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COGNITRONICS CORP
Form 10-K/A
April 28, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K/A
AMENDMENT NO. 1

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2005,
or
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission file number 1-8496

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

| | |
|--|--------------------------------------|
| NEW YORK | 13-1953544 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|--|------------|
| 3 Corporate Drive, Danbury, Connecticut | 06810 |
| (Address of principal executive offices) | (Zip Code) |

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

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

| Title of each class | Name of each exchange on which registered | Shares Outstanding as of March 1, 2006 |
|--|---|--|
| Common Stock, par value \$0.20 per share | American Stock Exchange | 6,865,691 |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 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 the Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer
Accelerated filer Non-Accelerated filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant computed by reference to the price the stock was last sold as of June 30, 2005, the last business day of the most recently completed second fiscal quarter, was \$13,303,389.

TABLE OF CONTENTS

The Company is amending its Annual Report on Form 10-K for the year ended December 31, 2005 to include in Part III items previously incorporated by reference.

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| Item | | |
|----------|--|----|
| Page | | |
| PART I | | |
| 1. | Business | .3 |
| 1A. | Risk Factors | .4 |
| 1B. | Unresolved Staff Comments. | .6 |
| 2. | Properties | .6 |
| 3. | Legal Proceedings. | .6 |
| 4. | Submission of Matters to a Vote of Security Holders. | .6 |
| | Executive Officers of the Company | .7 |
| PART II | | |
| 5. | Market for Company's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities | .8 |
| 6. | Selected Financial Data. | .8 |
| 7. | Management's Discussion and Analysis of Financial Condition and Results of Operation | .9 |
| 7A. | Quantitative and Qualitative Disclosures About Market Risk . | 11 |
| 8. | Financial Statements and Supplementary Data. | 12 |
| 9. | Changes in and Disagreements with Accountants on Accounting and Financial Disclosure. | 26 |
| 9A. | Controls and Procedures. | 27 |
| 9B. | Other Information. | 29 |
| PART III | | |
| 10. | Directors and Executive Officers of the Company. | 29 |
| 11. | Executive Compensation | 30 |
| 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters | 30 |
| 13. | Certain Relationships and Related Transactions | 34 |
| 14. | Principal Accountant Fees and Services | 36 |
| PART IV | | |
| 15. | Exhibits and Financial Statement Schedules | 38 |

PART I

Information set forth on this annual report on Form 10-K that are not historical facts, may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements generally are characterized by the use of terms such as "believe", "expect" and "may". Although the Company believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions, the Company's actual results could differ materially from these set forth in the forward-looking statements. Factors that might cause such a difference are set forth in Item 1A below. Given the uncertainties,

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the Company cautions readers not to place undue reliance on such forward-looking statements.

Item 1. Business

(a) Cognitronics Corporation (the "Company") was incorporated in January 1962 under the laws of the State of New York. The Company designs, manufactures and markets voice processing systems.

On November 18, 2005, the Company acquired ThinkEngine Networks, Inc., based in Marlborough, Massachusetts, for 1,149,705 shares of the Company's common stock, par value \$0.20 per share, \$1,250,000 in cash and notes in the aggregate amount of \$300,000. ThinkEngine is a provider of Time Division Multiplexing ("TDM") and Internet Protocol ("IP") capable conferencing bridges and media servers to the telecommunications industry.

On December 22, 2005, the Company sold Dacon Electronics Plc, its European distributorship operations based in Hertfordshire, England, to Silbury 307 Limited ("Silbury") in an arms length transaction for the payment of \$150,000 in cash and a note in the principal amount of \$150,000. Mr. Roy A. Strutt, the Company's former Vice President of European Operations and the Managing Director of Dacon Electronics Plc, is the sole shareholder of Silbury.

(b) The Company operates in one segment, voice processing. The Company designs, manufactures and sells equipment for use in telecommunication networks.

(c) (i) The Company designs, manufactures and sells media servers and application servers for use in telephone networks, cable VOIP networks, large enterprise and government markets. Areas of application include network announcements, interactive voice response (IVR), intelligent peripherals, audio conferencing, intelligent call routing, pre/post-paid calling cards and automatic speech recognition (ASR). The Company's primary products are the CX Series of Network Media Servers, and the VSR1000, a multi-function voice services router. These products are sold directly to telecommunications service providers, switch manufacturers, IP-based communications systems manufacturers, systems integrators, and value added resellers (VAR) who distribute the Company's products.

(ii) Status of publicly announced new products or industry segments requiring material investment. Inapplicable.

(iii) The Company has adequate sources for obtaining raw materials, components and supplies to meet production requirements, consisting primarily of electronic components and subassemblies, and did not experience difficulty during 2005 in obtaining such materials, supplies and components.

(iv) The Company relies on technological expertise, responsiveness to users' needs and innovations and believes that these are of greater significance in its industry than patent protection. There can be no assurance that patents owned or controlled by others will not be encountered and asserted against the Company's voice processing products or that licenses or other rights under such patents would be available, if needed. The Company has registered trademarks and names which the Company considers important in promoting the business of the Company and its products.

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- (v) Seasonality. Inapplicable.
 - (vi) The discussion of liquidity and sources of capital as set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations is included in Item 7 of this Annual Report on Form 10-K and is incorporated herein by reference.
 - (vii) In 2005, revenues included sales of \$2.1 million to Telcordia Technologies, Inc., \$1.4 million to Verizon Communications Inc., \$1.1 million to Comcast Corporation and \$.7 million to Telus Corporation. Over the past several years, a major portion of the revenues has come from one or two large customers. Accordingly, the loss of any of these customers could have a material adverse impact on the Company's results of operations.
 - (viii) The dollar amount of orders believed by the Company to be firm as of December 31, 2005 and 2004, amounted to \$3.1 million and \$.4 million, respectively. Substantially all of the orders as of December 31, 2005 can reasonably be expected to be filled during 2006.
 - (ix) Business subject to renegotiation. Inapplicable.
 - (ix) The Company competes, and expects to compete, in fields noted for rapid technological advances and the frequent introduction of new products and services. The Company's products are similar to those manufactured, or capable of being manufactured, by a number of companies, some of which are well established corporations with financial, personnel and technical resources substantially larger than those of the Company. The Company's ability to compete in the future depends on its ability to maintain the technological and performance advantages of its current products and to introduce new products and applications that achieve market acceptance. Future research and development expenditures will be based, in part, on future results of operations. There are no assurances that the Company will be able to successfully develop and market new products and applications.
 - (xi) Expenditures for research and development activities, as determined in accordance with generally accepted accounting principles, amounted to \$3.9 million (including purchase research and development of \$.7 million) in 2005, \$2.5 million in 2004 and \$2.6 million in 2003. In addition, the estimated dollar amount spent on the improvement of existing products or techniques was \$.1 million in 2005, 2004 and 2003.
 - (xii) Material effects of compliance with Federal, State or local provisions regulating the discharge of materials into the environment or otherwise relating to the protection of the environment. Inapplicable.
 - (xiii) At December 31, 2005, the Company and its subsidiaries employed 63 people.
- (d) Sales to foreign customers primarily represent export-type sales (primarily North America and Europe) of approximately \$.8 million in 2005 primarily to one customer, \$.5 million in 2004 and \$.1 million in 2003. Export sales generally do not involve any greater business risks than do sales to domestic customers. Selling prices and gross profit margins on export-type sales are comparable to sales to domestic customers.

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Item 1A. Risk Factors

The Company's business and future performance are affected by general industry and market conditions and growth rates, general U.S. and non-U.S. economic and political conditions (including the global economy), interest rate fluctuations and other events. The following items are representative of the risks, uncertainties and other conditions that can impact the Company's business, its future performance and the forward-looking statements that it makes in this report or that it may make in the future.

A Small Number of the Company's Customers Account for a Substantial Portion of Its Revenues, and Most of Its Receivables. The Loss of a Major Customer or Reduced Spending of These Service Providers Could Significantly Reduce the Company's Revenues, Profitability and Cash Flow.

A few large telecommunications service providers account for a substantial portion of the Company's revenues. The telecommunications industry has recently experienced substantial consolidation, as evidenced by the mergers of Sprint and Nextel, Cingular and AT&T Wireless, SBC and AT&T, Verizon and MCI and the announced merger of AT&T and BellSouth. As service providers increase in size, it is possible that an even greater percentage of the Company's revenues will be attributable to a smaller number of large service providers going forward.

Acquisition

In November 2005, the Company acquired ThinkEngine Networks, Inc. ("ThinkEngine"). ThinkEngine has never made a profit and will continue to generate losses and require funding until sales of the VSR1000 product line can be increased to sufficient levels, of which there can be no assurance.

The Company Operates in a Highly Competitive Industry with Many Participants.

The Company operates in a highly competitive environment, competing on the basis of product offerings, technical capabilities, quality, service and pricing. Competition for new service providers as well as for new infrastructure deployments is particularly intense.

The Company has a number of existing competitors, some of which are very large, with significantly greater technological and financial resources, brand recognition and established relationships with telecommunications service providers. In addition, new competitors may enter the industry as a result of shifts in technology. The Company cannot assure you that it will be able to compete successfully against existing or future competitors.

Technology Drives the Company's Products and Services. If the Company Fails to Keep Pace with Technological Advances in Its Industry, or If It Pursues Technologies That Do Not Become Commercially Accepted, Customers May Not Buy Its Products or Use Its Services.

The telecommunications industry uses numerous and varied technologies and large service providers often invest in several and, sometimes, incompatible technologies. The industry also demands frequent and, at times, significant technology upgrades. The Company does not have the resources to invest in all of these existing and potential technologies. As a result, the Company concentrates its resources on those technologies it believes have or will achieve substantial customer acceptance and in which it has appropriate technical expertise. However, existing products often have short product life cycles. In addition, the Company's choices for developing technologies may prove incorrect if customers do not adopt the products it develops or if those technologies ultimately prove to be unviable. The Company's operating results

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depend to a significant extent on the market acceptance of its products and its ability to enhance its existing products, to continue to introduce new products successfully and on a timely basis, and to develop new or enhance existing tools for its services offerings.

The Company Needs to Attract and Retain Highly Qualified Personnel.

The Company's future success is dependent on its ability to attract and retain key design engineering, sales and executive personnel. There is intense competition for qualified personnel, in particular, design engineers, and the Company may not be able to attract and retain engineers and other qualified personnel necessary for the development and introduction of new products or to replace engineers or other qualified personnel that may leave its employ.

The Telecommunications Market Fluctuates and Is Impacted By Many Factors, Including Decisions By Service Providers Regarding Their Deployment of Technology and Their Timing of Purchases, as Well as Demand and Spending for Communications Services By Businesses and Consumers.

After significant deterioration earlier this decade, the global telecommunications market stabilized in 2004 and experienced modest growth in 2005 as reflected in increased capital expenditures by service providers and growing demand for telecommunications services. Although the Company believes the overall market will continue to grow, the rate of growth could vary geographically and across different technologies, and is subject to substantial fluctuations. The specific market segment in which the Company participates may not experience the growth of other segments. In that case, the Company's results of operations may be adversely affected.

The Company Is Subject to Intellectual Property Litigation and Infringement Claims, Which Could Cause It to Incur Significant Expenses or Prevent the Company from Selling Its Products.

Intellectual property litigation can be costly and time-consuming and can divert the attention of management and key personnel from other business issues. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. A successful claim by a third party of patent or other intellectual property infringement by the Company could compel it to enter into costly royalty or license agreements or force it to pay significant damages and could even require it to stop selling certain products.

The Company Relies on Third Party Suppliers to Produce Subassemblies.

The Company has outsourced the production of subassemblies and certain finished goods. If a contract manufacturer terminates its relationship with the Company or is unable to fill its orders on a timely basis, or if the Company does not accurately forecast its requirements, the Company may be unable to deliver the affected products to meet its customers' orders.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

The facilities of the Company and its subsidiaries are located as follows:

| Location | Description | Square Feet | Lease Expiration Date |
|---|--|-------------|-----------------------|
| Danbury, Connecticut 3 Corporate Drive | Office, engineering, production and service facility | 27,600 | 10/31/08 |

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Marlborough, Massachusetts Office, engineering 11,405 Month to Month
100 Nickerson Road and service facility

The Company considers each of these facilities to be in good condition and adequate for the Company's business.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company or any of its subsidiaries is a party or of which any of their property is the subject.

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

None.

Executive Officers of the Company

The executive officers of the Company, their positions with the Company and ages as of March 23, 2006 are as follows:

| Name | Position(s) and Office(s) | Age |
|-------------------|---|-----|
| Brian J. Kelley | President and Chief Executive Officer; Director | 54 |
| Kenneth G. Brix | Vice President | 59 |
| Paul Gagne | Vice President and Chief Technology Officer | 53 |
| Harold F. Mayer | Secretary | 76 |
| Garrett Sullivan | Treasurer and Chief Financial Officer | 60 |
| Emmanuel A. Zizzo | Vice President | 65 |

No family relationships exist between the executive officers of the Company. Each of the executive officers was elected to serve until the next annual meeting of the Board of Directors or until his successor shall have been elected and qualified.

Mr. Kelley has been President and Chief Executive Officer of the Company since 1994. Prior to that he held senior management positions with TIE/Communications, Inc. from 1986 to 1994.

