, 2003 and 2004, deferred revenue related to this contract totaled approximately \$12.0 million and \$9.3 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately \$10 million with a domestic customer to provide a customized AFIS solution. This contract includes provisions that could require a refund of the entire contract value in the event of non-performance by the Company during the contract term. As a result of the refund provision, in accordance with SOP 97-2, the Company is deferring recognition of revenue from the contract until the expiration of the refund provision, which is expected to expire in the quarter ending December 31, 2005. As of December 31, 2003 and 2004, deferred revenue related to this contract totaled approximately \$700,000 and \$6.5 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues upon the expiration of the refund provisions.

**Note 6. Income Taxes**

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Prior to the Company's initial public offering, the Company elected to be treated as an S Corporation for U.S. federal income tax purposes. Under this election, the Company's stockholders, rather than the Company,

F-18

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

were subject to federal income taxes on their respective share of the Company's taxable income. The Company elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at the corporate level of 1.5%. The Company was also subject to state income taxes in various other states in which it does business.

Effective September 22, 2004, the Company terminated its S Corporation status. As a result of the termination of its S Corporation status, the Company recorded a one-time non cash credit of approximately \$13,000,000 to its income tax provision to recognize the estimated amount of previously unrecognized net deferred income tax assets as of the termination date. As a result of the termination of the Company's S Corporation status, the Company is subject to federal and certain state income taxes at the corporate level at statutory rates.

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

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
	(in thousands)		
<b>Current:</b>			
Federal	\$	\$	\$ 4,864
State	47	1,054	2,481
	47	1,054	7,345
<b>Deferred:</b>			
Federal			(12,268)
State	(47)	(296)	(1,505)
	(47)	(296)	(13,773)
Change in valuation allowance	35	(181)	
	\$ 35	\$ 577	\$ (6,428)

The components of deferred tax assets and liabilities are as follows:

**Year ended December 31,**

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	<u>2003</u>	<u>2004</u>
	(in thousands)	
Deferred tax assets:		
Deferred revenue	\$ 566	\$ 27,864
Stock compensation		1,557
Depreciation	26	(61)
Loss in equity investment	24	
Research credit	26	
Other	17	200
	<u>        </u>	<u>        </u>
Total deferred tax assets	\$ 659	\$ 29,560
	<u>        </u>	<u>        </u>
Deferred tax liabilities:		
Inventory	\$ (120)	\$ (14,826)
State taxes		(422)
	<u>        </u>	<u>        </u>
Total deferred tax liabilities	(120)	(15,248)
	<u>        </u>	<u>        </u>
Net deferred tax assets	\$ 539	\$ 14,312
	<u>        </u>	<u>        </u>

F-19

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following is a reconciliation of the statutory federal income tax rate to the Company's effective tax rate:

	<b>Year Ended</b>
	<b>December 31, 2004</b>
	<b>(in thousands)</b>
Federal income taxes at the statutory rate	\$ 12,654
State income taxes, net of federal benefit	634
Recognition of federal deferred tax assets upon termination of S Corporation status	(12,291)
Taxes not payable due to S Corporation status	(7,354)
Extraterritorial income exclusion	(408)
Amortization of deferred stock-based compensation	449
Other	(112)
	<b>\$ (6,428)</b>

**Note 7. Related Party Transactions**

On December 31, 2003, Ming Hsieh, the Company's President and Chief Executive Officer, Archie Yew, the Company's former Vice President-Finance, and the Company entered into a Stock Sale Agreement whereby Mr. Yew sold 20,000,000 shares of the Company's common stock, which represented Mr. Yew's entire interest in the Company, to Mr. Hsieh. Mr. Hsieh made an initial payment to Mr. Yew in the amount of \$6,292,150 on January 21, 2004, which was funded by a dividend paid by Cogent to Mr. Hsieh. Mr. Hsieh issued a Promissory Note to Mr. Yew for an aggregate amount equal to (i) \$2,813,778, plus, (ii) an amount equal to Mr. Yew's tax liability on the aggregate payment of \$9,105,928 plus, (iii) an additional amount equal to the taxes Mr. Yew is required to pay in connection with the Company's earnings as an S Corporation while Mr. Yew was a stockholder. The amounts described in clauses (i) and (iii) were paid in July 2004 and the amount in clause (ii) was paid in March 2005 by Mr. Hsieh, and the Promissory Note was cancelled.

