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COGNITRONICS CORP
Form 10-Q
November 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

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 (State or other jurisdiction of incorporation or organization)	13-1953544 (I.R.S. Employer Identification No.)
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3 Corporate Drive, Danbury, Connecticut (Address of principal executive offices)	06810-4130 (Zip Code)
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(203) 830-3400
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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

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

The Registrant has 6,652,370 shares of Common Stock, \$.20 par value per share outstanding at October 20, 2006.

Part I. FINANCIAL INFORMATION

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Item 1. FINANCIAL STATEMENTS

COGNITRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

	September 30, 2006	December 31, 2005
	----- (Unaudited)	----- (Note)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 1,125	\$ 1,750
Marketable securities	3,069	6,370
Accounts receivable, net	1,217	3,565
Inventories	1,934	2,245
Other current assets	239	137
	-----	-----
TOTAL CURRENT ASSETS	7,584	14,067
LOANS TO OFFICERS	473	2,029
PROPERTY, PLANT AND EQUIPMENT, NET	1,071	1,208
OTHER ASSETS, NET	3,559	3,901
	-----	-----
	\$12,687	\$21,205
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 356	\$ 814
Notes payable	300	300
Accrued compensation and benefits	871	1,817
Deferred service revenue	823	2,976
Income taxes payable	497	405
Other accrued expenses	962	504
	-----	-----
TOTAL CURRENT LIABILITIES	3,809	6,816
NON-CURRENT LIABILITIES	868	374
STOCKHOLDERS' EQUITY		
Common Stock, par value \$.20 per share, authorized 20,000,000 shares; issued 7,016,583 shares	1,403	1,403
Additional paid-in capital	13,957	15,498
Accumulated deficit	(5,960)	(1,281)
Accumulative other comprehensive loss	(580)	(580)
Unearned compensation		(156)
	-----	-----
	8,820	14,884
Less cost of 367,013 and 111,142 common shares in treasury	(810)	(869)
	-----	-----
TOTAL STOCKHOLDERS' EQUITY	8,010	14,015
	-----	-----
	\$12,687	\$21,205
	=====	=====

See Note to Condensed Consolidated Financial Statements.

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

Three Months Ended Nine Months Ended
September 30, September 30,

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	2006	2005	2006	2005
	----	----	----	----
REVENUES				
Sales	\$ 1,455	\$ 751	\$ 5,676	\$ 2,929
Service	444	235	1,264	832
	-----	-----	-----	-----
	1,899	986	6,940	3,761
COST OF REVENUES	950	598	3,894	1,969
	-----	-----	-----	-----
Gross Profit	949	388	3,046	1,792
OTHER COSTS AND EXPENSES:				
Research and development	947	760	3,828	2,269
Selling, general and administrative	1,481	772	4,169	2,510
Other (income)expense, net	(101)	(94)	(281)	(228)
	-----	-----	-----	-----
Loss before income taxes	(1,378)	(1,050)	(4,670)	(2,759)
PROVISION FOR INCOME TAXES	15	15	45	45
	-----	-----	-----	-----
Loss from continuing operations	(1,393)	(1,065)	(4,715)	(2,804)
Discontinued operations:				
Loss, net of tax		(266)		(977)
Impairment loss		(319)		(319)
Cumulative effect of change in accounting principle, net of tax				36
	-----	-----	-----	-----
NET LOSS	(1,393)	(1,650)	(4,679)	(4,100)
Currency translation adjustment		(3)		(28)
	-----	-----	-----	-----
COMPREHENSIVE LOSS	\$(1,393)	\$(1,653)	\$(4,679)	\$(4,128)
	=====	=====	=====	=====
LOSS PER BASIC AND DILUTED SHARE:				
Continuing operations	\$ (0.20)	\$ (0.19)	\$ (0.67)	\$ (0.50)
Discontinued operations		(0.05)		(0.17)
Impairment loss		(0.06)		(0.06)
Cumulative effect of change in accounting principle, net of tax			.01	
	-----	-----	-----	-----
Net loss	\$ (0.20)	\$ (0.29)	\$ (0.67)	\$ (0.72)
	=====	=====	=====	=====
Weighted average number of basic and diluted shares outstanding:	6,805,277	5,685,997	6,991,153	5,657,993
	=====	=====	=====	=====

See Note to Condensed Consolidated Financial Statements.