Mr. Brix has been a Vice President of the Company since 1994 with responsibility for U.S. sales and marketing. Prior to that he held senior sales management positions from 1987 to 1994.

Mr. Gagne has been a Vice President of the Company since 2006 with responsibility for engineering. Since 2001, he has been vice president of

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engineering for ThinkEngine Networks, Inc. which was acquired by the Company in 2005. Prior to that he held senior engineering positions.

Mr. Mayer has been Secretary of the Company since 1975. He was Treasurer from 1974 to 1989 and a Vice President of the Company from 1986 to 1996.

Mr. Sullivan has been Treasurer and Chief Financial Officer of the Company since 1989.

Mr. Zizzo has been a Vice President of the Company since 1995 with responsibility for operations, primarily manufacturing, purchasing and physical facilities, prior to which he had been Director of Operations since 1994.

PART II

Item 5. Market for Company's Common Equity Related Stockholder Matters and Issuer Purchases of Equity Securities

Cognitronics' Common Stock is traded on the American Stock Exchange under the symbol CGN. On March 1, 2006, there were 517 stockholders of record; the Company estimates that the total number of beneficial owners was approximately 2,200. Information on quarterly stock prices is set forth in Item 8 of this Annual Report on Form 10-K and is incorporated herein by reference.

The Company has never paid a cash dividend on its Common Stock and has used its cash for the development of its business. The Company has no present intention of paying a cash dividend and payment of any future dividends will depend upon the Company's earnings, financial condition and other relevant factors.

Item 6. Selected Financial Data

| | Year ended December 31, | | | | |
|---|--------------------------------------|----------|----------|----------|----------|
| | (in thousands except per share data) | | | | |
| OPERATING RESULTS | 2005 | 2004 | 2003 | 2002 | 2001 |
| | ---- | ---- | ---- | ---- | ---- |
| Revenues | \$7,750 | \$8,699 | \$5,096 | \$5,535 | \$12,977 |
| Loss from continuing operations | (2,591) | (341) | (3,482) | (6,361) | (872) |
| Loss from discontinued operations | (1,555) | (213) | (68) | (83) | (933) |
| Net loss | (4,146) | (554) | (3,550) | (6,444) | (1,805) |
| Loss per share | | | | | |
| Continuing operations | (0.44) | (0.06) | (0.62) | (1.17) | (0.16) |
| Discontinued operations | (0.26) | (0.04) | (0.01) | (0.02) | (0.17) |
| Net loss | (0.70) | (0.10) | (0.63) | (1.18) | (0.33) |
| Weighted average number of common shares outstanding, | 5,879 | 5,781 | 5,615 | 5,438 | 5,417 |
| FINANCIAL POSITION | | | | | |
| Working capital | \$7,251 | \$13,132 | \$12,851 | \$16,321 | \$23,092 |

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| | | | | | |
|--------------------------------|--------|--------|--------|--------|--------|
| Total assets | 21,205 | 18,956 | 18,898 | 22,812 | 28,573 |
| Stockholders' equity | 14,015 | 15,015 | 15,268 | 18,152 | 24,204 |
| Stockholders' equity per share | \$2.03 | \$2.59 | \$2.72 | \$3.34 | \$4.46 |
| Cash dividends paid | None | None | None | None | None |

Included in Continuing Operations in 2005 is the expensing of purchased in-process R&D of \$678,000 and an increase in deferred tax valuation allowance of \$829,000.

Included in Continuing Operations in 2004 is an inventory provision of \$666,000 and an increase in deferred tax valuation allowance of \$181,000.

Included in Continuing Operations in 2003 is an inventory provision of \$434,000 and an increase in deferred tax valuation allowance of \$1,151,000.

Included in Continuing Operations in 2002 is an inventory provision of \$951,000 and provisions for impairment of fixed assets of \$275,000 and an increase in the deferred tax valuation allowance of \$2,425,000.

Included in Continuing Operations in 2001 is an inventory provision of \$510,000 and a tax benefit due to an adjustment to the tax provision of \$155,000.

The above Selected Financial Data should be read in conjunction with the Consolidated Financial Statements of the Company, including the notes thereto, and the unaudited quarterly financial data included in Item 8 of this Annual Report on Form 10-K.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

Executive Summary

The Company designs, manufactures and sells voice processing equipment for use primarily in telecommunications service providers' central offices.

The Company's products include intelligent announcers, media servers and application servers. These products facilitate the deployment of voice resources in service providers' networks, both traditional circuit-switched networks, as well as the next generation of packet-based networks.

Beginning in 2001, expenditures for network development decreased significantly reflecting a decline in the competitive local exchange carrier market and reduced capital spending by large service providers. This trend intensified in 2002 and continued into 2003. The Company believes that the market for telecommunication equipment over the past several years has stabilized and is growing in certain areas, but the timing of such spending continues to be uncertain and may be adversely impacted by mergers and acquisitions among telecommunications service providers.

Established service providers are looking for ways to offer additional features on their legacy networks while they institute a multi-year plan to transition to IP based multimedia services. To effectively compete, the Company must expand its penetration in the market, increase the applications available on its intelligent peripherals, media servers and application servers and increase the capacity of its media servers.

Capital spending in the markets the Company serves can vary over a short period of time and change rapidly. In addition, the Company faces intense competition from larger and better financed competitors and a few customers account for a significant portion of the Company's revenue. As a result, the Company's performance is subject to large fluctuations. Because of these uncertainties, it is difficult for the Company to make accurate short and long-term

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projections of results of operations and cash flow.

In 2005 Revenues for Dacon Electronics, Plc (the Company's UK distributorship operation) decreased \$1.7 million (31%) to \$3.8 million and its loss from operations increased \$.9 million to \$1.1 million from 2004. In December 2005 the Company sold this operations.

As discussed more fully throughout the Management's Discussion and Analysis:

Loss from continuing operations increased in 2005 due to decreased revenues and higher research and development expenses.

The Company disposed of its European Distributorship Operations.

The Company acquired ThinkEngine Networks, Inc.

Results

The Company reported net losses from continuing operations of \$2.6 million, \$.3 million and \$3.5 million in 2005, 2004 and 2003, respectively.

In 2005, revenues decreased \$.9 million (11%) primarily due to decreased sales of \$1.3 million, offset, in part, by increased service revenue of \$.4 million. The lower sales were primarily due to a decrease in sales of \$5.0 million to a large telecommunications service provider. The Company has shipped approximately \$2.0 million of equipment to this customer in 2005 that will be recognized as revenue in the first quarter of 2006. This decrease was offset by increased sales of \$2.1 million to a telecommunication equipment integrator and \$1.1 million and \$.7 million to telecommunications service providers. ThinkEngine Networks, Inc. contributed less than \$.1 million in revenues in 2005. The Company's consolidated backlog at December 31, 2005 was \$3.1 million versus \$.4 million at December 31, 2004. A major portion of the Company's revenue came from a few customers. The loss of any of these customers would have a material adverse impact on the Company.

In 2004, revenues increased \$3.6 million (71%) from 2003 levels due to an increase in sales of the CX4000 to a large domestic telecommunications service provider. Sales to this customer increased \$3.7 million in 2004 from 2003, continuing a trend commenced in 2003. In addition, the increased revenues also resulted from an increase in service revenue resulting from the commencement of software and hardware maintenance agreements with a large customer.

Consolidated gross margin was 57% in 2005, 59% in 2004 and 30% in 2003. Included in cost of products sold was inventory obsolescence charges of \$.7 million in 2004 and \$.4 million in 2003. The decrease in gross margin percentage in 2005 from 2004 was primarily due to decreased sales volume and the increase in gross margin percentage in 2004 versus 2003 was primarily due to increased sales volume and improved product mix.

Research and development increased \$1.4 million (55%) in 2005 and decreased \$.2 million (5%) in 2004 from the prior year. The increase in 2005 primarily reflects the expensing of \$.7 million of purchased R&D, increased headcount and salaries and the acquisition of ThinkEngine. The decrease in 2004 primarily reflects lower personnel costs. The company anticipates increasing research and development expense in 2006.

Selling, general and administrative expense increased \$.3 million (11%) in 2005 and decreased \$.2 million (7%) in 2004 from the prior year period. In 2005, \$.1 million of the increase is due to the inclusion of ThinkEngine operations from November 18, 2005. The remaining increase is primarily due to increased personnel costs. In 2004, the decrease of \$.2 million is due to lower

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professional fees and personnel costs.

In 2003, other income includes a non-cash gain of \$.8 million on the termination of the Company's postretirement health benefits plan. Other income of \$.3 million in 2005, \$.2 million in 2004 and the remaining \$.2 million in 2003 is primarily interest income. The increase in 2005 primarily reflects higher interest rates.

The Company's effective tax rate for 2005 was (2%), for 2004 was (19%) and for 2003 was (2%). Deferred tax valuation allowances of \$.8 million in 2005, \$.2 million in 2004 and \$1.2 million in 2003 were included in tax expense. Forming a conclusion that such an allowance is not needed is difficult when there is evidence such as cumulative losses in recent years. The provision for income taxes is discussed in Note G to the Consolidated Financial Statements.

The effect of inflation has not had a significant impact on the operating results of the Company over the past few years. Technological advances and productivity improvements are continually being applied to reduce costs, thus reducing inflationary pressures on the operating results of the Company.

Total rental expense amounted to \$220,000 in 2005, \$190,000 in 2004 and \$186,000 in 2003. Future annual payments for long-term noncancellable leases for each of the five years in the period ending December 31, 2010 are approximately \$219,000, \$218,000, \$187,000, \$13,000 and \$0, respectively, and \$0 thereafter.

Off-Balance Sheet Arrangements

None.

Liquidity and Sources of Capital

Operations provided net cash of \$2.1 million in 2005 and used \$.3 million in 2004 and \$2.5 million in 2003. The cash provided by operations in 2005 is primarily attributable to \$2.1 million of prepaid revenue related to equipment shipped in 2005. The reduction in use of cash by operations in 2004 versus 2003 is due to the improvement in operating results. Cash (used) provided by investing activities was (\$2.5) million in 2005 and \$2.2 million in 2003. The Company used \$1.4 million in 2005 for the acquisition of ThinkEngine, had net purchases of marketable securities of \$.5 million in 2005 and net proceeds from sales of \$.1 million and \$2.4 million in 2004 and 2003 respectively. There were purchases of property, plant and equipment and software of \$.5 million, \$.1 million and, \$.2 million in 2005, 2004 and 2003, respectively.

Working capital was \$7.3 million at December 31, 2005, \$13.1 million at December 31, 2004 and \$12.9 million at December 31, 2003. The ratio of current assets to current liabilities was 2.1:1 at December 31, 2005 versus 5.5:1 at December 31, 2004 and 7.4:1 at December 31, 2003. The decreases in working capital in 2005 and 2004 from the prior year is due to the net loss and the Company's decision to terminate its defined benefit pension plan.

The Company's contractual obligations are as follows (amounts in thousands):

| Contractual Obligation | Payments due by period | | | | More than 5 years |
|------------------------|------------------------|------------------|-----------|-----------|-------------------|
| | Total | Less than 1 year | 1-3 Years | 3-5 Years | |
| Operating leases | \$637 | \$219 | \$405 | \$13 | \$0 |

The Company anticipates making capital expenditures of approximately \$.5 million, increasing the current level of expenditures for research and development and may repurchase up to 253,792 shares of its Common Stock in 2006. Based on current operating results, management believes that the cash

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and cash equivalents at December 31, 2005 will be sufficient to fund the Company's cash requirements for 2006; however, if the Company's operations deteriorate due to increased competition, loss of a large customer or otherwise, it may be required to obtain additional sources of funds through asset sales, capital market transactions or financing from third parties or a combination thereof. The Company cannot provide assurances that these additional sources of funds will be available or, if available, what the terms would be.

Assumptions and Estimates Used in Critical Accounting Policies

In the preparation of the financial statements in conformity with accounting principles generally accepted in the United States, management must make critical decisions regarding accounting policies and judgments regarding their application. Materially different amounts could be reported under different circumstances and conditions.

Revenue

We generally recognize product revenue, net of sales discounts and allowances, when persuasive evidence of an arrangement exists, shipment or delivery (dependent upon the terms of the sale) has occurred, all significant contractual obligations have been satisfied, the amount is fixed or determinable and collection is considered probable. Sales of services and system support are deferred and recognized ratably over the contract period.

Inventories - Slow-moving and Obsolescence

Due to a prolonged slow-down in spending by telecommunications service providers, inventory turnover has slowed. The Company recorded charges of \$.7 million and \$.4 million in 2004 and 2003, respectively, to reduce its carrying value of inventory to the lower of cost or market. If future capital expenditures by telecommunications service providers do not increase or decrease further, additional charges may be required.

Deferred Tax Assets

As of December 31, 2005, the Company has a valuation allowance of \$5.1 million for net deferred tax assets. In making such a determination, the Company considers its current and past performance, the market environment in which it operates, estimated future earnings, tax planning strategies and other factors. In the future, as these factors change, a change in the valuation reserve may be required. The Company will only recognize a deferred tax asset when, based upon available evidence, realization is more likely than not and will provide a valuation allowance as necessary.