On May 13, 2004, the Company entered into a Tax Matters Agreement with its sole stockholder, Mr. Hsieh, whereby the Company agreed to declare a dividend to Mr. Hsieh, prior to the pricing of the offering in an amount equal to the estimate of the Company's accumulated adjustments account, as defined by the Internal Revenue Code (increased for income which is exempt from tax as described in Internal Revenue Code Section 1368(e)(1)), not to exceed \$45,000,000. The Company also agreed to not file an amended income tax return or change any election or accounting method (except as required by law) if such filing or change would increase any tax liability of Mr. Hsieh, for any tax period. Mr. Hsieh, and the Company agreed to file all appropriate tax returns related to the Company's prior fiscal years as an S Corporation or in connection with the termination of its status as an S Corporation. The Tax Matters Agreement also provides for certain allocations of tax items for the periods prior to the termination of the Company's status as an S Corporation and after such termination. The Company further agreed to indemnify and hold harmless Mr. Hsieh, for any tax liabilities incurred by him in connection with changes to the Company's taxable income as a result of an increase or change in character of the Company's income during the period in which the Company was an S Corporation. The Company's obligation to indemnify Mr. Hsieh, is limited to the amount of the Company's actual tax savings in connection with such increases or changes with respect to its taxable income.

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Pursuant to the Tax Matters Agreement, Mr. Hsieh, agreed to indemnify and hold harmless the Company for any tax liability resulting from the Company's failing to qualify as an S Corporation at any time prior to the anticipated termination of the S Corporation status in connection with this offering. Mr. Hsieh has also agreed to indemnify the Company against increases in the Company's tax liabilities related to purchase prior to the termination of the Company's S Corporation election, but Mr. Hsieh's obligation to indemnify the Company for these liabilities is limited to the amount of his actual tax savings attributable to the circumstances giving rise to the increase in the Company's tax liability.

F-20



**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On September 4, 2004, the tax matters agreement was amended and restated to, among other things, increase the maximum amount of the dividend payable to the Company's stockholder to \$85,000,000. The total cash dividend, which was declared and paid to Mr. Hsieh in 2004, totaled \$65,500,000.

During the year ended December 31, 2004, certain employees over-contributed to the Employee Stock Purchase Plan. As a result, included in accrued expenses at December 31, 2004 are payables to employees totaling approximately \$49,000.

**Note 8. Bank Agreements**

The Company has a revolving line of credit with a U.S. bank to provide advances for trade finance transactions and working capital requirements of up to \$3,000,000. Borrowings under the line of credit bear interest at the bank's reference rate (interest rate at December 31, 2004 was 5.25%). The line of credit is secured by funds maintained in a money market account. There were no outstanding borrowings under this line at December 31, 2003 and 2004. Covenants in connection with the agreement impose restrictions and requirements related to, among other things, maintenance of certain insurance requirements, limitations on outside indebtedness, and use of proceeds for business operations. This line of credit was renewed in May 2004 and expires in May 2005.

**Note 9. Commitments and Contingencies*****Facility Lease***

The Company leases certain of its operating facilities under non-cancelable operating leases extending through September 30, 2009.

The following are the remaining future minimum rental payments required under the operating lease for each year ending December 31:

	<b>December 31,</b>
	<b>(in thousands)</b>
2005	\$ 204
2006	191
2007	197

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2008	203
2009	155
	<hr/>
	\$ 950
	<hr/>

Rent expense for 2002, 2003 and 2004 was approximately \$71,000, \$157,000 and \$220,000, respectively.

*Litigation*

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.

Table of Contents

## COGENT, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 10. Stock Option and Employee Benefit Plans***2000 Stock Option Plan*

The Company's Board of Directors has adopted the 2000 Stock Option Plan (the Plan), which authorizes the Company to grant or issue options to purchase up to a total of 16,000,000 shares of the Company's common stock. Options issued under the Plan vest as determined by the Plan Administrator, which is the Compensation Committee of the Board of Directors, at the time of grant and typically must be exercised within 10 years from the date of grant. The terms of options granted under these option plans are determined at the time of grant, which generally vest 25% at the completion of the first year and quarterly thereafter over the remaining three-year period.

