This 3DAdvisors Report Covers:

- ✓ **Insider Trading**: Insider Trading Behavior
- ✓ **Accounting**: Quality of Earnings Issues
- **Governance:** Corporate Governance Issues

Accounting Issues Underscore Urgent Insider Selling Cogent Inc. (NASDAQ:COGT)

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Cogent, Inc. provides automated fingerprint identification systems (AFIS) and other fingerprint biometrics solutions to governments, law enforcement agencies, and other organizations worldwide. It offers two primary AFIS solutions, Cogent Automated Fingerprint Identification System (CAFIS) and Cogent Live-ID. CAFIS is a networked AFIS solution for local, regional, and national systems. Cogent Live-ID enables customers to identify individuals who submit their fingerprints for border crossings, background checks, fraud prevention, criminal investigation, document identification, voting stations, and other activities where security is a concern. Cogent markets its AFIS solutions directly to end-users and indirectly through prime contractors, as well as its proprietary ASIC device indirectly through original equipment manufacturers, resellers, and distributors. The company has strategic relationships with IBM, Hewlett-Packard, Fujitsu, and Sun Microsystems. The company was founded by Ming Hsieh in 1990. It was formerly known as Cogent Systems, Inc. and changed its name to Cogent, Inc. in 2004. Cogent is headquartered in South Pasadena, California.

Summary of 3DAdvisors Findings for COGT

- **Insider Trading:** Behavior suggests real impatience or extreme urgency
- **Accounting:** The timing of revenue and a drop in deferred revenue
- **Accounting:** Additional risks to revenue
- **Accounting:** Lack of meaningful backlog information
- **Accounting:** The error in stock-based compensation amortization

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Discussion of 3DAdvisors Findings

Cogent initially attracted our attention recently (*Insider Research Bulletin* on 07/14/05) when key insiders sold very aggressively upon the expiration of lockups extending from the Company's September 2004 IPO, then sold again into a June 21st secondary, selling 7 of the 11 million shares offered in the deal (the Company sold the other 4 million shares). It is rare to see insiders selling into soft prices so close to a secondary offering, then again in that offering. The holdings reductions of the sellers were very large as well, all of which prompted us to take a closer look at the Company.

Further inspection reveals additional detail concerning the insider sales that betrays a sense of urgency in their actions; a concentrated revenue base and little to no backlog disclosure with regards to new business; high percentage of fixed-price contracts where percentage of completion accounting (POC) is utilized; a sharp decline in deferred revenue; and a clear sense of evasiveness in management's response to certain analyst questions.

Certainly, the Homeland Security element surrounding Cogent's core Automated Fingerprint Identification Systems (AFIS) business provides plenty of froth around this issue. Yet, in spite of the management's seemingly unbridled optimism, certain actions of key insiders seem at odds with the sunny outlook.

Insider Trading: Behavior suggests real impatience or extreme urgency

Clearly, the fact that Cogent CFO **Paul Kim** (37) was willing to slash his holdings by 90%, soon after the IPO's lockup expiration, hit our radar screen. Ditto for sales by Executive V.P. Operations, **Michael Hollowich** (58) who reduced his holdings by 60% during the same period, while **James Jasinski** (55), Executive V.P. Federal & State Systems trimmed his holdings by 57% in the secondary. Making this all that much more intriguing is that Cogent identifies just four executives as filing insiders, and three of them have recently dropped between 57% and 90% of their positions at their first opportunity and with no large replenishment of options coming downstream.

By the time the lock-up restrictions lapsed, Cogent's shares were trading nearly 30% off the highs at $25, but this didn't prevent insiders from monetizing their low-priced options. Between March 23rd and May 11th all four filing executives sold a total of 782,280 shares in the open market as the issue trended down from $25 to $21. Cogent is one of the few companies we've encountered with so few designated Section 16 filing executives. But the selling goes far beyond just these four.