Pensions

The Company accounts for its defined benefit pension plan in accordance with SFAS No. 87, "Employers' Accounting for Pensions" which requires that amounts recognized in financial statements be determined on an actuarial basis.

In 2006, the Company applied to the Pension Benefit Guarantee Corporation and the Internal Revenue Service for permission to terminate the Company's defined benefit plan. Reflecting this, the Company adjusted the discount rate used to calculate the plan liabilities to 4.73%.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The Company does not use derivative financial instruments. The Company's

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marketable securities consist of short-term and/or variable rate instruments and therefore a change in interest rates would not have a material impact on the value of these securities.

Item 8. Financial Statements and Supplementary Data

QUARTERLY FINANCIAL DATA (UNAUDITED) (in thousands except per share amounts)

| 2005, | First ----- | Second ----- | Third ----- | Fourth ----- |
|--|----------------|-----------------|----------------|-----------------|
| Revenues | \$1,721 | \$1,054 | \$ 986 | \$3,989 |
| Gross profit | 1,051 | 353 | 388 | 2,633 |
| Income(loss) from continuing operations | (498) | (1,241) | (1,065) | 213 |
| Loss from discontinued operations | (257) | (454) | (585) | (259) |
| Net loss | (755) | (1,695) | (1,650) | (46) |
| | | | | |
| Income (loss) per share | | | | |
| Continuing operations | (0.09) | (0.22) | (0.19) | .03 |
| Discontinued operations | (0.05) | (0.08) | (0.11) | (.04) |
| Net income (loss) | (0.13) | (0.30) | (0.29) | (.01) |
| | | | | |
| Common Stock price range | | | | |
| High | \$5.00 | \$4.05 | \$3.58 | \$3.10 |
| Low | 2.92 | 2.80 | 2.25 | 2.12 |
| | | | | |
| 2004 | First ----- | Second ----- | Third ----- | Fourth ----- |
| Revenues | 430 | 2,569 | 771 | 4,929 |
| Gross profit | (153) | 1,679 | 152 | 3,431 |
| Income(loss) from continuing operations | (1,537) | 283 | (1,192) | 2,105 |
| Income (loss) from discontinued operations | 186 | 93 | (156) | (336) |
| Net income (loss) | (1,351) | 376 | (1,348) | 1,769 |
| | | | | |
| Income (loss) per share | | | | |
| Continuing operations | (0.28) | 0.05 | (0.21) | 0.33 |
| Discontinued operations | 0.03 | 0.01 | (0.03) | (0.06) |
| Net income (loss) | (0.24) | 0.06 | (0.23) | 0.28 |
| | | | | |
| Common Stock price range | | | | |
| High | \$4.30 | \$4.50 | \$4.16 | \$4.35 |
| Low | 3.00 | 3.40 | 3.00 | 3.01 |

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In the fourth quarter of 2005, the Company expensed \$678,000 of purchased in process R&D in connection with the acquisition of ThinkEngine Networks, Inc. The gross margin percentage increased in the fourth quarter of 2005 to 66% from 48% for the first nine months primarily due to increased volume.

The gross margin percentage for the fourth quarter of 2004 was 65% versus 47% for the first nine months of 2004 primarily due to increased volume and an improved product mix.

The above financial information should be read in conjunction with the Consolidated Financial Statements, including the notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors of
Cognitronics Corporation

We have audited the accompanying consolidated balance sheets of Cognitronics Corporation and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the

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Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated 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. Our audits included 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cognitronics Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

/s/ Carlin, Charron & Rosen, LLP

Glastonbury, Connecticut
March 24, 2006

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

| | December 31, | |
|---|--------------|----------|
| | 2005 | 2004 |
| | ---- | ---- |
| ASSETS | (See Note A) | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 1,750 | \$ 2,222 |
| Marketable securities | 6,370 | 5,847 |
| Accounts receivable, less allowances of \$73 and \$46 | 3,565 | 3,737 |
| Inventories | 2,245 | 1,595 |
| Other current assets | 137 | 148 |
| Assets - discontinued operations | | 2,486 |
| | ----- | ----- |
| TOTAL CURRENT ASSETS | 14,067 | 16,035 |
| LOANS TO OFFICERS | 2,029 | 1,968 |
| PROPERTY, PLANT AND EQUIPMENT, net | 1,208 | 806 |
| OTHER ASSETS, less amortization of \$117 and \$533 | 3,901 | 147 |
| | ----- | ----- |
| | \$21,205 | \$18,956 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 814 | \$ 86 |

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| | | |
|--|----------|----------|
| Notes payable | 300 | |
| Accrued compensation and benefits | 1,817 | 842 |
| Deferred service revenues | 2,976 | 416 |
| Income taxes payable | 405 | 333 |
| Other accrued expenses | 504 | 338 |
| Liabilities - discontinued operations | | 888 |
| | ----- | ----- |
| TOTAL CURRENT LIABILITIES | 6,816 | 2,903 |
| OTHER LIABILITIES | 374 | 1,038 |
| COMMITMENTS AND CONTINGENCIES (Note k) | | |
| STOCKHOLDERS' EQUITY | | |
| Common Stock, par value \$.20 per share; authorized 20,000,000 shares; issued 7,016,583 and 5,866,878 shares | 1,403 | 1,173 |
| Additional paid-in capital | 15,498 | 12,586 |
| Retained earnings (accumulated deficit) | (1,281) | 2,865 |
| Cumulative other comprehensive loss | (580) | (225) |
| Unearned compensation | (156) | (303) |
| | ----- | ----- |
| | 14,884 | 16,096 |
| Less cost of 111,142 and 138,308 common shares in Treasury | (869) | (1,081) |
| | ----- | ----- |
| TOTAL STOCKHOLDERS' EQUITY | 14,015 | 15,015 |
| | ----- | ----- |
| | \$21,205 | \$18,956 |
| | ===== | ===== |

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

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
COGNITRONICS CORPORATION AND SUBSIDIARIES
(in thousands except per share data)

| | Year ended December 31, | | |
|--|-------------------------|---------|---------|
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| | (See Note A) | | |
| REVENUES | | | |
| Sales | \$6,666 | \$8,006 | \$4,879 |
| Service | 1,084 | 693 | 217 |
| | ----- | ----- | ----- |
| | 7,750 | 8,699 | 5,096 |
| COST AND EXPENSES | | | |
| Cost of revenues | 3,323 | 3,590 | 3,591 |
| Research and development | 3,853 | 2,438 | 2,619 |
| Selling, general and administrative | 3,432 | 3,097 | 3,314 |
| Other (income) expense, | (327) | (140) | (1,009) |
| | ----- | ----- | ----- |
| | 10,281 | 8,985 | 8,515 |
| | ----- | ----- | ----- |
| Pretax lox | (2,531) | (286) | (3,419) |
| PROVISION FOR INCOME TAXES | 60 | 55 | 63 |
| | ----- | ----- | ----- |
| LOSS FROM CONTINUING OPERATIONS | (2,591) | (341) | (3,482) |
| LOSS FROM DISCONTINUED OPERATIONS NET OF TAX | (1,555) | (213) | (68) |
| | ----- | ----- | ----- |
| NET LOSS | (4,146) | (554) | (3,550) |
| Currency translation adjustment | (170) | 121 | 129 |

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| | | | |
|------------------------------------|------------|-----------|------------|
| Minimum pension liability | (185) | (248) | 71 |
| | ----- | ----- | ----- |
| COMPREHENSIVE LOSS | \$ (4,501) | \$ (681) | \$ (3,350) |
| | ===== | ===== | ===== |
| LOSS PER SHARE - BASIC AND DILUTED | | | |
| LOSS FROM CONTINUING OPERATIONS | \$ (0.44) | \$ (0.06) | \$ (0.62) |
| LOSS FROM DISCONTINUED OPERATIONS | \$ (0.26) | \$ (0.04) | \$ (0.01) |
| NET LOSS | \$ (0.71) | \$ (0.10) | \$ (0.63) |

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

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
 COGNITRONICS CORPORATION AND SUBSIDIARIES
 Years ended December 31, 2003, 2004 and 2005
 (dollars in thousands)

| | Common Shares Issued | Stock Amount | Additional Paid-In Capital | Retained Earnings (Deficit) | Compre- hensive (Loss) |
|---|----------------------------|-----------------|----------------------------------|-----------------------------------|------------------------------|
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2002 | 5,863,229 | \$1,173 | \$13,192 | \$6,969 | \$ (298) |
| Shares issued pursuant to stock plans | | | (610) | | |
| Shares issued to directors | | | (14) | | |
| Directors' fees - common stock to be issued | | | 75 | | |
| Officers' awards - common stock to be issued | | | 151 | | |
| Currency translation adjustment | | | | | 129 |
| Minimum pension liability | | | | | 71 |
| Net loss | | | | (3,550) | |
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2003 | 5,863,229 | 1,173 | 12,794 | 3,419 | (98) |
| Shares issued pursuant to stock plans | 3,649 | | (116) | | |
| Shares issued to directors | | | (290) | | |
| Directors' fees - common stock to be issued | | | 47 | | |
| Officers' awards - common stock to be issued | | | 151 | | |
| Currency translation adjustment | | | | | 121 |
| Minimum pension liability | | | | | (248) |
| Net loss | | | | (554) | |

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| | | | | | |
|---|-----------|---------|----------|-----------|---------|
| Balance at December 31, 2004 | 5,866,878 | 1,173 | 12,586 | 2,865 | (225) |
| Shares issued pursuant to stock plans | | | (168) | | |
| Shares issued in connection with acquisition | 1,149,705 | 230 | 2,897 | | |
| Directors' fees - common stock to be issued | | | 20 | | |
| Officers' awards - common stock to be issued | | | 163 | | |
| Currency translation adjustment | | | | | (170) |
| Minimum pension liability | | | | | (185) |
| Net loss | | | | (4,146) | |
| Balance at December 31, 2005 | 7,016,583 | \$1,403 | \$15,498 | \$(1,281) | \$(580) |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS
COGNITRONICS CORPORATION AND SUBSIDIARIES
(dollars in thousands)

| | Year ended December 31, | | |
|--|-------------------------|--------------|----------------|
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| | (See Note A) | | |
| OPERATING ACTIVITIES | | | |
| Loss from continuing operations | \$ (2,591) | \$ (341) | \$ (3,482) |
| Adjustments to reconcile net loss to net cash used by operating activities: | | | |
| Income tax expense | 60 | 55 | 63 |
| Depreciation and amortization | 373 | 349 | 502 |
| Expensing of purchased R&D | 678 | | |
| (Gain) loss on disposition of assets | 1 | (1) | 2 |
| Shares issued as compensation | 330 | 404 | 454 |
| Net (increase) decrease in | | | |
| Accounts receivable | 438 | (3,512) | 358 |
| Inventories | 189 | 527 | 885 |
| Other assets | 99 | 2,205 | (329) |
| Net increase (decrease) in | | | |
| Accounts payable | 550 | (138) | 57 |
| Accrued compensation and benefits | (136) | (95) | (1,047) |
| Other accrued liabilities | 2,128 | 363 | 125 |
| | 2,119 | (184) | (2,412) |
| Income taxes paid | (5) | (81) | (60) |
| NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES | 2,114 | (265) | (2,472) |
| INVESTING ACTIVITIES | | | |
| Purchase of marketable securities | (10,412) | (7,646) | (5,713) |
| Sale of marketable securities | 9,889 | 7,755 | 8,144 |
| Acquisition of ThinkEngine Networks, Inc. (Note I) | (1,442) | | |
| Additions to property, plant and equipment | (512) | (72) | (144) |
| Purchase of software licenses | (33) | (51) | (36) |
| NET CASH (USED) PROVIDED BY INVESTING ACTIVITIES | (2,510) | (14) | 2,251 |
| FINANCING ACTIVITIES | | | |

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| | | | |
|--|---------|---------|---------|
| Shares issued pursuant to stock plans, | 45 | 24 | 10 |
| | ----- | ----- | ----- |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 45 | 24 | 10 |
| | ----- | ----- | ----- |
| DISCONTINUED OPERATIONS | (121) | 257 | |
| | ----- | ----- | ----- |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (472) | 2 | (211) |
| CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR | 2,222 | 2,220 | 2,431 |
| | ----- | ----- | ----- |
| CASH AND CASH EQUIVALENTS - END OF YEAR | \$1,750 | \$2,222 | \$2,220 |
| | ===== | ===== | ===== |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS COGNITRONICS CORPORATION AND SUBSIDIARIES

Note A. Summary of Significant Accounting Policies

Organization. The Company designs, manufactures and markets voice processing products.

Risks and Uncertainties. A major portion of the Company's revenues is generated by sales to a small number of customers. The Company had net revenue of \$1.4 million, \$6.8 million and \$2.8 million in 2005, 2004 and 2003, respectively, to one major customer and in 2005 net revenue of \$2.1 million and \$1.1 million to two other customers. The loss of any of these customers would have a material adverse impact on the Company. The Company's receivables are primarily from major, well-established companies in the telecommunications industry, and at December 31, 2005, three such companies accounted for 75% of the Company's accounts receivable. The Company's markets are subject to rapid technological change and frequent introduction of new products. The Company's products are similar to those manufactured, or capable of being manufactured, by a number of companies, some of which are well established with financial, personnel and technical resources substantially larger than those of the Company. The Company's ability to compete in the future depends on its ability to maintain the technological and performance advantages of its current products and to introduce new products and applications that achieve market acceptance.