*2004 Equity Incentive Plan*

In May 2004, the Company's board of directors and stockholders approved the 2004 Equity Incentive Plan (the Equity Plan). A total of 16,000,000 shares of common stock are initially authorized and reserved for issuance under the Equity Plan for incentives such as stock options, stock appreciation rights, restricted stock awards, restricted stock units, performance shares, performance units and deferred stock awards. The actual number of awards which may be granted under the Equity Plan shall be reduced, at all times, by the number of stock options outstanding under the 2000 Stock Option Plan. The number of shares reserved for issuance under the Equity Plan is subject to an annual increase on January 1 of each year beginning in 2005 equal to the lesser of (a) 1.5% of the outstanding shares on the immediately preceding December 31<sup>st</sup> (b) 750,000 shares or (c) a lesser amount as determined by the Board. The terms of options granted under these option plans are determined at the time of grant, which generally vest 25% at the completion of the first year and quarterly thereafter over the remaining three-year period, and in any case the option price may not be less than the fair market value per share on the date of grant.

A summary of the Company's stock option activity follows:

	Number of options	Weighted- Average Exercise Price	Range of Exercise Price
Outstanding, January 1, 2002	7,611,000	\$ 0.30	\$ 0.30 - \$ 0.60
Granted	270,000	\$ 0.60	\$ 0.60
Canceled or forfeited	(15,000)	\$ 0.30	\$ 0.30
Outstanding, December 31, 2002	7,866,000	\$ 0.31	\$ 0.30 - \$ 0.60
Granted	1,527,000	\$ 0.75	\$ 0.75
Canceled or forfeited	(68,000)	\$ 0.30	\$ 0.30

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Outstanding, December 31, 2003	9,325,000	\$ 0.39	\$ 0.30 - \$ 0.75
Granted	2,682,000	\$ 2.15	\$ 1.00 - \$34.43
Exercised	(88,040)	\$ 0.53	\$ 0.30 - \$ 0.75
Canceled or forfeited	(69,000)	\$ 0.61	\$ 0.30 - \$ 0.75
	<hr/>		
Outstanding, December 31, 2004	11,849,960	\$ 0.78	\$ 0.30 - \$34.43
	<hr/>		

F-22

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes information about stock options outstanding at December 31, 2004:

Exercise Price	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-Average Remaining Contract Life (Years)	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
\$ 0.30	7,417,860	5.64	\$ 0.30	7,412,860	\$ 0.30
\$ 0.60	250,000	7.01	\$ 0.60	177,500	\$ 0.60
\$ 0.75	1,500,100	8.20	\$ 0.75	583,850	\$ 0.75
\$ 1.00	1,985,000	9.03	\$ 1.00	441,500	\$ 1.00
\$ 4.50 - \$11.00	685,500	9.49	\$ 5.07	15,500	\$ 5.15
\$ 18.01 - \$34.43	11,500	9.86	\$ 27.01		\$
	<b>11,849,960</b>	<b>6.79</b>	<b>\$ 0.78</b>	<b>8,631,210</b>	<b>\$ 0.38</b>

As of December 31, 2002, 2003 and 2004, the number of options exercisable was 3,776,750, 5,728,500 and 8,631,210, respectively, and the weighted average exercise price of those options was \$0.30, \$0.31 and \$0.38, respectively.

Information regarding stock options granted during the years ended December 31, 2002, 2003 and 2004 is summarized as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Fair Value of Options
<b>Year Ended December 31, 2002</b>			
Exercise price equals fair value of common stock	270,000	\$ 0.60	\$ 0.44
	<b>270,000</b>		
<b>Year Ended December 31, 2003</b>			
Exercise price is less than fair value of common stock	1,527,000	\$ 0.75	\$ 3.22

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	1,527,000			
<b>Year Ended December 31, 2004</b>				
Exercise price equals fair value of common stock	16,000	\$	22.51	\$ 7.19
Exercise price is less than fair value of common stock	2,666,000	\$	2.03	\$ 13.57
	2,682,000			

As of December 31, 2004, there were 4,062,000 shares available for future grants under the Company's stock option plans.

*Non-employee Stock Options*

During the year ended December 31, 2004, the Company granted 132,000 stock options to non-employees for services. As of December 31, 2004, 132,000 stock options were both outstanding and exercisable. The fair value of the option shares earned is calculated using the Black-Scholes option-pricing model. The primary component in the Black-Scholes calculation is the value of the Company's common stock at the time the option shares are earned. As the grants were 100% vested and non-forfeitable at the date of grant, such date was treated

**Table of Contents**

**COGENT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

as the measurement date. For the year ended December 31, 2004, the Company recorded \$1,014,000 in compensation expense related to non-employee stock options, which represents the total value of the options at the grant date.

