Cogent, Inc.
Form 10-Q
November 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

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

Commission file number 000-50947

COGENT, INC.

(Exact name of registrant as specified in its charter)

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

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

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 x No ¨

Indicate by check mark whether the registrant is a larger 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 x 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 x

As of November 1, 2007, there were 94,861,784 shares of the registrant s common stock outstanding.

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COGENT, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

COGENT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands, except share data)

(unaudited)

	December 31, 2006	September 30, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 18,801	$ 22,582
Investments in marketable securities	318,070	309,133
Billed accounts receivable, net of allowance for doubtful accounts of $692 and $676 at December 31, 2006 and September 30, 2007, respectively	26,798	15,050
Unbilled accounts receivable	530	914
Inventory and contract related costs	19,439	9,026
Prepaid expenses and other current assets	1,854	1,229
Deferred income taxes	24,929	24,861
Total current assets	410,421	382,795
Investments in marketable securities	77,355	126,447
Property and equipment, net	32,874	33,476
Restricted cash	576	
Deferred income taxes	18,494	6,065
Intangible and other assets	1,221	985
Total assets	$ 540,941	$ 549,768
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,102	$ 8,671
Accrued expenses	4,260	7,328
Income taxes payable	4,386	4,176
Deferred revenues	32,343	12,552
Total current liabilities	45,091	32,727
Long-term liabilities		
Deferred revenues	5,161	2,875
Other liabilities	130	1,392
Total liabilities	50,382	36,994
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2006 and September 30, 2007, respectively		
Common stock, $0.001 par value; 245,000,000 shares authorized;		

94,493,209 and 94,844,019 shares issued and outstanding at		
December 31, 2006 and September 30, 2007, respectively	120	120
Additional paid-in capital	419,446	421,940
Retained earnings	75,019	94,492
Accumulated other comprehensive (loss) income	(154)	94
Treasury stock, at cost: 340,000 shares at December 31, 2006 and September 30, 2007, respectively	(3,872)	(3,872)
Total stockholders equity	490,559	512,774
Total liabilities and stockholders equity	$ 540,941	$ 549,768

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share data)

(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	**2007**	**2006**	**2007**
Revenues:				
Product revenues	$ 18,399	$ 16,016	$ 42,586	$ 65,714
Maintenance and services revenues	4,976	6,496	16,737	18,205
Total revenues	23,375	22,512	59,323	83,919
Cost of revenues:				
Cost of product revenues	9,942	8,144	21,327	28,906
Cost of maintenance and services revenues	1,464	1,955	4,604	5,446
Total cost of revenues	11,406	10,099	25,931	34,352
Gross profit	11,969	12,413	33,392	49,567
Operating expenses:				
Research and development	2,098	2,670	6,315	7,775
Selling and marketing	1,955	2,361	5,700	6,422
General and administrative	3,490	5,670	8,852	17,546
Total operating expenses	7,543	10,701	20,867	31,743
Operating income	4,426	1,712	12,525	17,824
Other income:				
Interest income	4,654	5,756	12,325	16,530
Other, net	19	(195)	476	185
Total other income	4,673	5,561	12,801	16,715
Income before income taxes	9,099	7,273	25,326	34,539
Income tax provision	3,366	3,129	9,276	13,607
Net income	$ 5,733	$ 4,144	$ 16,050	$ 20,932
Basic net income per share	$ 0.06	$ 0.04	$ 0.17	$ 0.22
Diluted net income per share	$ 0.06	$ 0.04	$ 0.17	$ 0.22
Shares used in computing basic net income per share	94,178	94,436	94,024	94,331
Shares used in computing diluted net income per share	95,988	95,976	96,153	95,972