Principles of Consolidation. The financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. Intercompany accounts and transactions have been eliminated in consolidation.

Revenue Recognition. We generally recognize product sales, net of sales discounts and allowances, when persuasive evidence of an arrangement exists, shipment or delivery (dependent upon the terms of the sale) has occurred, all significant contractual obligations have been satisfied, the amount is fixed or determinable and collection is considered probable. Sales of services and system support are deferred and recognized ratably over the contract period.

Research and Development Costs. Research and development costs include the costs of engineering, design, feasibility studies, outside services, personnel and other costs incurred in development of the Company's products. All such costs are charged to expense as incurred.

Use of Estimates. The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported

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in the financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Value of Financial Instruments. The carrying amounts of the Company's financial instruments (trade receivables/payables and other short-term and long-term debt) due to their terms and maturities approximate fair value.

Cash and Cash Equivalents. The Company considers financial instruments with a maturity of three months or less from the date of purchase to be cash equivalents. At December 31, 2005, essentially all of the Company's cash and cash equivalent balances were with two financial institutions.

Marketable Securities. Marketable securities are classified as available for sale and are reported at fair value which approximates amortized cost. They are comprised of investments in municipal bond funds and high grade corporate debt and auction rate preferred equity securities. The maturities are short term or have reset provisions.

Inventories. Inventories are stated at the lower of cost (first-in, first-out method) or market. Provisions for slow moving and obsolete inventories are provided based on historical experience and product demand.

Property, Plant and Equipment. Property, plant and equipment is carried at cost less allowances for depreciation, computed in accordance with the straight-line method based on estimated useful lives. The estimated lives for machinery and equipment are 5 to 12 years and for furniture and fixtures are 3 to 10 years. Repairs and maintenance are expensed when incurred.

Income Taxes. Income taxes are provided on all revenue and expense items included in the consolidated statement of operations, regardless of the period in which such items are recognized for income tax purposes, adjusted for items representing permanent differences between pretax accounting income and taxable income. Deferred income taxes result from the future tax consequences associated with temporary differences between the carrying amounts of assets and liabilities for tax and financial reporting purposes. A valuation allowance is provided to the extent the Company cannot determine that the ultimate realization of net deferred tax assets is more likely than not.

Stock Based Compensation. The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value (85% of the fair value for the Stock Purchase Plan) at the date of grant. The Company accounts for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and therefore recognizes no compensation expense for stock options granted.

If the Company had elected to recognize compensation expense for the 1990 Stock Option Plan, the 1967 Stock Purchase Plan and the Directors' Stock Option Plan based on the fair value at the grant date, consistent with the method presented by Statement of Financial Accounting Standards ("SFAS") No.123, "Accounting for Stock Based Compensation", as amended, the pro forma net loss and net loss per share would be as follows (in thousands except per share information):

| | 2005 | 2004 | 2003 |
|--|-----------|---------|-----------|
| | ---- | ---- | ---- |
| Net loss, as reported | \$(4,146) | \$(554) | \$(3,550) |
| Add: Stock-based compensation expense included therein | 330 | 404 | 454 |
| Deduct: Total stock-based compensation under fair valuation method | (742) | (707) | (843) |
| | ----- | ----- | ----- |
| Pro forma net loss | \$(4,558) | \$(857) | \$(3,939) |
| | ===== | ===== | ===== |

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| | | | |
|--|---------|---------|---------|
| Net loss per share As reported Basic and Diluted | \$(.70) | \$(.10) | \$(.63) |
| Pro forma Basic and Diluted | \$(.78) | \$(.15) | \$(.70) |

The estimated weighted average fair value per share of stock options granted were \$1.58, \$2.56 and \$1.49 for 2005, 2004 and 2003, respectively. The fair value for the stock options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 2005, 2004 and 2003, respectively: risk-free interest rates of 4.4%, 4.4% and 2.2%; no dividend yields; volatility factors of the expected market price of the Company's common stock of .55 in 2005, .73 in 2004 and .67 in 2003; and a weighted average expected life of the option of 7.5 years in all years for the Option Plan and 5 years for the Directors' Option Plan.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options.

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

SFAS No. 123(R) allows the use of both closed form models (e.g., Black-Scholes Model) and open form models (e.g., lattice models) to measure the fair value of the share-based payment as long as that model is capable of incorporating all of the substantive characteristics unique to share-based awards. In accordance with the transition provisions of SFAS No. 123 (R), the expense attributable to an award will be measured in accordance with the Company's measurement model at that award's date of grant. The Company is currently evaluating the impact of the adoption of SFAS No. 123(R) on the Company's financial position and results of operations.

Income (Loss) Per Share. In computing basic earnings (loss) per share, the dilutive effect of stock options and warrants are excluded, whereas for diluted earnings per share they are included. The shares used in both the basic and diluted earnings per share calculations were 5,878,785, 5,780,603 and 5,614,825 for 2005, 2004 and 2003, respectively.

Goodwill. The Company has classified as goodwill the cost in excess of fair value of the net assets of companies acquired in purchase transactions. Goodwill and other long-lived assets were reviewed for impairment whenever events such as product discontinuances, plant closures, product dispositions or other changes in circumstances indicate that the carrying amount may not be recoverable. An impairment charge is recognized if a reporting unit's goodwill carrying amount exceeds its implied fair value.

In the third quarter of 2005, the Company, based on the continuing losses Of its UK subsidiary, determined that the related goodwill was impaired and

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Expensed \$319,000 of goodwill. This amount is included in loss from discontinued operations.

Reclassification. Certain prior year amounts have been reclassified to conform to the current year presentation.

Note B. Marketable Securities

The Company's marketable securities consist of corporate and municipal bonds and auction rate preferred stock. Unrealized gains/losses on marketable securities were immaterial in all years presented and therefore have not impacted cumulative other comprehensive loss. Management believes that the Company's marketable securities are sufficiently diversified to minimize risks from individual and industry concentrations. However, marketable securities are subject to fluctuations in market value due to risks of securities markets as a whole.

Note C. Accounts Receivable

The allowance for doubtful accounts was increased by \$65,000, \$34,000 and \$40,000 in 2005, 2004 and 2003, respectively, by charges to costs and expenses. The Company wrote off uncollectible accounts, net of recoveries, of \$38,000, \$23,000 and \$15,000 in 2005, 2004 and 2003, respectively. The allowance is based on historical trends, aging of accounts receivable balances and the credit worthiness of the customer.

Note D. Inventories, net (in thousands):

| | 2005 | 2004 |
|-------------------------------|---------|---------|
| | ---- | ---- |
| Finished and in process | \$1,571 | \$864 |
| Materials and purchased parts | 674 | 731 |
| | ----- | ----- |
| | \$2,245 | \$1,595 |
| | ===== | ===== |

Included in the above amounts is the Company's reserve for slow moving and obsolete inventories totaling \$3,054,000 and \$3,163,000 at December 31, 2005 and 2004, respectively. The provision for slow moving and obsolete inventories was increased by \$666,000 and \$293,000 in 2004 and 2003, respectively by charges to cost of products sold and was reduced by \$109,000 in 2005 due to the sale of the reserved items.

Note E. Property, Plant and Equipment, net (in thousands):

| | 2005 | 2004 |
|----------------------------------|---------|---------|
| | ---- | ---- |
| Machinery and equipment | \$2,870 | \$2,245 |
| Furniture and fixtures | 1,174 | 1,147 |
| | ----- | ----- |
| | 4,044 | 3,392 |
| Less allowances for depreciation | 2,836 | 2,586 |
| | ----- | ----- |
| | \$1,208 | \$ 806 |
| | ===== | ===== |

The Company has recorded depreciation expense of \$269,000, \$277,000 and \$290,000 in 2005, 2004 and 2003, respectively.

Note F. Other Liabilities (in thousands):

| | 2005 | 2004 |
|--|--------|--------|
| | ---- | ---- |
| Accrued officers' supplemental pension | \$ 313 | \$ 368 |
| Accrued deferred compensation | 176 | 207 |
| Accrued defined benefit pension plan | 775 | 740 |

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| | | |
|--|--------|---------|
| | ----- | ----- |
| | 1,264 | 1,315 |
| Less current portion (included in accrued compensation and benefits) | 890 | 277 |
| | ----- | ----- |
| | \$ 374 | \$1,038 |
| | ===== | ===== |

Note G. Income Taxes

The components of the provision (benefit) for income taxes for the years ended December 31 are as follows (in thousands):

| | | | |
|-------------------|------|------|------|
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| Current: | | | |
| State | \$60 | \$55 | \$63 |
| Deferred | 0 | 0 | 0 |
| | --- | --- | --- |
| Total Tax Expense | \$60 | \$55 | \$63 |
| | === | === | === |

Deferred income taxes reflect the net tax effects of temporary differences between carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets as of December 31, 2005 and 2004 are as follows (in thousands):

| | | |
|--|---------|---------|
| | 2005 | 2004 |
| | ----- | ----- |
| Deferred tax liabilities | \$ 84 | \$ 96 |
| Deferred tax assets: | | |
| Inventory valuation | 1,174 | 1,252 |
| Accrued liabilities and employee benefits | 2,146 | 1,272 |
| Accrued deferred compensation | 167 | 199 |
| Federal operating loss carryforward expiring in 2019 | 1,007 | 981 |
| Separate return federal operating loss carryforwards expiring in 2008 and 2009 | 445 | 445 |
| Other | 222 | 195 |
| | ----- | ----- |
| Total deferred tax assets | 5,161 | 4,344 |
| Valuation allowance | (5,077) | (4,248) |
| | ----- | ----- |
| | 84 | 96 |
| | ----- | ----- |
| Net deferred tax assets | \$ 0 | \$ 0 |
| | ===== | ===== |

The Company has increased its valuation allowances by \$829,000, \$181,000 and \$1,151,000 in 2005, 2004 and 2003, respectively, as the Company cannot determine that the ultimate realization of its net deferred tax asset is more likely than not.

A reconciliation of the statutory federal income tax rate to the effective tax rate on pre tax loss for the years ended December 31, is as follows:

| | | | |
|--|---------|---------|---------|
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| Statutory federal income tax rate | (34.0)% | (34.0)% | (34.0)% |
| State income taxes, net of federal tax benefit | 1.4 | 12.7 | 1.2 |
| Write-off of purchased R&D, | 6.9 | | |
| Nontaxable interest income | (.8) | (1.0) | |
| Goodwill amortization | (1.0) | (9.4) | (.1) |
| Valuation allowance | 29.8 | 63.3 | 33.7 |
| Other | .1 | (12.4) | 1.0 |
| | ----- | ----- | ----- |
| | 2.4% | 19.2% | 1.8% |

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| | ==== | ==== | ==== |
|---|-------------------------|----------|------------|
| Note H. Other (Income) Expense, Net (in thousands): | Year Ended December 31, | | |
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| Interest expense | \$ 25 | \$ 14 | \$ 17 |
| Interest income | (352) | (154) | (177) |
| Settlement gain in plan termination | | | (849) |
| | ----- | ----- | ----- |
| | \$ (327) | \$ (140) | \$ (1,009) |
| | ===== | ===== | ===== |

Note I. Acquisition

On November 18, 2005, the Company acquired ThinkEngine Networks, Inc. ("ThinkEngine") at a cost of \$4,869,000 including \$1,250,000 in cash, 1,149,705 shares of Common Stock valued at \$3,127,000, \$300,000 in one year interest-free notes and other costs of \$192,000. ThinkEngine, based in Marlborough, Massachusetts, is an innovative provider of carrier-grade Voice over Internet Protocol (VOIP) solutions.

The acquisition has been accounted for by the purchase method. The purchase price was allocated to purchased in process research and development (\$678,000), net current and long term assets (\$308,000) and the value of intangible assets (\$3,883,000) with estimated remaining useful lives of four to ten years. The following are unaudited pro forma results of operations as if the acquisition had taken place at the beginning of the respective year (in thousands except per share amounts):

| | 2005 | 2004 | 2003 |
|---------------------------------|------------|------------|------------|
| | ---- | ---- | ---- |
| Revenues | \$ 8,762 | \$ 9,348 | \$ 5,172 |
| Loss from continuing operations | \$ (6,048) | \$ (4,708) | \$ (7,281) |
| Net loss | \$ (7,599) | \$ (5,048) | \$ (7,349) |
| Loss per share: | | | |
| Loss from continuing operations | \$ (0.89) | \$ (0.68) | \$ (1.08) |
| Net Loss | \$ (1.11) | \$ (0.71) | \$ (1.09) |

Note J. Discontinued Operations

On December 22, 2005, the Company sold its UK subsidiary, Dacon Electronics, Plc ("Dacon") in an arms length transaction to a company owned by the former Vice President of European Operations for \$150,000 in cash and a \$150,000 note. In addition, Dacon issued a note for \$275,000 for amounts previously advanced to Dacon by the Company. A charge of \$425,000 to reserve for these two notes was included in the loss on sale of discontinued operations.