COGNITRONICS CORPORATION AND SUBSIDIARIES

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

	Nine Months Ended	
	September 30,	
	2006	2005
	----	----
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	\$ (3,273)	\$ 2,202
	-----	-----

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INVESTING ACTIVITIES		
Purchase of marketable securities	(4,753)	(8,123)
Sales of marketable securities	7,967	6,665
Repayment of officers' loans	124	
Additions to property, plant and equipment	(239)	(47)
	-----	-----
NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES	3,099	(1,505)
	-----	-----
FINANCING ACTIVITIES		
Repurchase of shares	(452)	
Shares issued pursuant to employee stock plans	1	38
	-----	-----
NET CASH (USED) PROVIDED BY FINANCING ACTIVITIES	(451)	38
	-----	-----
CASH PROVIDED (USED) BY DISCONTINUED OPERATIONS	0	(90)
	-----	-----
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(625)	645
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	1,750	2,222
	-----	-----
CASH AND CASH EQUIVALENTS - END OF PERIOD	\$ 1,125	\$2,867
	=====	=====
INCOME TAXES PAID	\$ 2	\$ 2
	=====	=====
INTEREST PAID	\$ 0	\$ 2
	=====	=====
NON-CASH INVESTING AND FINANCING ACTIVITIES		
Repayment of officers' loans and accumulated interest with Common Stock	\$1,472	\$ -
	=====	=====

See Note to Condensed Consolidated Financial Statements.

NOTE TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

September 30, 2006

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date. For further information,

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refer to the consolidated financial statements and footnotes thereto and the quarterly financial data included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106, and 132R" (SFAS No. 158). SFAS No. 158 requires that the funded status of defined benefit postretirement plans be recognized on the company's balance sheet, and changes in the funded status be reflected in comprehensive income, effective fiscal years ending after December 15, 2006. SFAS No. 158 also requires the measurement date of the plan's funded status to be the same as the company's fiscal year-end effective fiscal years ending after December 15, 2008. If the company had applied the provisions of SFAS No. 158 to the consolidated balance sheet for fiscal 2005, would have been no impact.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS No. 157). The purpose of SFAS No. 157 is to define fair value, establish a framework for measuring fair value and enhance disclosures about fair value measurements. The measurement and disclosure requirements are effective for the company beginning in the first quarter of fiscal 2008. The company is currently evaluating whether SFAS No. 157 will result in a change to its fair value measurements.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109" (SFAS No. 109). The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective for the company beginning in the first quarter of fiscal 2007. The company is currently evaluating the impact this statement will have on its consolidated financial statements.

Inventories (in thousands):

	September 30, 2006	December 31, 2005
	----	----
Finished and in process	\$1,509	\$1,571
Materials and purchased parts	425	674
	-----	-----
	\$1,934	\$2,245
	=====	=====

Non-Current Liabilities (in thousands):

	September 30, 2006	December 31, 2005
	----	----
Accrued supplemental pension plan	\$ 273	\$ 313
Accrued deferred compensation	149	176
Accrued pension expense	703	775
	-----	-----
	1,125	1,264

Less current portion included

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in accrued compensation and benefits	257 ----- \$ 868 =====	890 ----- \$ 374 =====
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Income Per Share

In computing basic earnings per share, the dilutive effect of stock options and warrants are excluded, whereas for diluted earnings per share they are included. For all periods presented, options and warrants were anti-dilutive and therefore were not included in the determination of net loss per share.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R) ("SFAS No. 123(R)"), "Share-Based Payment," which establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS No. 123(R), share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant). Prior to January 1, 2006, the Company accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. The Company also followed the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). The Company elected to adopt the modified prospective transition method as provided by SFAS No. 123(R) and, accordingly, financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing share-based compensation.