***Employee Stock Purchase Plan***

In May 2004, the Company's board of directors and stockholders adopted the 2004 Employee Stock Purchase Plan (the "Purchase Plan") which became effective immediately upon the closing of the Company's initial public offering. The Purchase Plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. A total of two million shares of common stock are initially authorized and reserved for sale under the Purchase Plan. The Purchase Plan permits eligible employees to purchase shares of common stock at a fifteen percent (15%) discount through payroll deductions during sequential six month offering periods. Unless the Board establishes a higher price, the price at which shares are purchased under the Purchase Plan for such six month offering period is equal to 85% of the lesser of the fair market value of the common stock on the first day of such offering period or the purchase date, which is the last day of the offering period.

***Employee Benefit Plans***

The Company has a 401(k) plan that allows eligible employees to contribute up to 15% of their salary, subject to annual limits. All employees age 18 or older with three months of service and whose employment is not governed by a union contract are eligible for participation. After one year of service, the Company contributes 3% of total compensation, which is also subject to annual limits, and may, at its discretion, make additional contributions regardless of profitability. The Company's contribution related expense was \$231,000, \$218,000 and \$239,000 in 2002, 2003 and 2004, respectively.

**Note 11. Initial Public Offering**

In September 2004, the Company completed the sale of 20,700,000 shares of common stock, including the underwriters' exercise of an over-allotment option, at a price of \$12.00 per share. A total of \$248,400,000 in gross proceeds was raised in the initial public offering. After deducting the underwriting discount of \$17,388,000 and offering expenses of \$2,377,000, net proceeds were \$228,635,000. A portion of the net proceeds from the initial public offering, together with the Company's existing cash balances, was used to fund a final dividend of \$65,500,000 to its stockholder of record prior to its initial public offering in connection with the termination of its prior S Corporation status (see Note 1).

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 12. 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):

	<b>Year Ended December 31, 2002</b>				
	<b>Americas</b>	<b>Europe</b>	<b>Asia</b>	<b>Other</b>	<b>Total</b>
<b>Revenues:</b>					
<b>Product revenues</b>	\$ 7,257	\$ 1,496	\$ 1,697	\$	\$ 10,450
<b>Maintenance and services revenues</b>	4,432	1,015	460		5,907
<b>Total</b>	\$ 11,689	\$ 2,511	\$ 2,157	\$	\$ 16,357
	<b>Year Ended December 31, 2003</b>				
	<b>Americas</b>	<b>Europe</b>	<b>Asia</b>	<b>Other</b>	<b>Total</b>
<b>Revenues:</b>					
<b>Product revenues</b>	\$ 21,476	\$ 2,005	\$ 1,397	\$ 33	\$ 24,911
<b>Maintenance and services revenues</b>	5,865	785	618		7,268
<b>Total</b>	\$ 27,341	\$ 2,790	\$ 2,015	\$ 33	\$ 32,179
	<b>Year Ended December 31, 2004</b>				
	<b>Americas</b>	<b>Europe</b>	<b>Asia</b>	<b>Other</b>	<b>Total</b>
<b>Revenues:</b>					
<b>Product revenues</b>	\$ 63,711	\$ 3,905	\$ 545	\$ 6,537	\$ 74,698
<b>Maintenance and services revenues</b>	10,874	1,325	791		12,990
<b>Total</b>	\$ 74,585	\$ 5,230	\$ 1,336	\$ 6,537	\$ 87,688

At December 31, 2003 and 2004, the Company's property and equipment, net of accumulated depreciation and amortization in the United States was approximately \$5,653,000 and \$5,505,000, respectively. At December 31, 2003 and 2004, the Company's property and equipment, net of accumulated depreciation and amortization in foreign countries was approximately \$30,000 and \$2,974,000, respectively.

**Note 13. Subsequent Events**



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In February 2005, the Company's Board of Directors resolved to terminate the 2004 Employee Stock Purchase Plan effective April 30, 2005.

### Note 14. Pro Forma Information (Unaudited)

The pro forma unaudited income tax adjustments presented represent taxes which would have been reported had the Company been subject to Federal and state income taxes as a C Corporation. The pro forma provision for income taxes differs from the statutory income tax rate due to the following:

	2002	2003	2004
	(in thousands)		
Federal income taxes at the statutory rate	\$ 787	\$ 3,418	\$ 12,654
State income taxes, net of federal benefit	(24)	400	1,335
Research credits	(130)	(101)	
Foreign taxes	(1)	(71)	89
Amortization of deferred stock-based compensation		506	2,311
Extraterritorial income exclusion			(1,569)
Other	4	(29)	17
	\$ 636	\$ 4,123	\$ 14,837

F-25

**Table of Contents****COGENT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 15. Unaudited Quarterly Information**

In the opinion of management, the following unaudited quarterly data has been prepared on the same basis as the audited financial statements and includes all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the results of operations for the periods presented.