As a result, the Company has reclassified Dacon's operations as discontinued operations and, accordingly, has segregated the assets, liabilities, revenues and expenses of the discontinued operations in its Consolidated Balance Sheets, Statement of Operations and notes thereto.

Assets and liabilities of the discontinued operations at December 31, 2004 are as follows (in thousands):

| | |
|--------------------------|---------|
| Assets | |
| Cash | \$ 614 |
| Accounts receivable, net | 729 |
| Other current assets | 708 |
| Fixed assets, net | 116 |
| Goodwill, net | 319 |
| | ----- |
| Total assets | \$2,486 |

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| | |
|---------------------------|--------|
| | ===== |
| Liabilities | |
| Accounts payable | \$ 262 |
| Other current liabilities | 466 |
| Deferred revenue | 160 |
| | ----- |
| Total liabilities | \$ 888 |
| | ===== |

Summary results for discontinued operations for the years ended December 31 are as follows (in thousands).

| | 2005 | 2004 | 2003 |
|-----------------------------------|------------|----------|---------|
| | ---- | ---- | ---- |
| Revenue | \$ 3,826 | \$5,526 | \$5,161 |
| Operating expense | 4,976 | 5,739 | 5,229 |
| | ----- | ----- | ----- |
| Operating loss | (1,150) | (213) | (68) |
| Loss on impairment of goodwill | (319) | | |
| Loss on sale | (86) | | |
| | ----- | ----- | ----- |
| Loss from discontinued operations | \$ (1,555) | \$ (213) | \$ (68) |
| | ===== | ===== | ===== |

Note K. Commitments and Contingencies

Leases. Total rental expense amounted to \$220,000 in 2005, \$190,000 in 2004 and \$186,000 in 2003. Future annual payments for long-term noncancellable leases for each of the four years in the period ending December 31, 2009 are approximately \$219,000, \$218,000, \$187,000 and \$13,000, respectively, and \$0 thereafter.

Pension Plan. The Company and its domestic subsidiaries have a defined benefit pension plan covering substantially all employees. The benefits are based on years of service and the employee's compensation. No additional service cost benefits were earned subsequent to June 30, 1994. Because of this curtailment of the Plan in 1994, at this time the Projected Benefit Obligation and Accumulated Benefit Obligation are the same. The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, plus such additional amounts as the Company may determine to be appropriate from time to time. The components of net cost of the plan for the years ended December 31 are as follows (in thousands):

| | 2005 | 2004 | 2003 |
|--|-------|-------|-------|
| | ---- | ---- | ---- |
| Interest cost on projected benefit obligation, | \$ 91 | \$ 92 | \$106 |
| Actual (return)/loss on plan assets | (33) | (14) | (109) |
| Net amortization and deferral | (3) | (33) | 63 |
| Settlement loss | | | 58 |
| | ----- | ----- | ----- |
| Net periodic pension cost | \$ 55 | \$ 45 | \$118 |
| | ===== | ===== | ===== |

The following table sets forth the plan's funded status and the accrued pension liability recognized in the Company's Consolidated Balance Sheets at December 31 (in thousands):

| | 2005 | 2004 |
|--|---------|---------|
| Projected and accumulated benefit obligation for services rendered to date | | |
| Beginning of year | \$1,681 | \$1,489 |
| Loss (gain) due to change in estimates | 183 | 214 |
| Interest cost | 91 | 92 |

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| | | |
|---|----------|----------|
| Less benefits paid | (112) | (114) |
| | ----- | ----- |
| End of year | 1,843 | 1,681 |
| | ----- | ----- |
| Plan assets at fair value | | |
| Beginning of year | 941 | 825 |
| Actual return on plan assets | 33 | 14 |
| Contribution | 206 | 216 |
| Less benefits paid | (112) | (114) |
| | ----- | ----- |
| End of year | 1,068 | 941 |
| | ----- | ----- |
| Plan assets less than benefit obligation | (775) | (740) |
| Unrecognized net loss | 709 | 524 |
| Minimum pension liability adjustment | (709) | (524) |
| | ----- | ----- |
| Accrued pension liability (included in other liabilities) | \$ (775) | \$ (740) |
| | ===== | ===== |

The discount rates used in determining the projected benefit obligation were 4.7% in 2005 and 5.5% in 2004. The expected long-term rate of return on plan assets used in determining the net periodic pension cost was 6.5% in 2005 and 2004. In determining the expected return on plan assets, the Company considers the relative weighting of plan assets, the historical performance of total plan assets and individual assets categories and economic and other indicators of future performance. The Company may also consult with other professionals in developing expected returns. The plan's weighted-average asset allocations at December 31, 2005 and 2004 by asset category, are as follows:

| Asset Category, | 2005 | 2004 |
|---------------------------|------|------|
| Equity Securities | 51% | 56% |
| Debt Securities | 25% | 31% |
| Cash and cash equivalents | 24% | 13% |

In 2006, the Company applied to the Pension Benefit Guarantee Corporation and the Internal Revenue Service for permission to terminate this Plan. Reflecting this, the Company intends to contribute approximately \$800,000 in 2006 to this plan and \$1,870,000 in benefit payments is expected to be paid in 2006. When the Company terminates the Plan, it will recognize an expense of approximately \$709,000.

401(k) Retirement Plan. The Company has a defined contribution plan covering substantially all domestic employees. The Company's contribution, until June of 2003 was based upon the participants' contributions. In June of 2003, the Company suspended its contribution. The expense was \$23,000 in 2003.

Officers' Supplemental Pension Plan. The Company has an unfunded, noncontributory defined benefit pension plan covering certain retired officers. The components of net pension cost of the plan for the years ended December 31 are as follows (in thousands):

| | | | |
|---|------|------|------|
| | 2005 | 2004 | 2003 |
| | ---- | ---- | ---- |
| Interest cost on projected benefit obligation | \$16 | \$19 | \$24 |
| Amortization of actuarial gains | (1) | (2) | (3) |
| | --- | --- | --- |
| Net periodic pension cost | \$15 | \$17 | \$21 |
| | === | === | === |

The following table sets forth the plan's status and the accrued pension liability recognized in the Company's Consolidated Balance Sheets at

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| December 31 (in thousands): | 2005 | 2004 |
|---|-------|-------|
| Projected benefit obligations | | |
| Balance at beginning of period | \$322 | \$347 |
| Loss due to change in estimate | | 25 |
| Interest expense | 16 | 19 |
| Less benefits paid | (70) | (69) |
| | ---- | ---- |
| Balance at end of period | 268 | 322 |
| Unrecognized net gain | 45 | 46 |
| | ---- | ---- |
| Accrued pension liability (included in other liabilities) | \$313 | \$368 |
| | ==== | ==== |

The discount rate used in determining the projected benefit obligation was 5.5% in 2005 and 2004. All participants are retired and receiving benefits under the Plan and therefore future increases in compensation are not applicable. The following benefit payments and contributions are expected to be paid: \$69,000 in 2006, \$65,000 in 2007, \$50,000 in 2008, \$50,000 in 2009, \$50,000 in 2010 and an aggregate of \$23,000 for the five year period ending in 2015.

Other Postretirement Benefit Plans. In addition to the Company's pension plans, the Company had a contributory, unfunded defined benefit plan providing certain health care benefits for domestic employees who retired prior to March 31, 1996, which was terminated effective December 31, 2003. The components of postretirement benefit cost for the year ended December 31, 2003 are as follows (in thousands):

| | |
|-------------------|---------|
| | 2003 |
| | ---- |
| Interest cost | \$ 45 |
| Net amortization | (9) |
| Settlement gain | (849) |
| | ----- |
| Net periodic cost | \$(813) |
| | ===== |

The net benefits paid were \$32,000 for 2003.

Deferred Compensation. At December 31, 2005 and 2004, the liability relating to a deferred compensation arrangement between the Company and a former director and officer of the Company was \$176,000 and \$207,000, respectively and is included in other liabilities. The Company expects to make payments in 2006 totaling \$46,000 under this contract.

Note L. Stock Plans

The 1990 Stock Option Plan provides for the grant, at fair market value on the date of grant, of nonqualified stock options and incentive stock options. Options generally become exercisable in three equal annual installments on a cumulative basis commencing six months from the date of grant and expire ten years after the date granted.

The Company also has the 1967 Employee Stock Purchase Plan which provides for the grant to purchase shares at 85% of the fair market value of the stock on the date offered. Generally, rights to purchase shares under this plan expire 12 months (maximum 27 months) after the date of grant. For each of the three years in the period ended December 31, 2005, no grants were granted, exercised or cancelled. At December 31, 2005, there were no grants outstanding and there were 52,478 shares available for future grant.

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The Company also has a time accelerated restricted stock plan ("Restricted Stock Plan") which provides for the award of shares to key employees; generally, the awards vest in five equal annual installments commencing two years after the date of the award. Vesting may be accelerated based on the achievement of certain financial performance goals.

The Company may, in certain circumstances, offer nonqualified options as an inducement to enter into employment with the Company (Inducement Options). Options generally become available in three equal annual installments on a cumulative basis generally commencing six months after the date of grant and expiring in 10 years.

In 2002, the company granted to key employees the right to receive 395,000 common shares which vested on January 2, 2006. Such rights were subject to immediate vesting in the event of change of control of the Company and pro-rata vesting in the event of death or involuntary termination of employment for reasons other than cause. The total value of the rights at the date of grant was \$612,000 and was based on the market price of \$1.55 per share.

The Directors' Stock Option Plan provides for an annual grant of options to non-employee officers and directors. This plan provides for the automatic award of options to purchase 3,000 shares of Common Stock at the fair market value at the date of grant to each person who is a participant on August 1 of each year and pro-rated awards in certain cases. The awards expire five years (ten years for awards granted after 2000) after the date granted. In 2002, the plan was amended to provide for grant on November 9, 2002 of options to purchase 5,500 shares for each participant, and in 2003 the plan was amended to increase the amount granted to 6,000 shares for each participant.

Share information pertaining to these plans is as follows:

| | Inducement Options | 1990 Options Plan | Restricted Stock Plan | Directors' Option Plan |
|-----------------------------------|-----------------------|-------------------------|-----------------------------|------------------------------|
| | ----- | ----- | ----- | ----- |
| Outstanding at December 31, 2002 | 0 | 1,040,325 | 258,680 | 101,250 |
| Granted | | 248,500 | 103,187 | 36,000 |
| Cancelled or expired | | (154,525) | | (12,000) |
| Vested | | | (32,830) | |
| Exercised | | (3,000) | | |
| | ----- | ----- | ----- | ----- |
| Outstanding at December 31, 2003 | 0 | 1,131,300 | 329,037 | 125,250 |
| Granted | | 3,000 | | 30,000 |
| Cancelled or expired | | (144,751) | | (12,000) |
| Vested | | | (53,550) | |
| Exercised | | (12,497) | | (14,500) |
| | ----- | ----- | ----- | ----- |
| Outstanding at December 31, 2004, | 0 | 977,052 | 275,487 | 128,750 |
| Granted | 705,000 | 167,000 | | 30,000 |
| Cancelled or expired | | (26,667) | (22,900) | |
| Vested | | | (70,137) | |
| Exercised | | (27,166) | | |
| | ----- | ----- | ----- | ----- |
| Outstanding at December 31, 2005 | 705,000 | 1,090,219 | 182,450 | 158,750 |
| | ===== | ===== | ===== | ===== |
| Available for future grant | | 8,515 | 22,900 | 28,750 |
| | | ===== | ===== | ===== |

Under the 1990 Option Plan, the exercise price for options granted in 2003 was \$2.20, in 2004 was \$3.50 and in 2005 was \$2.70. The weighted average exercise

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price for the options outstanding under the Option Plan is \$3.95 with expiration dates ranging from 2010 to 2015. Options were exercised under the Option Plan at weighted average exercise prices of \$1.55, \$1.65 and \$1.66 in 2003, 2004 and 2005, respectively. Shares exercisable under the Option Plan and weighted average exercise price at December 31, 2003, 2004 and 2005 were 681,764 and \$6.53, 708,058 and \$4.88 and 841,729 and \$4.37, respectively. The weighted average remaining lives for options outstanding at December 31, 2003, 2004 and 2005 were 7.3, 8.25 and 6.76 years, respectively.

Under the Restricted Stock Plan compensation expense was \$146,000, \$208,000 and \$228,000 in 2005, 2004 and 2003, respectively.

The exercise price for options granted in 2003, 2004 and 2005 under the Directors' Stock Option Plan were \$2.11, \$3.50 and \$3.22, respectively. The weighted average exercise price for the options outstanding under the plan is \$3.59 with expiration dates ranging from 2006 to 2015. No options were exercised in 2003 and 2005; in 2004, options with a weighted average exercise price of \$1.93 were exercised. Shares exercisable at December 31, 2003, 2004 and 2005 were 101,250, 104,750 and 128,750, respectively. The weighted average remaining lives for options outstanding at December 31, 2003, 2004 and 2005 were 7.6, 7.6 and 7.5 years, respectively.

The exercise price for 705,000 inducement options granted in 2005, in connection with the acquisition of ThinkEngine Networks were issued at an exercise price of \$2.55 with expiration in 2015. At December 31, 2005, 70,000 shares were exercisable.