The Company has recognized compensation expense for its restricted stock grants. Upon adoption of SFAS 123(R), using the modified prospective method, the Company recognized a benefit of \$36,000 as a cumulative effect of a change in accounting principle resulting from the requirement to estimate forfeitures of the Company's restricted stock grants at the date of grant instead of recognizing them as incurred. The estimated forfeiture rate was applied to the previously recorded compensation expense of the Company's unvested restricted stock in determining the cumulative effect of a change in accounting principle. The cumulative benefit, net of tax, increased both basic and diluted earnings per share by \$0.01 for the nine-month period ended September 30, 2006.

SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense over the service period (generally the vesting period) in the consolidated financial statements based on their fair values. For options with graded vesting, the Company values the stock option grants and recognizes compensation expense as if each vesting portion of the award was a separate award. Under the modified prospective method, awards that were granted, modified, or settled on or after January 1, 2006 are measured and accounted for in accordance with SFAS 123R. Unvested equity-classified awards that were granted prior to January 1, 2006 will continue to be accounted for in accordance with SFAS 123, except that compensation expense for all such awards are recognized in the results of operations over the remaining vesting periods. The impact of forfeitures that may occur prior to vesting is also estimated and considered in the amount recognized.

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The Company has stock-based compensation plans under which directors, officers and other eligible employees receive stock options and other equity-based awards. The plans provide for the grant of stock options and restricted stock awards.

Stock options are granted with an exercise price equal to the market value of a share of common stock on the date of grant. Stock options generally expire in 10 years and vest over thirty months.

Restricted stock awards generally vest over four to six years.

The following table summarizes stock option activity:

	Inducement Options		1990 Stock Option Plan		Directors' Option Plan	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
	-----	-----	-----	-----	-----	-----
Outstanding at December 31, 2005	705,000	\$2.55	1,090,219	\$3.95	158,750	\$3.59
Granted	140,000	\$2.92	342,500	\$4.17	38,500	\$2.11
Exercised			(67,868)	\$1.71		
Forfeited/ expired	(232,500)	\$2.55	(681,468)	\$4.31	(17,000)	\$8.40
	-----		-----		-----	
Outstanding at September 30, 2006	612,500	\$2.63	683,383	\$3.92	180,250	\$2.82
	=====		=====		=====	
Shares available for future grant			347,483		7,250	
Weighted average remaining term		9.20 years		3.93 years		7.50 years
Intrinsic value:						
Outstanding		\$2,000		\$181,000		\$45,000
Exercisable		\$0		\$173,000		\$37,000

In 2006, the terms for 342,500 options under the 1990 Stock Option Plan were modified to make them exercisable for a period of two years subsequent to termination of service. This was treated as a forfeiture and grant of new options in the above table. An expense of \$132,000 related to such modification was included as severance expense in selling, general and administrative expenses.

In 2006, shares of stock were used to exercise options to purchase 65,868 shares with an intrinsic value of \$82,000 and cash was used to exercise options to purchase 1,000 shares with an intrinsic value of \$2,000. The intrinsic value for stock options is calculated based on the exercise price of the underlying awards and the market price of our common stock as of the reporting date.

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On January 2, 2006, 395,000 common shares, which were granted in 2002, vested. The total value of the restricted stock awards, at the date of grant, aggregated \$612,000 and was based on the market price of \$1.55 per share.

On August 16, 2006, 200,000 restricted common shares with a market value of \$410,000 were granted. These shares vest and the restrictions lapse, subject to acceleration for change in control, on the fourth anniversary of the date of grant. With regards to these shares, for the three months and the nine months ended September 30, 2006, the Company recognized \$13,000 of expense included in selling, general and administrative expense.

In addition, the Company has a Restricted Stock Plan, the activity of which is summarized as follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested as of December 31, 2005	182,450	\$2.58
Granted	-	
Vested	(79,850)	\$2.86
Forfeited	(52,300)	\$2.54

Unvested as of September 30, 2006	50,300	\$2.18
	=====	
Shares available for future grant	75,200	
	=====	

The following table summarizes the pro forma effect of stock-based compensation as if the fair value method of accounting for stock compensation had been applied for the three-month and nine-month periods ended September 30, 2005 (in thousands except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net loss, as reported	\$(1,650)	\$(4,100)
Add: Stock-based compensation included therein	79	244
Deduct: Total stock-based compensation under the fair value method	(105)	(372)
	-----	-----
Pro forma net loss	\$(1,676)	\$(4,228)
	=====	=====
Loss per share applicable to common shareowners:		
As reported: Basic and diluted	\$(0.29)	\$(0.72)
Pro forma: Basic and diluted	\$(0.29)	\$(0.75)