As we mentioned earlier, the post lock-up selling alone isn't what compelled us to highlight the trading behavior at Cogent, it's what took place after the most recent open-market sales that has grabbed our attention. On May 16th, with the issue trading at its lowest price since November, the Company filed a registration statement to sell 11 million shares. Of the total shares being offered, Cogent's top four executives were to account for 7 million (CEO Hsieh sold an additional 1.65 million shares to cover the over-allotment) with the proceeds from 4 million shares going to the Company. The offering was completed on June 21st after the issue rebounded off the bottom and insiders capitalized on the higher prices, receiving $25.50 for their shares. It seems that the motivation for the offering rested more on the executives' desire to liquidate their holdings than for the Company's capital needs.

Even more telling, however, and something we had not mentioned in our recent *Insider Research Bulletin*, is the fact that many employees, outside of the circle of four Section 16 key executives, have been quick to sell as soon as the chance arose, that they accepted far worse tax consequences than they would have had they waited until next year. This is because they were not willing to retain their exercised-for shares for the full holding period in order to get capital gains treatment on their shares. Since options issued by Cogent had been Incentive Stock Options (ISO's) as opposed to Non-Qualified Options, they were subject to special holding period restrictions which, if not adhered to, would have the most costly of tax consequences. By not holding for the required period, many of the Q1 and Q2 sales by Cogent insiders and employees were considered "disqualifying dispositions" which meant that the difference between the exercise price of the options (which ranged from just $0.30 to $1.00 per share) and the Market price of the shares ($25 range) was treated as personal income for those involved. Had they waited a year from exercise, the difference would have been a capital gain.

Figure 1. COGT Daily Closing Price, October 1, 2004 through July 28, 2005. Blue diamond is the date of the COGT secondary; blue shaded area is where four insiders sold 782,280 shares. Source: Reuters and COGT SEC Filings.

The holding period works as follows:

To avoid a disqualifying disposition, insiders have to hold the stock acquired through exercising ISO options beyond the later of the following two dates:

- One year after the date of the ISO exercise, or
- Two years after the date of the ISO grant.

Since the options were granted in May of 2004, the latter of the two dates, for the Q1 exercises, would have been Q1 of 2006. The good news to Cogent in all of this is that it realized a tax benefit of $5.5 million during the Q1 period and the Company attributed the disqualifying dispositions to the drop in its effective tax rate to 35% in the quarter. However, the total amount of selling related to these disqualifying dispositions topped even Cogent's expectations as it had originally projected that its effective tax rate would drop to 28% in Q2 as a result of these actions. Interestingly enough, however, yesterday's Q2 release revealed that Cogent's effective tax rate was, in fact, 22% for the period, and it was driven down by "the amount of research and development tax credits generated from stock option exercises during the quarter". It didn't take us too long to figure out that this meant Cogent engineers (the heart of the Company's work force) picked up the pace of their stock selling dramatically during the period.

Cogent spends much time telling the investment public about its numerous opportunities in an obviously intriguing market. The Company spends far less effort talking about competition and the attendant complexities of the worldwide bidding process it finds itself in. The actions of both employees and management, with regards to the treatment of their holdings, imply that there is much more risk on the horizon than the Company is willing to specifically reveal to investors.

The selling by all four named executives:

- **Paul Kim (37)** – CFO. Kim joined Cogent in January 2004 after coming over from storage area network firm JNI Corp. Upon his hire, he was awarded 950,000 options that the Company reports on all of its filings are supposed to vest over four years. Although they do vest over a four-year period, the vesting was front-loaded with just under half of the options becoming exercisable within the first year. This explains how Kim was able to monetize 448,777 options under the cover of a 10b5-1 trading plan from March 23rd (the day after the lock-up expiration) through June 21st at an average price of $24.50. Of the total he's sold so far, 225,000 shares were distributed on June 21st into the secondary offering, while 1,215 shares were his only common shares that were acquired in April under the Company's Employee Stock Purchase Plan. In all, **the sales have wiped out 90% of his actionable position**, which will take years to replenish even at the current vesting pace of 44,532 options per quarter.