Note M. Cumulative Other Comprehensive Loss

Cumulative other comprehensive loss consists of the following at December 31 (in thousands):

| | 2005 | 2004 | 2003 |
|---|----------|----------|---------|
| | ---- | ---- | ---- |
| Cumulative translation adjustment | | \$ 170 | \$ 50 |
| Minimum pension liability net of tax of \$128 | (580) | (395) | (148) |
| | ----- | ----- | ----- |
| | \$ (580) | \$ (225) | \$ (98) |
| | ===== | ===== | ===== |

Note N. Related Party Transactions

Prior to August 2002, the Company had advanced amounts to officers primarily for personal income taxes related to various stock option plans. The amounts outstanding at December 31, 2005 and 2004 of \$1,996,000 and \$1,968,000 include interest accrued on the advances. This indebtedness bears interest at rates approximating market rates and is payable upon demand.

In 2005, the Company sold its UK distributorship operations to a company owned by its former Vice President of European Operations. See Note J.

Note O. Quarterly Financial Data (Unaudited)

(in thousands except per share amounts)

| 2005 | First | Second | Third | Fourth |
|--|----------|----------|----------|----------|
| | ----- | ----- | ----- | ----- |
| Revenues | \$1,721 | \$1,054 | \$ 986 | \$3,989 |
| Gross profit | 1,051 | 353 | 388 | 2,633 |
| Income (loss) from continuing operations | (498) | (1,241) | (1,065) | 213 |
| Loss from discontinued operations | (257) | (454) | (585) | (259) |
| Net income (loss) | (755) | (1,695) | (1,650) | (46) |
| Income (loss) per share: | | | | |
| Continuing operations | \$ (.09) | \$ (.22) | \$ (.19) | \$ (.03) |
| Discontinued operations | (.05) | (.08) | (.11) | (.04) |
| Net loss | (.13) | (.31) | (.29) | (.01) |

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| 2004 | First | Second | Third | Fourth |
|--|----------|---------|----------|---------|
| | ----- | ----- | ----- | ----- |
| Revenues | \$2,261 | \$4,243 | \$1,889 | \$5,832 |
| Gross profit | 748 | 2,499 | 713 | 3,794 |
| Income (loss) from continuing operations | (1,537) | 283 | (1,192) | 2,105 |
| Income (Loss) from discontinued operations | 186 | 93 | (156) | (336) |
| Net income (loss) | (1,351) | 376 | (1,348) | 1,769 |
| Net income (loss) per share: | | | | |
| Continuing operations | \$ (.28) | \$.05 | \$ (.21) | \$.33 |
| Discontinued operations | .03 | .01 | (.03) | (.06) |
| Net income (loss) | (.24) | .06 | (.23) | .28 |

The Company expensed \$678,000 of purchased in process R&D in connection with The acquisition of ThinkEngine Networks, Inc. in the fourth quarter of 2005. The gross margin percentage for the fourth quarter of 2005 was 62% versus 48% for the first nine months of 2005 due to increased volume.

The gross margin percentage for the fourth quarter of 2004 was 65% versus 47% for the first nine months of 2004 due to increased volume and an improved product mix. The gross margin percentage for the fourth quarter of 2003 was 24% versus 45% for the first nine months of 2003 primarily due to lower volume and lower absorption of overhead.

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

Not applicable.

Item 9A. Controls and Procedures

Quarterly Evaluation. The Company's management carried out an evaluation as of December 31, 2005 of the effectiveness of the design and operation of the Company's "disclosure controls and procedures," which the Company refers to as the Company's disclosure controls. This evaluation was done under the supervision and with the participation of Company management, including the Chief Executive Officer and Chief Financial Officer. Rules adopted by the Commission require that the Company present the conclusions of the Chief Executive Officer and Chief Financial Officer about the effectiveness of the Company's disclosure controls as of the end of the period covered by this annual report.

CEO and CFO Certifications. Included as Exhibits 31.1 and 31.2 to this Annual Report on Form 10-K are forms of "Certification" of the Company's Chief Executive Officer and Chief Financial Officer. The forms of Certification are required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002. This section of the Annual Report on Form 10-K is the information concerning the evaluation referred to in the Section 302 certifications. This information should be read in conjunction with the Section 302 certifications for a more complete understanding of the topics presented.

Disclosure Controls and Procedures and Internal Control over Financial Reporting. Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act, such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to Company management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Internal control over financial reporting is a process designed by, or under

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the supervision of, the Company's Chief Executive Officer and Chief Financial Officer, and effected by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the Company's assets;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the Company's receipts and expenditures are being made only in accordance with authorizations of management or the Company's Board of Directors; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material adverse effect on the Company's financial statements.

Limitations on the Effectiveness of Controls. Management, including the Company's Chief Executive Officer and Chief Financial Officer, do not expect that the Company's disclosure controls and procedures or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management's override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Scope of the Evaluation of the Company's Disclosure Controls and Procedures. As of December 31, 2005, the Company carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures. This evaluation of the Company's disclosure controls and procedures included a review of the Company's internal audit procedures, as well as discussions with members of management and others in the Company, as appropriate. In the course of the evaluation, the Company sought to identify data errors, control problems or acts of fraud and to confirm that appropriate corrective action, including process improvements were being undertaken. The overall goals of these various evaluation activities are to monitor the company's disclosure controls and procedures and to make modifications as necessary. The Company's intent in this regard is that the disclosure controls and procedures will be maintained as systems that change (including with improvements and corrections) as conditions warrant. Among other matters, the Company sought in this evaluation to determine whether there were any "significant deficiencies" or "material weaknesses" in the company's internal

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control over financial reporting, or whether the Company had identified any acts of fraud involving personnel who have a significant role in the Company's internal control over financial reporting. The Company also sought to deal with other control matters in the evaluation, and in any case in which a problem was identified, management considered what revision, improvement and/or correction was necessary to be made in accordance with the Company's on-going procedures.

Periodic Evaluation and Conclusion of Disclosure Controls and Procedures. As of December 31, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that such controls and procedures were effective as of December 31, 2005.

Changes in Internal Control Over Financial Reporting. During the three months ended December 31, 2005, there were no changes in the Company's internal control over financial reporting that has materially affected, or are reasonably likely to materially affect, the Company's internal control for financial reporting.

Item 9B. Other Information

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Company

Information Concerning Directors

The following table sets forth with respect to each director: (1) his name and age, all positions and offices with the Company currently held by him, and his principal occupation over the last five years (including other directorships and business experience) and (2) the period during which he has served as a director of the Company.

| Name, Age, Positions, Principal Occupation, Directorships and Business Experience ----- | Director Since ----- |
|---|----------------------------|
| J. T. CONNORS, 57, U.S. Country Manager of Bank of Ireland Wholesale Financial Services, a division of The Bank of Ireland since September 2005. Prior to that he had served as counsel in the New York office of the law firm of Pillsbury Winthrop Shaw Pittman LLP, formerly known as Shaw Pittman LLP, since 2003, a business and financial consultant, from 2001 to 2003 and President and Chief Operating Officer of Fortis Capital Holdings Inc (a financial services company), and its predecessor, Mees Pierson Holdings Inc., since 1997 and General Counsel of Mees Pierson Holdings Inc. from 1993 to 1997. | 2000 |
| ROBERT C. FLEMING, 49, has been a founder of Prism Venture Partners ("Prism"), a venture capital investment firm, since 1996. | 2005 |

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| | |
|---|------|
| BRIAN J. KELLEY, 54, has been President and Chief Executive Officer of the Company since 1994. Prior to that he held senior management positions with TIE/Communications, Inc. from 1986 to 1994. | 1994 |
| JACK MEEHAN, 56, has been President and Chief Executive Officer of Novus, LLC (a telephone systems equipment company) since November 2001. Prior to that he had been President and Chief Executive Officer of Aztec International, Inc. (a similar business), a subsidiary of Aztec Technology Partners, Inc., since 1983. | 1991 |
| WILLIAM A. MERRITT, 69, has been President of Integrated Communications Systems Corp. since 1992, Vice President and General Counsel of Seaboard Properties, Inc. and a Managing Member of the Seaboard Group of companies since 1992 and acting Chief Financial Officer of McAllister Towing and Transportation Company, Inc. since 1997. | 1994 |
| WILLIAM J. STUART, 54, has been a general partner with Still River Funds since September 2001. Prior to that he had been Vice President of the Broadband Infrastructure & Access Group of ADC Telecommunications, Inc. since October 2000, Vice President and Chief Financial Officer of Broadband Access Systems, Inc. from October 1999 to September 2000, Vice President and Chief Financial Officer of NetCore Systems, Inc. from May 1999 to October 1999 and Vice President and Chief Financial Officer of Telco Systems, Inc. from January 1997 to January 1999. | 2001 |

The foregoing directors were each elected at the 2005 Annual Meeting of Stockholders, except Mr. Fleming who was elected by the Board on December 16, 2005 pursuant to contractual terms in connection with the acquisition of ThinkEngine Networks, Inc. in November 2005. The contractual terms provide that, so long as Prism or one of its affiliated funds holds 400,000 or more shares of the Company's Common Stock, the Company shall cause an individual designated by Prism and Acceptable to the Company's Board of Directors to be elected a director.

Qualifications of Audit Committee Members

The Company's Board has reviewed the qualifications of each of the members of the Audit Committee, comprised of Messrs. Meehan, Merritt and Stuart, and has determined that all of them are independent (as independence is defined in Section 121A of the American Stock Exchange's listing standards). The Board also determined that William J. Stuart qualifies as an "audit committee financial expert" as defined by the SEC pursuant to the Sarbanes-Oxley Act of 2002.

Code of Business Conduct and Ethics

The Company has adopted a Code of Business Conduct that applies to all of its directors, officers and employees, including its chief executive officer and chief financial officer. The Board reassessed and restated the Code of Business Conduct and Ethics in 2005, a copy of which will be provided, without charge upon a written request addressed to Corporate Secretary, Cognitronics Corporation, 3 Corporate Drive, Danbury, CT 06810-4130.

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Section 16(a) Beneficial Ownership Reporting Compliance

In accordance with Section 16(a) of the Exchange Act, the Company's directors, officers and any person holding more than ten percent of the Company's Common Stock are required to file reports of ownership and any changes in ownership with the Securities and Exchange Commission, the American Stock Exchange and the Company. The Company believes that all of these filing requirements were timely satisfied during 2005 by its directors, officers and ten percent holders, except each of the following failed to file such reports: Messrs. Brix, Connors, Keefe, Kelley, Mayer, Meehan, Sullivan, Stuart and Zizzo - 1 report, 1 transaction each and Mr. Merritt - 7 reports, 8 transactions.

Executive Officers

The identification of the executive officers of the Company and their positions with the Company and ages as of March 23, 2005 is set forth under the caption Executive Officers of the Company in Part I of this Annual Report on Form 10-K/A.

Item 11. Executive Compensation

The following tables and notes set forth the compensation paid or accrued by the Company during the fiscal years ended December 31, 2005, 2004 and 2003 to its five most highly compensated executive officers whose aggregate cash compensation exceeded \$100,000 for services rendered to the Company in 2005.

Summary Compensation Table

| (a) Name and Principal Position | (b) Year | Annual Compensation | | | Long-term Compensation A | |
|--|-------------|---------------------|--------------------|--|-------------------------------------|------------------------------|
| | | (c) Salary \$ | (d) Bonus \$ | (e) Other Annual Compensation \$(2) | (f) Restricted Stock \$(1) | (g) Options/ SARs # |
| Brian J. Kelley President and Chief Executive Officer | 2005 | 294,808 | 60,000 | | | 80,000 |
| | 2004 | 270,000 | | | | |
| | 2003 | 282,116 | | | 73,011 | 60,000 |
| Kenneth G. Brix Vice President, Sales | 2005 | 161,114 | 30,000 | | | 40,000 |
| | 2004 | 148,500 | | | | |
| | 2003 | 155,160 | | | 26,400 | 25,000 |
| Roy A. Strutt Former Vice President, European Operations and Managing Director, Dacon Electronics Plc | 2005 | 206,309 | | | | |
| | 2004 | 214,185 | | | | |
| | 2003 | 197,184 | | | 26,400 | 25,000 |
| Michael N. Keefe (4) Vice President, | 2005 | 137,442 | | | | 10,000 |
| | 2004 | 126,000 | | | | |

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| | | | | | |
|---------------------|------|---------|--------|--------|--------|
| Engineering | 2003 | 131,654 | | 26,400 | 25,000 |
| Garrett Sullivan | 2005 | 137,442 | 30,000 | | 20,000 |
| Treasurer and Chief | 2004 | 126,000 | | | |
| Financial Officer | 2003 | 131,654 | | 26,400 | 25,000 |

(1) The Compensation Committee awarded restricted shares of Common Stock under the terms of the Restricted Stock Plan on October 24, 2003, as follows: Mr. Kelley - 60,000 shares and Messrs. Brix, Strutt, Keefe and Sullivan - 25,000 shares each. The value of the shares on the award date is reflected in the table above. The shares vest 20% annually beginning on the second anniversary of the award provided the officer remains employed by the Company until the vesting date (except that if the officer is terminated prior to the vesting date by reason of a change in control, all restricted shares become vested immediately). Dividends will be paid on the restricted shares. Aggregate shares vested in 2003 as follows: Mr. Kelley - 11,550 shares, Messrs. Brix, Keefe and Sullivan - 4,000 shares each and Mr. Strutt - 2,030 shares. Aggregate shares vested in 2004 as follows: Mr. Kelley - 19,000 shares, Messrs. Brix, Keefe and Sullivan - 6,950 shares each and Mr. Strutt - 4,500 shares. Aggregate shares vested in 2005 as follows: Mr. Kelley - 24,137 shares, Messrs. Brix, Keefe and Sullivan - 8,900 shares each and Mr. Strutt - 6,900 shares. The number of shares and value of the aggregate restricted stock holdings at December 31, 2005 are: Mr. Kelley - 70,050 shares, \$168,821, Messrs. Brix, Keefe and Sullivan - each 26,100 shares, \$62,901 and Mr. Strutt - 0 shares, \$0.