The following table summarizes the components and classification of stock-based compensation expense included in the Statements of Operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Stock options	\$ 51	\$	\$442	\$
Stock options-severance	132		132	
Restricted stock	22	76	72	233
Other	0	3	0	11

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	---	----	----	---
Total stock-based compensation	\$205	\$ 79	\$646	\$244
	====	====	====	====
Cost of products and services	\$ 15	\$ 7	\$ 41	\$ 21
Selling, general and administrative	156	61	390	188
Research and development	34	11	215	35
	----	----	----	----
Total stock-based compensation	\$205	\$ 79	\$646	\$244
	====	====	====	====

As a result of adopting FAS 123(R), the Company's loss before income taxes and loss from continuing operations for the three months and nine months ended September 30, 2006 is \$51,000 and \$442,000, respectively, larger than if it had continued to account for share-based compensation under APB 25. Basic and diluted loss per share from continuing operations for the three months and nine months ended September 30, 2006 would have been \$(0.20) and \$(0.61), respectively, if the Company had not adopted FAS 123(R), compared to reported basic and diluted loss from continuing operations per share of \$(0.20) and \$(0.67), respectively.

No tax benefits were attributed to the stock-based compensation expense because a valuation allowance is maintained for substantially all net deferred tax assets. The Company elected to adopt the alternative method of calculating the historical pool of windfall tax benefits as permitted by FASB Staff Position (FSP) No. SFAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards." This is a simplified method to determine the pool of windfall tax benefits that is used in determining the tax effects of stock compensation in the results of operations and cash flow reporting for awards that were outstanding as of the adoption of SFAS 123(R).

The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company's stock options granted during the nine months ended September 30, 2006. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards. The following table summarizes the assumptions used to compute the weighted average fair value of stock option grants of \$0.47 and \$0.66, respectively, during the three-month and nine-month periods ended September 30, 2006:

	Three Months	Nine Months
Dividend yield	0.0%	0.0%
Weighted average volatility	49.7%	50.9%
Risk-free interest rate	5.0%	4.9%
Expected holding period (in years)	2.52	2.68

No dividend yield was assumed because the Company has never paid a cash

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dividend.

The weighted average volatility for the current period was developed using historical volatility.

The risk-free interest rate was developed using the U.S. Treasury yield for periods equal to the expected life of the options on the grant date. An increase in the risk-free interest rate will increase stock compensation expense.

The expected holding period was developed after considering vesting schedules, life of the option, historical experience and estimates of future exercise behavior patterns. An increase in this assumption would increase stock compensation expense.

SFAS 123R requires the recognition of stock-based compensation for the number of awards that are ultimately expected to vest. As a result, for most awards, recognized stock compensation was reduced for estimated forfeitures prior to vesting primarily based on historical annual forfeiture rates of approximately 5%. Estimated forfeitures will be reassessed in subsequent periods and may change based on new facts and circumstances. Prior to January 1, 2006, actual forfeitures were accounted for as they occurred for purposes of required pro forma stock compensation disclosures.

As of September 30, 2006, approximately \$.3 million and \$.4 million of unrecognized stock compensation (net of estimated forfeitures) related to unvested option awards and unvested stock grants, respectively, are expected to be recognized over weighted-average periods of 1.5 and 3.4 years, respectively.

In addition, for the purpose of the Statement of Cash Flows, the realization of tax benefits in excess of amounts recognized for financial reporting purposes will be recognized as a financing activity rather than an operating activity as in the past.

Pension Plan

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

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Interest cost on projected benefit obligation	\$19	\$22	\$61	\$67
Expected return on plan assets	(18)	(14)	(51)	(43)
Amortization of net loss	14	8	35	23
	---	---	---	---
Net periodic pension cost	\$15	\$16	\$45	\$47
	===	===	===	===

The Company has decided not to complete the previously announced termination of this plan. The Company expects funding requirements to be \$150,000 in

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2006, of which \$117,000 was funded during the nine months ended September 30, 2006.