- **Michael Hollowich (58)** – Executive V.P., Operations. Hollowich has been issued five different stock option awards covering a total of 340,000 options since joining the Company in February 2001. From April 27th through May 11th he exercised a majority of his March 2011 options and sold the underlying 57,280 shares at roughly $22. These sales were just the precursor to the 75,000 shares he sold in the secondary offering on June 21st, **which in all has reduced his position by 60%**. The shares sold in June were acquired when he exercised three separate series with expiration dates ranging between March 2011 and January 2013. Hollowich currently has 87,670 vested options and will have roughly 11,000 new options vest each quarter.

- **James Jasinski (55)** – Executive V.P., Federal and State Systems. Jasinski joined Cogent in May 2002 after serving as a vice president at DynCorp for two years and the FBI for 22 years before that. Since he started at COGT, he has received four options series that cover a total of 240,000 options. Unlike the others, Jasinski didn't sell following the lock-up expiration, but then unloaded 100,000 shares, **equal to 57% of his ownership stake**, in the secondary at $25.50. All that remains is 75,001 vested options and roughly 16,000 new options that will vest each quarter.

- **Ming Hsieh (49)** – Chairman, President, CEO. Hsieh founded the Company back in 1990 and is currently the largest shareholder. At the time of the IPO, Hsieh held 60 million shares equal to 76.9% of the outstanding shares, plus 600,000 vested options held for his wife. In October 2004, prior to the lock-up expiration date, Hsieh entered into a 10b5-1 trading plan to sell up to 250,000 shares per month. He executed his first sale under the plan on April 1st and sold a total of 500,000 shares by May 6th as the shares traded down from $25 to $21. Obviously, those sales barely put a dent into his sizeable position, but we can't say the same for his next distributions. On June 21st Hsieh went out of plan to sell 6.6 million shares into the secondary, including 633,750 shares acquired from exercising all his wife's vested options. Two days later he sold an additional 1.65 million shares to the underwriters at the same price of $25.50 to cover over-allotments. In all, the selling trimmed his holdings by 15%.

Accounting: The timing of revenue and a drop in deferred revenue

With 80% of Cogent's contracts being fixed price and an abundance of them utilizing percentage of completion (POC) accounting, it's not difficult to see the opportunities for revenue management. For example, Cogent explains the composition of its deferred revenue balance in a fashion that provides details for the obvious circumstances for up front payments from customers but then the Company goes on to describe another component of Deferred Revenue that is quite curious and not explained at all. From Cogent's first quarter SEC Form 10-Q (bolding is ours for emphasis):

> Our deferred revenue balance results primarily from payments received from customers in advance of recognition of the related revenue and, to a lesser extent, from invoicing of customers prior to recognition of the related revenue. For example, certain customers, such as CNE, make upfront payments resulting in cash collected prior to our recognition of revenue. We record this upfront payment as deferred revenue and reduce the deferred revenue balance as revenue is recognized. As a result, our deferred revenue balance fluctuates from quarter to quarter because it is a function of the timing of (i) the receipt of cash payments from those customers who pay in advance of revenue recognition, (ii) **invoicing of customers in advance of revenue recognition and** (iii) amortization of deferred revenues into revenues.

While deferred revenue arising from payments by customers in advance of revenue recognition is clear and not unusual, less clear is deferred revenue arising from invoicing of customers in advance of revenue recognition. No explanation is given as to why customers would be invoiced, absent sufficient work having been performed to justify revenue recognition. Little is accomplished other than getting an asset and liability on the balance sheet. Conceivably it is an effort to get cash in hand more quickly, but opportunities for managing the timing of revenue recognition abound as well. Better disclosure would explain the rationale for the practice.