(2) The amount perquisites was less than the lesser of \$50,000 or 10% of total annual salary and bonus for the named executive officers.

(3) These amounts represent (a) pension contributions, (b) term life insurance premiums paid by the Company for the benefit of the officers' beneficiaries and (c) personal use of automobile in the following amounts: Mr. Kelley - \$1,200 in insurance premiums and personal use of automobile - \$10,729, Mr. Brix - \$990 in insurance premiums, Messrs. Keefe and Sullivan - \$840 in insurance premiums and Mr. Strutt - \$14,505 in pension contributions. There are no cash values associated with the term life insurance.

(4) On March 31, 2006, Mr. Keefe's employment as Vice President, Engineering terminated. Under the terms of his severance, the Company will pay severance compensation in installments aggregating a minimum of \$21,538 through June 2, 2006 and a maximum of \$110,385 through January 19, 2007 under certain circumstances.

Option Grants in 2005

Individual Grants

| (a) | (b) | (c) | (d) | (e) | (f) | (g) |
|-----------------|----------------------|---|------------------------|-----------------|---------|----------|
| Name | Options Granted# (1) | % of Total Options Granted to Employees in 2005 | Exercise Price (\$/Sh) | Expiration Date | 5% (\$) | 10% (\$) |
| Brian J. Kelley | 80,000 | 9.2% | 2.70 | 10/25/15 | 135,841 | 344,248 |

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| | | | | | | |
|------------------|--------|------|------|----------|--------|---------|
| Kenneth G. Brix | 40,000 | 4.6% | 2.70 | 10/25/15 | 67,921 | 172,124 |
| Roy A. Strutt | None | | | | | |
| Michael N. Keefe | 10,000 | 1.1% | 2.70 | 10/25/15 | 16,980 | 43,031 |
| Garrett Sullivan | 20,000 | 2.3% | 2.70 | 10/25/15 | 33,960 | 86,062 |

(1) These options were granted under the Company's 1990 Stock Option Plan at an exercise price equal to the closing market price on the date of grant and are exercisable in three equal installments over 30 months. Normally, options are granted in connection with the review of annual compensation; however, the Compensation Committee may grant options at other dates at its discretion.

Aggregate Option Exercises in 2005 and 2005 Year-end Option Values

| (a) | (b) | (c) | (d) | (e) |
|------------------|---------------------------------|---------------------------------|---|---|
| Name | Shares Acquired on Exercise (#) | Value Realized on Exercise (\$) | Number of Unexercised Options at Year End Exercisable/Unexercisable | Value of Unexercised In-the-Money Options at Year End Exercisable/Unexercisable |
| Brian J. Kelley | None | | 242,500 100,000 | \$60,000 \$4,200 |
| Kenneth G. Brix | None | | 86,667 48,333 | \$25,000 \$1,750 |
| Roy A. Strutt | None | | 86,667 0 | \$25,000 \$0 |
| Michael N. Keefe | None | | 86,667 18,333 | \$25,000 \$1,750 |
| Garrett Sullivan | None | | 86,667 28,333 | \$25,000 \$1,750 |

Pension Plans

In 1977, the Company adopted a non-contributory, defined benefit pension plan covering substantially all employees in the United States. The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, plus such additional amounts as the Company may determine to be appropriate from time to time.

In 1994, the Company amended the pension plan to eliminate future benefit accruals after June 30, 1994. Accordingly, new employees are not eligible to participate in the plan and the accrued pension benefit of earlier participants will remain at the level earned based on service through June 30, 1994. At January 1, 2006, the accrued annual pension benefits payable upon the retirement of the officers identified in the Summary Compensation Table were: Brian J. Kelley - \$0; Kenneth G. Brix - \$0; Michael N. Keefe - \$6,319; Garrett Sullivan - \$4,623; and Roy A.

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Strutt - \$0. In September 2005, Board approved the termination of pension plan subject to the approval of the Internal Revenue Service and the Pension Benefit Guaranty Corporation, which is expected to be granted in 2006; upon receipt of the approvals, the present value of the accrued benefit of all participants, including the officers identified above, is expected to be distributed.

Compensation of Directors

Directors who were not employees of the Company in 2005 were entitled to payment of (a) an annual fee of \$8,000, (b) \$1,000 for each Board meeting attended, of which there were four during 2005, and for each meeting of a committee of the Board not held in conjunction with a Board meeting, of which there was one in 2005 and (c) \$1,000 for each substantive part of a business day that a director is requested to assist management in the future development of the Company's business, of which there were two such occasions in 2005. Directors may voluntarily defer the receipt of such fees to a future year. Directors may elect to be paid in cash or in shares of Common Stock of the Company. If a director elected to be paid in shares, he was entitled to 125% of the equivalent value in shares. Directors are also entitled to reimbursement of reasonable travel expenses.

In September 1998, the Board unanimously approved the Directors' Stock Option Plan covering directors and officers who are not employees of the Company; the stockholders approved the adoption of the Directors' Stock Option Plan (the "Directors' Plan") and the awards thereunder at the Annual Meeting of Stockholders on May 13, 1999. The Board of Directors amended the Directors' Plan in 2000, 2001 and 2003, which amendments were approved by stockholders on May 11, 2000, May 17, 2001 and May 8, 2003, respectively. The terms of the Directors' Plan provide for an automatic award to each person who is a participant of options to purchase (1) 3,000 shares of Common Stock on August 1, 2000, 2001 and 2002, (2) 6,000 shares of Common Stock in each subsequent year thereafter, (3) sixty days following the initial election of a director by the Board of Directors a pro rata portion of shares of the annual award and (4) 5,500 shares of Common Stock on November 9, 2002. The option exercise price is 100% of the fair market value per share of Common Stock on the date of the award, as defined in the Directors' Plan. Generally, the options become exercisable one year after the date of award and expire ten years after the date of award. During 2006, Messrs. Connors, Meehan, Merritt and Stuart were awarded options to purchase 6,000 shares of Common Stock each on August 1 at an exercise price of \$3.22 per share. None of the Directors exercised options in 2005.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee is composed of Messrs. Meehan, Merritt and Stuart, each of whom are "non-employee directors" for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended. Mr. Connors was counsel with the law firm of Pillsbury Winthrop Shaw Pittman LLP until September 2005, which the Company retained during during that period.

The Company has advanced to officers amounts principally for income taxes related to stock awards under its 1990 Stock Option and Restricted Stock Plans and stock bonuses. In connection therewith, the largest aggregate amount the executive officers were indebted to the Company since January 1, 2005, which is also the aggregate amount at April 1, 2006 are as follows: Mr. Kelley, President and a director - \$550,637; Mr. Brix, a Vice President - \$189,611; Mr. Keefe, a Vice President - \$95,426; and Mr. Sullivan, Treasurer - \$427,609; and Mr. Strutt, a former Vice President -

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\$684,769 which was fully repaid prior to April 1, 2006. The above indebtedness, which is partially unsecured and is payable on demand, bears interest at varying rates approximating market rates. There were no such advances subsequent to July 28, 2002.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholders Matters

The following table sets forth information as to ownership of the Common Stock of the Company as of April 1, 2006 with respect to (i) current directors of the Company; (ii) the executive officers listed on the Summary Compensation Table; (iii) current directors and executive officers as a group; and (iv) beneficial owners of more than 5%.

| Name of Beneficial Owner(k) ----- | Shares Beneficially Owned ----- | Percent of Shares Outstanding ----- |
|--|--|--|
| Bruce Galloway | 461,600 (k) | 6.9% |
| Prism Venture Partners III, LLC | 1,149,705 (j) | 17.2% |
| John T. Connors , Director | 23,500 (b) (c) | (a) |
| Robert C. Fleming, Director..... | 1,149,705 (j) | 17.2% |
| Brian J. Kelley, President, CEO and Director..... | 807,792 (b) (d) (e) | 11.6% |
| Jack Meehan, Director | 23,500 (b) (c) | (a) |
| William A. Merritt, Director..... | 33,200 (b) (c) | (a) |
| William J. Stuart, Director | 32,895 (b) (c) (f) | (a) |
| Kenneth G. Brix, Vice President | 211,567 (b) | 3.1% |
| Michael N. Keefe, former Vice President | 222,944 (b) (h) | 3.3% |
| Roy A. Strutt, former Vice President .. | 4,875 (b) (g) | (a) |
| Garrett Sullivan, Treasurer and CFO ... | 233,455 (b) (i) | 3.4% |
| All directors and officers, as a group including those listed above, consisting of 13 persons..... | 3,037,595 (b) (c) (l) | 40.3% |

- (a) The percentage of shares beneficially owned does not exceed one percent.
- (b) Of the shares of Common Stock shown above as beneficially owned, the number of shares with respect to which the following persons had a right to acquire beneficial ownership within 60 days were: John T. Connors - 23,500, Brian J. Kelly - 289,167, Jack Meehan - 23,500, William A. Merritt - 23,500, William J. Stuart - 23,750, Kenneth G. Brix - 108,333, Michael N. Keefe - 98,333, Garrett Sullivan - 101,667 and all current directors and officers as a group - 845,200. Other than shares as to which he had a right to acquire beneficial ownership or as noted below, each person held sole voting and sole investment power with respect to the shares shown above.
- (c) Does not include equivalent shares of Common Stock recorded in the books and records of the Company as deferred compensation, as follows: John T. Connors - 25,522 shares, Jack Meehan - 42,649 shares and William A. Merritt - 41,912 shares and all current officers and directors as a group - 110,083 shares.
- (d) With respect to 110,133 of the shares, voting and investment power is shared with Mr. Kelley's spouse.
- (e) Includes 4,500 shares held in Mr. Kelley's name as custodian for his three children.

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- (f) With respect to 8,145 of the shares, voting and investment power is shared with Mr. Stuart's spouse.
- (g) Includes 4,875 shares held in the name of Mr. Strutt's spouse.
- (h) With respect to 2,955 of the shares, voting and investment power is shared with Mr. Keefe's spouse.
- (i) With respect to 32,257 of the shares, voting and investment power is shared with Mr. Sullivan's spouse.
- (j) Based upon information set forth in a Schedule 13D filed with the SEC on November 25, 2005 by Prism Venture Partners III, L.P. ("PVP III"), which owns of record 1,116,134 shares and Prism Venture Partners III-A, L.P. ("PVP III-A"), which owns of record 33,571 shares. The 13D was also filed by Prism Venture Partners III, LLC ("PVP LLC"), John L. Brooks, III, Robert C. Fleming and William M. Seifert. Each of the indicated parties has shared voting and dispositive power over all of the shares. Messrs. Brooks, Fleming and Seifert are members of PVP LLC which is the sole general partner of PVP III and PVP III-A. Mr. Fleming is also a director of the Company.
- (k) Based upon information set forth in a Schedule 13G filed with the SEC on February 23, 2006 by Strategic Turnaround Equity Partners, LP ("STEP"), Bruce Galloway and Gary Herman. Mr. Galloway has sole voting and dispositive power over 99,300 shares and shared voting and dispositive power over 362,300 shares. Mr. Herman has sole voting and dispositive power over 2,500 shares and shared voting and dispositive power over 157,200 shares. STEP has sole voting and dispositive power over no shares and shared voting and dispositive power over 156,200 shares. Messrs. Galloway and Herman are managing members of the general partner of STEP.
- (l) With respect to 1,308,070 of the shares, voting and investment power is shared with the spouses or other affiliates of the beneficial owners.
- (m) The business address of each of the named beneficial owners is c/o Cognitronics Corporation, 3 Corporate Drive, Danbury, CT 06810-4130, except for Mr. Strutt whose business address is c/o Dacon Electronics Plc, 1 Enterprise Way, Hemel Hempstead, Hertfordshire, HP27Y3, United Kingdom, Mr. Fleming and Prism Venture Partners III, LLC whose business address is 100 Lowder Brook Drive, Suite 2500, Westwood, MA 02090 and Bruce Galloway whose business is c/o Galloway Capital Management, LLC, 720 Fifth Avenue, New York, New York 10019.