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended, September 30, 2006	Nine Months Ended, September 30, 2007
Cash Flows from operating activities:		
Net income	$ 16,050	$ 20,932
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,423	1,369
Allowance for doubtful accounts	206	(16)
Realized loss on investments	4	
Share-based compensation expense	3,562	2,193
Amortization of discount on available for sale securities	(1,512)	(4,391)
Deferred income taxes	8,849	11,411
Changes in assets and liabilities:		
Billed accounts receivable	30,022	11,784
Unbilled accounts receivable	620	(384)
Inventory and contract related costs	1,090	10,289
Prepaid expenses and other current assets	(736)	664
Other assets	(129)	124
Accounts payable	(116)	4,424
Accrued expenses	851	2,694
Income taxes payable	339	852
Deferred revenues	(7,578)	(22,077)
Other liabilities		56
Net cash provided by operating activities	52,945	39,924
Cash Flows from investing activities:		
Proceeds from sale of available-for-sale securities	893,420	1,243,467
Purchase of available-for-sale securities	(935,762)	(1,279,046)
Restricted cash		585
Purchase of property and equipment	(934)	(1,814)
Net cash used in investing activities	(43,276)	(36,808)
Cash Flows from financing activities:		
Proceeds from the exercise of stock options	834	468
Repurchase of common stock	(3,872)	
Net cash (used in) provided by financing activities	(3,038)	468
Effect of exchange rate changes on cash	64	197
Net increase in cash and cash equivalents	6,695	3,781
Cash and cash equivalents, beginning of period	19,805	18,801

Cash and cash equivalents, end of period	$	26,500	$	22,582
Supplemental disclosures of cash flow information:				
Cash received (paid) during the period for:				
Interest income	$	10,219	$	11,808
Income taxes	$	(1)	$	(705)
Non-cash financing activities				
Capitalized share-based compensation expense (inventory and contract related costs)	$	173	$	36

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. General

Company Background

Cogent, Inc. and subsidiaries (Cogent or the Company) was initially incorporated in the state of California on April 20, 1990 as Cogent Systems, Inc. and was reincorporated in Delaware on May 3, 2004 as Cogent, Inc. Cogent is a provider of advanced automated fingerprint identification systems (AFIS) solutions, which typically consist of Cogent s Programmable Matching Accelerator (PMA) servers and other AFIS equipment, including work stations and live-scans, bundled with Cogent s proprietary software and other fingerprint biometrics products and solutions, to governments, law enforcement agencies and other organizations worldwide. Cogent also provides professional services, technical support and maintenance services to its customers.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2007 and the condensed consolidated statements of income for the three and nine months ended September 30, 2006 and 2007 and condensed consolidated statements of cash flows for the nine months ended September 30, 2006 and 2007 are unaudited. These statements should be read in conjunction with the audited consolidated financial statements and related notes, together with management s discussion and analysis of financial position and results of operations, contained in the Company s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on March 1, 2007.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2006 and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of September 30, 2007, and its results of operations for the three and nine months ended September 30, 2006 and 2007 and its cash flows for the nine months ended September 30, 2006 and 2007. The condensed consolidated balance sheet as of December 31, 2006 has been derived from the December 31, 2006 audited financial statements. The interim financial information contained in this quarterly report is not necessarily indicative of the results to be expected for any other interim period or for the entire year.

Classification of Revenues

Product Revenues

The timing of product revenues recognition is dependent on the nature of the product sold. Product revenues are generally comprised of the following:

Revenues associated with AFIS solutions that do not require significant modification or customization of the Company s software, exclusive of amounts allocated to maintenance for which the Company has vendor-specific objective evidence of fair value, or VSOE, are recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided all other criteria for revenue recognition have been met. For example, the Company recognizes revenue in this manner from sales of its PMA servers to the DHS under a blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

Revenues associated with AFIS solutions that require significant modification or customization of the Company s software, are recognized using the percentage-of-completion method as described by SOP 81-1. The percentage-of-completion method reflects the portion of the anticipated contract revenue, excluding maintenance that has VSOE, which has been earned, equal to the ratio of labor effort expended to date to the anticipated final labor effort, based on current estimates of total labor effort necessary to complete the project. Material differences may result in the amount and timing of the Company s revenue for any period if actual results differ from the Company s judgments and estimates. The Company recognizes revenue in this manner from sales of significant initial AFIS deployments. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period or until the time when such VSOE is established. Revenues recognized under such arrangements were $7.2 million and zero for the three months ended September 30, 2006 and 2007, respectively, and $9.7 million and $11.8 million for the nine months ended September 30, 2006 and 2007, respectively.