With that being said, it is interesting to note the drop off in Deferred Revenues (D/R's) of late, which dropped 30% in Q1, 2005 to $41.5 million from $59.7 million at 12/31/04. In Q2, D/R's dropped another 24%, this time to $31.6 million. The Company goes to great lengths to repeat, *ad nauseam*, that backlog and Deferred Revenues are not important. It is certainly understandable that the continuing recognition of revenue from the Venezuelan contracts is taking D/R's down, but at the same time Cogent talks about booking millions in new contracts from other customers. This leaves us to wonder why some of these new deals are not beginning to be reflected in Deferred Revenues. When asked this same question in the Q2 conference call (about how much of Q2's $75 million in new orders would hit D/R), CFO Kim replied "as a lot of people know, these large contracts are very complex and determining the accounting treatment for it takes some time. We're working with the auditors to determine the revenue recognition treatment for both those two contracts". Funny how, in Q3 and Q4 of 2004, when earlier contracts were signed with Venezuela, Cogent had booked certain leasing revenues in the quarter the deals were inked, but not this time. In this case, the comment "working with the auditors" may have an ominous ring to it.

As D/R's drop, there seems to be a growing risk of a gap in revenues. Cogent signed $75 million in new contracts in Q2 but not much of it seems to be going into 2005 revenues. A $34 million contract with Morocco for Cogent's AFIS applications will not contribute until 2006. The $32 million add-on to the Venezuelan contract will not produce "significant" revenues until the 3rd or 4th quarter. Meanwhile, Cogent has already spent $6 million in "upfront material and subcontractor costs" in Venezuela as of the Q2 earnings release date.

With regards to revenue timing, it's interesting to note how Cogent allocates revenue related to its Venezuelan contracts. In the third quarter of 2004, Cogent entered into contracts with Venezuela's National Electoral Council (CNE) totaling $54 million. Since Vendor-Specific Objective Evidence (VSOE) of the maintenance element of the contract did not exist, all revenue other than the lease component of the revenue had to be amortized over the life of the contracts. Since they were caught in the "lack of Vendor Specific Objective Evidence" bind relating to the maintenance elements of the contracts, and therefore could not put anything in revenue up for maintenance revenue, putting as much value on the lease component as they could was the only way they could get something in current revenue for the deals. Cogent estimated that $7 million of the contract was the value of the lease component, which was recognized immediately in Q3 of 2004. In Q4 of 2004, Cogent entered into another contract with Venezuela's CNE. This one was valued at $20.2 million. In this case, the lease component of the contract was valued at $3.7 million and was immediately booked as revenue in that quarter. Interesting how the lease value represented 12.9% of the first contract, yet a greater 18.3% of the second, an unexplained increase. To this, we should note that Cogent provides no detail whatsoever of its leasing activity in its financials.

Another recent contract win, disclosed by Cogent, is a $2.5 million contract with the Haitian Government. It will be interesting to see if that beleaguered entity will contribute to further deterioration of Cogent's DSO's which jumped from 47 to 70 days during Q2.

With regards to that jump in DSO's, CFO Kim's only explanation was that it was due to the timing of payments and that "we fully believe the balance is collectible". Kim later acknowledged that the delay in payments was related to U.S. government entities. We can't help but wonder, however, if the delay in receiving payment is due to any disputes, claims or unfilled obligations. They simply offer no real explanation for the delay in payments except for to say they happened.

Accounting: Additional risks to revenue

The main drivers to Cogent's business, at this time, are the Department of Homeland Security (DHS) and Venezuela's National Electoral Council (CNE). To be frank, it is difficult to imagine a company doing business in places such as Venezuela and Haiti without palms being greased. Morocco, the location of Cogent's newest contract, is no haven for clean government practices either. Indeed, in its bidding process, Cogent claims that "We enhance our opportunities for being selected as a prime or subcontractor by utilizing references from our existing customers, usually bidding on a fixed price basis and employing consultants who have strong relationships in our international markets." We find it quite interesting that directly on the heels of the signing of the recently announced $32 million Venezuela contract, and at least one full quarter, if not two, from booking significant revenues, Cogent has already spent $6 million in "upfront material and subcontractor costs". Regarding Venezuela, we find ourselves wondering if any consultant possesses the last name of "Chavez".