Acquisition

On November 18, 2005, the Company acquired ThinkEngine Networks, Inc. The following are unaudited pro forma results for the three-month and nine-month periods ended September 30, 2005 as if the acquisition had taken place at the beginning of the period (amounts in thousands):

	Three Months	Nine Months
Revenues	\$ 1,194 =====	\$ 4,776 =====
Loss from continuing operations	\$(1,935) =====	\$(5,302) =====
Net loss	\$(2,520) =====	\$(6,598) =====
Loss per share:		
Loss from continuing operations	\$ (.28) =====	\$ (.78) =====
Net loss	\$ (.37) =====	\$ (.97) =====

Reclassifications

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

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 its former Vice President of European Operations. As a result, the Company has reclassified the revenues and expenses related to Dacon's operations as discontinued operations in its Consolidated Statement of Operations and Comprehensive Income.

Summary results for discontinued operations for the three-month and nine-month periods ended September 30, 2005 are as follows (in thousands).

	Three Months	Nine Months
Revenue	\$1,352	\$2,942
Operating costs and expenses	1,618 -----	3,922 -----
Operating loss	\$ (266) =====	\$ (980) =====
Loss from discontinued operations	\$ (266) =====	\$ (980) =====

Related Party Transaction

During the nine-month period ended September 30, 2006, current and former officers of the Company repaid loans and accumulated interest, aggregating

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approximately \$1,596,000. Repayment consisted of \$124,000 and 568,625 shares of Company common stock, valued at the closing market price at the date of repayment of loans.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain Factors That May Affect Future Results

The following information, including, without limitation, the Quantitative and Qualitative Disclosures About Market Risk that are not historical facts, may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements generally are characterized by the use of terms such as "believe", "expect" and "may". Although the Company believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions, the Company's actual results could differ materially from those set forth in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, variability of sales volume from quarter to quarter, product demand, pricing, market acceptance, litigation, risk of dependence on significant customers and third party suppliers, intellectual property rights, risks in product and technology development and other risk factors detailed in this Quarterly Report on Form 10-Q, the Company's Form 10-K for the year ended December 31, 2005 and in the Company's other Securities and Exchange Commission filings.

Results of Operations

The Company reported losses from continuing operations of \$1.4 million (\$0.20 per basic and diluted share) and \$4.7 million (\$0.67 per basic and diluted share) for the three-month and nine-month periods ended September 30, 2006, respectively versus losses of from continuing operations of \$1.1 million and \$2.8 million, respectively, in the prior year periods. Included in the results from operations for the three months and nine months ended September 30, 2006 was \$0.1 and \$0.4, respectively, of expense related to the expensing of stock options. Net loss was \$1.4 million and \$4.7 million for the three and nine-month periods ended September 30, 2006 versus \$1.6 million and \$4.1 million, respectively, in the prior year periods.

A continuing shift in the wireline segment of the telecommunications market with increasing emphasis on capital investment in next generation services and build-out of the fiber optic infrastructure has resulted in a decreasing amount of available capital investment funding for the legacy wireline operations. This has impacted the demand for the Company's CX Media Servers. Accordingly, the Company has reduced and reassigned personnel. Reflecting the increased demand for next generation voice services and conferencing solutions, additional resources are being added to sales, marketing and R&D efforts supporting the VSR1000 product, including personnel reassigned from supporting the CX Media Server products.

Consolidated revenues for the quarter ended September 30, 2006 increased \$0.9 million, or 93%, from the prior year period. Revenues increased \$0.5 million due to the inclusion of ThinkEngine Networks, Inc. ("ThinkEngine") acquired in November of 2005 and increased product sales of \$0.4 million to a cable operator. Consolidated revenues of \$6.9 million for the nine months ended September 30, 2006 increased \$3.2 million (85%) from the prior year period. Revenues increased due to increased product sales of \$1.9 million to a telecommunications service provider in 2005 and recognized as a sale in the current year and \$1.4 million due to the inclusion of ThinkEngine, offset, in part, by lower sales of \$0.8 million to a world-wide telecommunications system integrator.