Equity Compensation Plan Information

The following table sets forth securities authorized for issuance under all equity compensation plans of the Company at December 31, 2005.

| Equity Compensation Plan Information | | | |
|---------------------------------------|---|---|---|
| | (a) | (b) | (c) |
| Plan Category | Number of Securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of Securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by | 1,237,970 | \$3.83 | 112,642(1) |

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security holders

| | | | |
|--|--------------|--------|---------|
| Equity compensation plans not approved by security holders | 1,281,083(2) | \$2.55 | 60,497 |
| Total | 2,519,053 | \$3.37 | 173,139 |

(1) Consists of (a) 52,478 shares available for grant of rights under the 1967 Employee Stock Purchase Plan, (b) 37,264 shares available for grant of stock options and (c) 22,900 shares for grant under the Restricted Stock Plan.

(2) Consists of shares available for issuance, as follows:

- (a) Rights granted in 2002 to executives to receive 395,000 shares of Common Stock on January 2, 2006. Such rights are subject to immediate vesting in the event of a change in control of the Company and pro-rata vesting in the event of death or involuntary termination for reasons other than cause. The total value of the rights at the date of grant was \$612,000 based on the fair market value of the Common Stock (\$1.55 per share) on the date of grant; \$160,000 was charged to expense in 2005 related to this grant.
- (b) Rights of directors to receive 110,083 shares of Common Stock. Directors may elect to receive their fees in shares of Common Stock and defer receipt of such shares to a future date. If a director elects to be paid in shares, he is entitled to 125% of the equivalent value of the fees in shares.
- (c) Rights granted in 2001 to executives to receive 71,000 shares of Common Stock, the receipt of which has been voluntarily deferred by the executives to a future year. The total value of the rights was \$338,000 based on the average fair market value of the Common Stock as the shares vested during 2001 (\$4.76 per share), which amount was charged to expense in 2001.
- (d) Employment inducement stock options granted to newly hired employees during 2005 to purchase 705,000 shares of Common Stock at an average exercise price of \$2.55 per share; the exercise price is equal to the fair market value of the Common Stock on the date of grant.

(3) Consists of shares available for issuance for directors' fees.

Changes in Control. None.

Item 13. Certain Relationships and Related Transactions

Indemnity Agreements between the Company and individual officers and directors have been executed to allow those officers and directors to benefit from New York's indemnification statute. In accordance with the provisions of these Indemnity Agreements, the Company has agreed, subject to limitations, to indemnify and pay the reasonable expenses of officers and directors adjudicated liable in any civil, criminal or other action or proceeding, including any derivative action, for the acts or decisions made by them in good faith while performing services for the Company. Such indemnification would be made by the Company as specified in the Indemnity Agreements and any expenses or other amounts paid by way of indemnification, otherwise than by court order or action of the stockholders, would be reported to stockholders as provided by law. No indemnification by the Company would be made to or on behalf of any officer or director if a judgment or other final adjudication adverse to such officer or director established that his acts were committed in bad faith or were the result of active and deliberate dishonesty and

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were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled. The Indemnity Agreements also obligate the Company to advance to officers and directors funds to pay the reasonable expenses incurred from time to time before any final determination of their rights to indemnification, subject to repayment to the extent required by the indemnification terms.

The Company's Certificate of Incorporation limits the personal liability of directors to the Company or its stockholders for certain breaches of duty as directors, as permitted by New York law.

The Company carried Directors' and Officers' Liability Insurance covering directors and officers for amounts up to \$5 million in 2005.

Until October 2005, the Company retained Pillsbury Winthrop Shaw Pittman LLP. John T. Connors, a director, was counsel of that firm until September 2005.

The Company has entered into Executive Severance Agreements (the "Agreements") regarding change in control with Messrs. Kelley, Brix, Strutt, Keefe, Sullivan and one other officer of the Company (individually, the "Executive"; collectively, the "Executives"). Under these Agreements, a "change in control" occurs if (a) the stockholders of the Company approve (i) any merger or consolidation of the Company (unless the voting stock of the Company outstanding immediately prior thereto continues to represent more than 50% of the combined voting power of the Company or the surviving entity thereafter or at least a majority of the directors of the Company or the surviving entity after the merger or consolidation were directors of the Company prior thereto), (ii) the sale, lease, exchange or other transfer of all or substantially all of the Company's assets to any other company or (iii) any plan or proposal for the liquidation or dissolution of the Company, (b) persons who were directors of the Company on November 1, 1995 (the "Incumbent Directors") cease for any reason to constitute at least a majority of the Board of Directors, provided, however, that any person subsequently becoming a director whose election is approved by a vote of at least a majority of the then Incumbent Directors will be considered an Incumbent Director or (c) any person (other than the Company, its subsidiaries or any employee benefit plan of the Company), together with all affiliates and associates of such person, becomes the beneficial owner, directly or indirectly, of 20% or more of the Company's Common Stock. The Agreements provide that the Executive's compensation, responsibilities and employee benefits will not be reduced following a change in control. The Agreements also provide that if the Executive's employment with the Company is terminated under certain circumstances the Executive will continue to receive certain medical, insurance and other employee benefits for a period of two years and will receive a lump sum payment equal to, but limited by the amount deductible for income tax purposes under the Internal Revenue Code, 200% of the sum of (A) the greater of (i) the Executive's annual salary as in effect immediately prior to the termination or (ii) the Executive's salary as in effect immediately prior to the change in control and (B) the greater of (i) the Executive's annual bonus for the prior annual period, including performance bonus, amounts vested under the Company's Restricted Stock Plan and amounts under any other bonus program of the Company (the "Bonus Amounts") or (ii) the average Bonus Amounts for the prior two years. These benefits will be provided to the Executives, other than Mr. Kelley, in the event that the Executive's employment is terminated within two years following a change in control (i) by the Company for any reason other than death, disability or cause or (ii) by the Executive under certain, limited circumstances, and to Mr. Kelley if his employment is voluntarily or

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involuntarily terminated (other than for death, disability or cause) within two years following a change in control. Payments to the Executives under the Agreements are limited to such amounts to permit all payments to the Executives to be made by the Company to be deductible in accordance with Section 280G of the Internal Revenue Code. The terms of these Agreements expire on October 16, 2010, unless a change in control has occurred on or prior to such date, in which case the Agreements will continue in effect for two years following the change in control.

In the event of a change in control, the Company's 1990 Stock Option and Directors' Option Plans provide that all outstanding stock options will become fully exercisable. In the event of a change in control followed by termination of employment, the Company's Restricted Stock Plan provides that the restrictions on shares of the Company's Common Stock previously awarded will terminate.

Information with respect to advances to officers is set forth in Item 11 herein under the caption Compensation Committee Interlocks and Insider Participation.

Except as described above, no director or officer had any material interest in any material transaction of the Company or any of its subsidiaries during the period from January 1, 2005 to April 28, 2006 or any such proposed transaction, nor had any of their associates.

Item 14. Principal Accountant Fees and Services

The Company's Audit Committee has policies and procedures that require the pre-approval by the Audit Committee of all fees paid to, and services provided by, the Company's independent auditing firms. Pursuant to the Sarbanes-Oxley Act of 2002, the fees and services provided as noted in the table below were authorized and approved by the Audit Committee in compliance with the pre-approval policies and procedures described herein.

The aggregate fees billed or expected to be billed by the Company's principal independent auditors for its 2005 services are as follows:

| | 2005 | 2004 |
|---|-----------|----------|
| | ---- | ---- |
| Audit Fees - Review of the Company's quarterly financial statements, audit of the annual financial statements and related consultation. | \$138,600 | \$99,000 |
| Audit-Related Fees | None | None |
| Tax Fees | None | None |
| Other fees | None | None |

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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) and (2) and (c) The response to this portion of Item 15 is submitted as a separate section beginning on page 32 of this Annual Report on Form 10-K.

(a) (3) and (b) The response to this portion of Item 15 is submitted as a separate section beginning on page 33 of this Annual Report on Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on April 28, 2006.

COGNITRONICS CORPORATION
Registrant
by /s/Garrett Sullivan

Garrett Sullivan
Treasurer

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Item 15 (a) (1) and (2) and (c)

(a) (1) Financial Statements

The following financial statements of the Company are included in Item 8. Financial Statements Covered by Reports of Independent Registered Public Accounting Firms:

| | Page |
|---|------|
| Report of Independent Registered Public Accounting Firm. | 13 |
| Consolidated Balance Sheets, December 31, 2005 and 2004. | 14 |
| Consolidated Statements of Operations and Comprehensive Loss for each of the three years in the period ended December 31, 2005 . . | 15 |
| Consolidated Statements of Stockholders' Equity for each of the three years in the period ended December 31, 2005. | 16 |
| Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2005. | 17 |
| Notes to Consolidated Financial Statements | 18 |

(2) and (c) Financial Statement Schedules

Schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions, are inapplicable, or the information has been included in the Company's financial statements and, therefore, have been omitted.

Item 15(a)(3) and (c)

INDEX TO EXHIBITS

Exhibit

- 3.1 Certificate of Incorporation as filed on January 2, 1962 (Exhibit 3-1-A to Form S-1 Registration Statement No. 2-27439 and incorporated herein by reference).
- 3.2 Amendment, dated June 28, 1965 (Exhibit 3-1-B to Form S-1 Registration Statement No. 2-27439 and incorporated herein by reference).
- 3.3 Amendment, dated September 29, 1966 (Exhibit 3-1-C to Form S-1 Registration Statement No. 2-27439 and incorporated herein by reference).
- 3.4 Amendment, dated October 30, 1967 (Exhibit 3-1-D to Form S-1 Registration Statement No. 2-27439 and incorporated herein by reference).
- 3.5 Amendment, dated July 14, 1981 (Exhibit 3.5 to Annual Report on Form 10-K for the fiscal year ended December 31, 1983 and incorporated herein by reference).
- 3.6 Amendment, dated August 15, 1984 (Exhibit 3.6 to Annual Report on Form 10-K for the fiscal year ended December 31, 1984 and incorporated herein by reference).
- 3.7 Amendment dated May 26, 1988 (Exhibit 3.7 to Annual Report on Form 10-K for the fiscal year ended December 31, 1988 and incorporated herein by reference).
- 3.8 Amendment dated November 3, 1994 (Exhibit 3.8 to Annual Report on Form

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- 10-K for the year ended December 31, 1994 and incorporated herein by reference).
- 3.9 Amendment, dated September 1, 1999 (Exhibit 3.9 to Annual Report on Form 10-K for the fiscal year ended December 31, 2004 and incorporated herein by reference).
 - 3.10 Amendment, dated July 25, 2000 (Exhibit 3.1 to Quarterly Report on Form 10-Q for the period ended June 30, 2000 and incorporated herein by reference).
 - 3.11 By-laws of the Company (Exhibit 3.9 to Annual Report on Form 10-K for the year ended December 31, 1994 and incorporated herein by reference).
 4. Specimen Certificate for Common Stock (Exhibit 4-1 to Form S-1 Registration Statement No. 2-27439 and incorporated herein by reference).
 - 10.1 1990 Stock Option Plan, as amended (Exhibit 10.1 to Quarterly Report on Form 10-Q for the period ended June 30, 2003 and incorporated herein by reference).
 - 10.2 Lease, dated April 30, 1993, between The Danbury Industrial Corporation, landlord, and Cognitronics Corporation, tenant (Exhibit 10.3 to Annual Report on Form 10-K for the year ended December 31, 1993 and incorporated herein by reference).
 - 10.3 Lease amendment, dated as of January 27, 2003, between the Danbury Industrial Corporation and Cognitronics Corporation (Exhibit 10.3 to Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference).
 - 10.4 Form of Indemnity Agreement, dated October 27, 1986, between each Director (with equivalent form for each Officer) and Cognitronics Corporation (Exhibit 10.7 to Annual Report on Form 10-K for the year ended December 31, 1986 and incorporated herein by reference).
 - 10.5 Supplemental Pension Plan for Officers, as amended November 2, 1993 (Exhibit 10.6 to Annual Report on Form 10-K for the year ended December 31, 1993 and incorporated herein by reference).
 - 10.6 Cognitronics Corporation Restricted Stock Plan (Exhibit 10.2 to Quarterly Report on Form 10-Q for the period ended June 30, 2003 and incorporated herein by reference).
 - 10.7 Form of Executive Severance Agreement between certain officers and Cognitronics Corporation (Exhibit 10.8 to Annual Report on Form 10-K for the year ended December 31, 1997 and incorporated herein by reference).
 - 10.8 Addendum to Executive Severance Agreement between certain officers and Cognitronics Corporation (Exhibit 10.8 to Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference).
 - 10.9 The Directors' Stock Option Plan, as amended (Exhibit 10.3 to Quarterly Report on form 10-Q for the period ended June 30, 2003 and incorporated herein by reference).
 21. List of subsidiaries of the Company as of December 31, 2005 (Exhibit 21 to Annual Report on Form 10-K for the year ended December 31, 2005).
 23. Consent of Independent Registered Public Accounting Firm, dated March 31, 2006 (Exhibit 23 to Annual Report on Form 10-K for the year ended December 31, 2005).
 - 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (attached as Exhibit 31.1 to this Annual Report on Form 10-K/A).
 - 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (attached as Exhibit 31.2 to this Annual Report on Form 10-K/A).
 - 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 (attached as Exhibit 32.1 to this Annual Report on Form 10-K/A).
 - 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 (attached as Exhibit 32.2 to this Annual Report on Form 10-K/A).