Clearly, should Chavez and his government ever take serious enough action to cause the U.S. to impose sanctions on Venezuela, the impact would be far from immaterial for Cogent. With the exception of the DHS, still absent from Cogent's book of business are contracts with more respectable nations.

With such a majority of Cogent's contracts with the DHS being fixed-price, we found an exchange, in the Q2 conference call especially interesting. When Cogent revealed that its databases related to the implementation of the DHS's US-Visit program (finger print identification of persons entering the U.S.) had been growing more significantly than originally forecasted, an analyst posed an interesting question:

> **Analyst**:
>
> And if you could you just talk about -- when you talk an increase in the databases and then the number of transactions is this more than was originally contemplated at the start of the year? So is the requirement for processing power growing beyond expectations?
>
> **Jim Jasinski, Cogent Inc. - EVP of Federal and State Systems**:
>
> The databases are growing faster than was originally envisioned, for lots of different reasons. It is going to -- of course, as that database increases and the numbers of transactions being sent through the databases will of course drive the amount of processing power that will be required to support the effort. The success that they've enjoyed with the program is very encouraging, both the government and to Cogent. It's a number of new potential applications that they're looking at, which could be very beneficial, both for protecting the borders and also for revenue generation. But that all is still in the process, and if it happens, it will be very good and very beneficial to all.

It seemed to us that the analyst was really asking whether or not costs were increasing in fulfilling a key fixed-cost contract. Certainly, this exchange cried for more probing which was not in the cards from a conference call dominated by analysts representing the sell-side firms that recently sold Cogent's June secondary.

<u>Accounting: Lack of meaningful backlog information</u>

We also find it interesting how Cogent only provides backlog information once per year, as required, in its 10K. Despite many questions, management steadfastly refuses to reveal meaningful backlog statistics, other than to say that opportunities abound everywhere and that they are chasing down opportunities and submitting proposals all over the globe. To us, it seems that their hesitance to disclose at least a bare bones backlog number on a quarterly basis is not motivated by competitive concerns but instead it seems the Company is not pleased enough with its backlog and therefore flatly refuses to disclose it.

With deferred revenues dropping and no clear disclosure of new revenue hitting the books in the near term, we're not surprised that the Company has back-loaded its revenue guidance heavily toward the second half of 2005.

Accounting: Error in deferred stock-based compensation amortization

In the Q3 of 2004, Cogent disclosed that an error that had extended back into 2003 had been discovered in the calculation of amortization of deferred stock-based compensation. This was prior to the Company's IPO. Cogent retroactively re-stated its Q1, 2004 statements to cover for the error, and in the process, accelerated the amortization rate of deferred stock-based amortization going back to 2003, recognizing the initial difference in Q1 of 2004. As a result, the effect of the accelerated amortization has been to reduce such expense in the subsequent years.

It appears that Cogent was initially spreading out the amortization over a longer period than was proper and was called to task on it by the auditors. They may have been stretching earnings a bit in the earlier years. The move clearly has the appearance of a deliberate effort to show higher annual earnings, during those earlier periods, rather than a bookkeeping mistake, as the Company implies.

This reminds us of the fact that Cogent converted from a Sub S Corp to a C Corp at the time of its IPO and just prior to doing so, switched auditors. Clearly, neither party would admit it but there must have been something to force the switch from KPMG at that time. One would figure that KPMG would not voluntarily give up the possibility of the $1.2 million audit fee (ultimately paid to successor Deloitte & Touche) in connection with the Company's IPO unless it were for good reason.