Revenue associated with the sale of the Company s application specific integrated circuit, or ASIC applications, stand-alone live-scans and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with service offerings where the Company maintains and operates a portion of the AFIS systems on an outsourced application-hosting basis is recognized on a per transaction basis provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with contracts where sufficient VSOE cannot be established for the allocation of revenue to the various elements of the arrangement is deferred until the earlier of the point at which (i) such sufficient VSOE does exist or (ii) all elements of the arrangement have been delivered.

Cash received from customers in advance of recognition of the related revenue is recorded as deferred revenue.

Maintenance Revenues

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. The Company recognizes all maintenance revenue ratably over the applicable maintenance period. The Company determines the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions contained in a particular arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. The Company considers substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to its normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is included in product revenues and recognized ratably over the term of the maintenance period.

Services Revenues

Professional services revenue is primarily derived from engineering services and AFIS system operation and maintenance services that are not an element of an arrangement for the sale of products. These services are generally billed on a time-and-materials basis. The majority of the Company s professional services are performed either directly or indirectly for U.S. government organizations. Revenue from such services is recognized as the services are provided.

Consistent with EITF Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the amount of revenue recognized from commissions where the Company is acting as an agent is the net amount after payments are made to the primary obligor responsible for delivering the services.

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Concentration

The Company derives a significant portion of its revenues and accounts receivable from a limited number of customers as described below:

Percentage of Revenues	Three months ended September 30, 2006	Three months ended September 30, 2007	Nine months ended September 30, 2006	Nine months ended September 30, 2007
Customer A	*	18%	17%	15%
Customer B	31%	*	21%	17%
Customer C	*	*	*	10%
Customer D	18%	26%	*	*

Percentage of Billed Accounts Receivable	December 31, 2006	September 30, 2007
Customer D	24%	*
Customer E	*	10%

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

Note 2 Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 does not require new fair value measurements but rather defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of SFAS 157 on its consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159, permits an entity, through an irrevocable option, to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis, at fair value with changes in fair value recorded in earnings. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007 with early adoption permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity elects to apply the provisions of SFAS 157. The Company is currently assessing the impact of SFAS 159 on its consolidated financial position and results of operations.

Note 3 Share-Based Compensation

The Company has two stock option plans, the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, which authorize the issuance of stock options, restricted stock and other share-based instruments to employees. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment,* (SFAS 123R) using the modified prospective transition method.

The fair values of each award granted under the Company s stock option plans during the three and nine months ended September 30, 2006 and 2007 were estimated at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

	Three months ended September 30, 2006	Three months ended September 30, 2007	Nine months ended September 30, 2006	Nine months ended September 30, 2007
Volatility	46%	46%	46%	46%
Risk-free interest rate	4.85%	4.62%	4.80%	4.68%
Dividend yield	0.00%	0.00%	0.00%	0.00%
Expected life (years)	6.1	6.1	6.1	6.1

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The weighted average estimated grant date fair values of options granted under the Company s stock option plans for the three and nine months ended September 30, 2006 and 2007 were as follows:

	Three months ended September 30, 2006	Three months ended September 30, 2007	Nine months ended September 30, 2006	Nine months ended September 30, 2007
Weighted average fair value	$ 7.11	$ 7.20	$ 8.45	$ 6.55

As of September 30, 2007, there was approximately $2.8 million of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 0.8 years. Based on currently outstanding options, total share-based compensation expense for fiscal year 2007 is expected to be approximately $2.5 million.

The options outstanding as of September 30, 2007 have generally been granted with a 10-year term, vest 25% at the completion of the first year and vest quarterly thereafter over the remaining three-year period. A summary of option activity under the plans for the nine months ended September 30, 2007 is as follows:

	Number of Options	Weighted Average Exercise Price
Outstanding, December 31, 2006	2,489,607	$ 4.33
Granted	278,150	12.89
Exercised	(350,810)	1.41
Canceled or forfeited	(22,437)	16.79
Outstanding, September 30, 2007	2,394,510	$ 5.64
Exercisable at September 30, 2007	1,620,002	$ 3.45

A summary of the status of the Company s nonvested shares as of September 30, 2007, and changes during the nine months ended September 30, 2007 is presented below:

	Number of Options	Weighted Average Grant-Date Fair Value
Nonvested options at December 31, 2006	1,147,680	$ 7.76
Granted	278,150	6.55
Vested	(628,885)	6.99
Canceled or forfeited	(22,437)	11.67
Nonvested options at September 30, 2007	774,508	7.9

A total of 3,540,023 options remain available for grant under the Company s share-based compensation plans at September 30, 2007.