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The gross margin percentage was approximately 50% and 44%, respectively, in the quarter and nine months ended September 30, 2006 versus 46% and 48%, respectively, in the prior year. Included in cost of revenues for the nine months ended September 30, 2006 are contract cancellation fees of \$.4 million, amortization of intangibles of \$.4 million and provision for obsolescence of \$.1 million. There were no similar charges in the prior year periods.

Research and development expense increased \$.2 million (25%) and \$1.6 million (69%), respectively, for the three-month and nine-month periods ended September 30, 2006 as compared to the prior year's periods primarily due to the inclusion of ThinkEngine (\$.4 million and \$1.5 million, respectively), the expensing of stock options (\$.2 million in the nine-month period) and severance costs (\$.2 million in the nine-month period).

Selling, general and administrative expense increased \$.7 million (91%) and \$1.7 million (66%) for the three and nine-month periods ended September 30, 2006, respectively, primarily due to the inclusion of ThinkEngine (\$.3 million and \$.8 million, respectively), the expensing of stock options (\$.2 million in the nine-month period) and severance expense (\$.6 million and \$.7 million, respectively).

Other (income) expense, for the nine months ended September 30, 2006, increased due to higher interest earned on cash balances and marketable securities, reflecting higher interest rates, offset, in part, by lower balances.

No tax benefit was provided for the losses incurred in 2006 since the Company cannot determine that the realization of the net deferred tax asset is more likely than not.

Liquidity and Sources of Capital

Net cash used by operations for the nine months ended September 30, 2006 was \$3.3 million versus cash provided by operations of \$2.2 million in the comparable period of 2005; this variance from the prior year is primarily attributable to increased loss from continuing operations and the decrease in deferred revenue of \$2.1 million in the 2006 period versus a \$2 million increase in the 2005 period. The cash provided by investing activities of \$3.1 million in 2006 primarily reflects net sales of marketable securities and repayment of officers loans. The cash used by financing activities of \$.5 million primarily represents the acceptance of the Company's Common Stock by the Company for the payment of withholding tax liabilities.

Working capital and the ratio of current assets to current liabilities was \$3.8 million and 2.0:1 at September 30, 2006 compared to \$7.2 million and 2.1:1 at December 31, 2005.

During the remainder of 2006, the Company anticipates purchasing \$.1 million of equipment. Management believes that its cash and cash equivalents and marketable securities will be sufficient to meet these needs in 2006. However, to meet its longer-term capital needs, the Company may in the future be required to seek new sources of debt or equity financing or may seek to sell certain Company assets. The Company may also be required to further reduce operating costs in order to meet its obligations. The Company's ability to fund its operations is heavily dependent on the growth of its revenues over current levels to achieve profitable operations. No assurance can be given that management's initiatives will be successful or that any such additional sources of financing will be available on acceptable terms or at all.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

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

Item 4. CONTROLS AND PROCEDURES

Cognitronics Corporation's management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective as of the end of the period covered by this report in ensuring that all material information required to be disclosed in this quarterly report and all information required to be disclosed by the Company under the Securities Exchange Act of 1934 has been made known to them in a timely fashion. During the three months ended September 30, 2006, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Part II. OTHER INFORMATION

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The Company, on July 10, 2006, granted to an employee inducement options to purchase 10,000 shares of the Company's Common Stock at an exercise price of \$2.30. The options become exercisable over a 30-month period in three installments (the earliest being 6 months from date of grant) and expire 10 years from date of grant. In addition, the Company, on August 16, 2006, granted to an employee 200,000 inducement restricted shares of the Company's Common Stock. The restrictions will lapse on the fourth anniversary of the date of grant, subject to acceleration due to a change in control of the Company. The issuance of inducement options and restricted shares were not registered under the Securities Act in reliance on the exceptions set forth in Section 4(2) of the Securities Act.

In July and August of 2006, the company accepted 66,363 and 259,472 shares of its Common Stock (valued at \$2.42 and \$2.02 a share, respectively) in repayment of loans to officers of \$161,000 and \$524,000, respectively.

Item 6. EXHIBITS

Index to Exhibits

Exhibit

- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

SIGNATURE

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

COGNITRONICS CORPORATION
Registrant

Date: November 14, 2006

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