	<b>Three Months Ended</b>			
	<u>March 31, 2003</u>	<u>June 30, 2003</u>	<u>September 30, 2003</u>	<u>December 31, 2003</u>
<b>Revenues:</b>				
Product revenues	\$ 2,081	\$ 3,875	\$ 1,271	\$ 17,684
Maintenance and services revenues	1,816	1,381	1,705	2,366
<b>Total revenues</b>	<b>3,897</b>	<b>5,256</b>	<b>2,976</b>	<b>20,050</b>
<b>Cost of revenues:</b>				
Cost of product revenues	786	1,422	651	5,022
Cost of maintenance and services revenues	391	433	444	783
Amortization of deferred stock-based compensation	39	39	89	138
<b>Total cost of revenues</b>	<b>1,216</b>	<b>1,894</b>	<b>1,184</b>	<b>5,943</b>
<b>Gross profit</b>	<b>2,681</b>	<b>3,362</b>	<b>1,792</b>	<b>14,107</b>
Operating expenses	2,609	2,713	2,783	3,462
Other (expense)	(62)	(48)	(44)	(455)
Income tax provision (benefit)	1	35	(62)	603
<b>Net income (loss)</b>	<b>\$ 9</b>	<b>\$ 566</b>	<b>\$ (973)</b>	<b>\$ 9,587</b>
Basic net income (loss) per share	\$ 0.00	\$ 0.01	\$ (0.02)	\$ 0.16
Diluted net income (loss) per share	\$ 0.00	\$ 0.01	\$ (0.02)	\$ 0.14
<b>Number of shares used in per share computations:</b>				
Basic	60,000	60,000	60,000	60,000
Diluted	66,894	67,464	60,000	68,327

**Three Months Ended**

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	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004
<b>Revenues:</b>				
Product revenues	\$ 12,694	\$ 13,621	\$ 19,933	\$ 28,450
Maintenance and services revenues	2,704	3,441	3,515	3,330
<b>Total revenues</b>	<b>15,398</b>	<b>17,062</b>	<b>23,448</b>	<b>31,780</b>
<b>Cost of revenues:</b>				
Cost of product revenues	2,365	3,152	7,577	12,457
Cost of maintenance and services revenues	619	907	1,012	1,069
Amortization of deferred stock-based compensation	114	156	230	169
<b>Total cost of revenues</b>	<b>3,098</b>	<b>4,215</b>	<b>8,819</b>	<b>13,695</b>
<b>Gross profit</b>	<b>12,300</b>	<b>12,847</b>	<b>14,629</b>	<b>18,085</b>
Operating expenses	7,508	5,217	5,868	5,858
Other income	36	416	106	2,185
Income tax provision (benefit)	311	337	(11,578)	4,502
<b>Net income</b>	<b>\$ 4,517</b>	<b>\$ 7,709</b>	<b>\$ 20,445</b>	<b>\$ 9,910</b>
Basic net income per share	\$ 0.08	\$ 0.13	\$ 0.33	\$ 0.12
Diluted net income per share	\$ 0.07	\$ 0.11	\$ 0.29	\$ 0.11
<b>Number of shares used in per share computations:</b>				
Basic	60,000	60,000	61,493	80,792
Diluted	68,576	69,262	70,987	91,716

**Table of Contents****SCHEDULE II****COGENT, INC.****VALUATION AND QUALIFYING ACCOUNTS**

<b>Description</b>	<b>Balance at Beginning of Period</b>	<b>Additions Charged to Costs and Expenses</b>	<b>Deductions and other Adjustments</b>	<b>Balance at End of Period</b>
Year ended December 31, 2002: Allowance for doubtful accounts	\$ 29,000	\$ 51,000		\$ 80,000
Year ended December 31, 2003: Allowance for doubtful accounts	\$ 80,000	\$ 70,000		\$ 150,000
Year ended December 31, 2004: Allowance for doubtful accounts	\$ 150,000	\$ 79,000		\$ 229,000

S-1