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The following tables further describe stock options outstanding at September 30, 2007:

Range of Exercise Prices		Options Outstanding: Number Outstanding at September 30, 2007	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Options Exercisable: Number Exercisable at September 30, 2007	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$ 0.30	$ 0.60	157,252	3.1	$ 0.35	$ 2,411	157,252	3.1	$ 0.35	$ 2,411
0.75	0.75	348,997	5.5	0.75	5,211	336,372	5.5	0.75	5,022
1.00	1.00	823,377	6.3	1.00	12,087	637,691	6.3	1.00	9,361
4.50	8.50	471,284	6.7	4.89	5,086	347,968	6.7	4.81	3,783
11.00	34.43	593,600	8.9	16.90	926	140,719	8.2	21.20	57
0.30	34.43	2,394,510	6.7	5.64	$ 25,721	1,620,002	6.1	3.45	$ 20,634

Range of Exercise Prices		Nonvested Options Expected to Vest: Number Expected to Vest at September 30, 2007	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$ 0.75	$0.75	12,625	6.0	$ 0.75	$ 188
1.00	1.00	185,686	6.3	1.00	2,726
4.50	8.50	123,316	6.7	5.11	1,303
11.00	34.43	394,120	5.6	13.60	757
0.75	34.43	715,747	6.0	9.02	$ 4,974

The Company defines in-the-money options at September 30, 2007 as options that had exercise prices that were lower than the $15.68 market value of its common stock at that date. The aggregate intrinsic value of options outstanding at September 30, 2007 is calculated as the difference between the exercise price of the underlying options and the market value of the Company s common stock for the 2.2 million shares that were in-the-money at that date. There were 1.5 million in-the-money options exercisable at September 30, 2007. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2007 was $24.1 million and $4.2 million, respectively, determined as of the date of exercise.

The share-based compensation expense included in the Company s results of operations was as follows:

	For the three months ended September 30, 2006	For the three months ended September 30, 2007	For the nine months ended September 30, 2006	For the nine months ended September 30, 2007
	(in thousands)			
Cost of product revenues	$ 87	$ 48	$ 246	$ 285
Cost of maintenance and services revenues	70	57	373	262
Research and development expenses	118	72	529	274
Selling and marketing expenses	331	266	1,103	726
General and administrative expenses	383	168	1,311	646
	$ 989	$ 611	$ 3,562	$ 2,193

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Note 4. Fair Value of Investments in Marketable Securities

The Company has investments classified as available-for-sale securities included in short-term and long-term investments, categorized as follows:

	December 31, 2006	September 30, 2007
	(in thousands)	
Type of Security:		
Short-term instruments	$ 87,861	$ 103,288
Corporate debt securities with maturities of less than one year	122,831	123,318
Municipal securities with maturities of less than one year	52,811	49,626
U.S. government securities with maturities of less than one year	54,567	32,901
Total short-term investments	318,070	309,133
Corporate debt securities with maturities between one and three years	64,679	99,831
U.S. government securities with maturities between one and three years	12,676	26,616
Total long-term investments	77,355	126,447
	$ 395,425	$ 435,580

The Company s short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper. These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of stockholders equity. The accumulated unrealized loss on available for sale securities at December 31, 2006 and September 30, 2007 was as follows:

	December 31, 2006	September 30, 2007
	(in thousands)	
Accumulated unrealized loss	$ 351	$ 102

The Company utilizes specific identification in computing realized gains and losses on the sale of investments. The Company recorded a realized loss of $4,000 for the three and nine months ended September 30, 2006 and no realized gain or loss for the three and nine months ended September 30, 2007.

Note 5. Inventory and Contract Related Costs

Inventory and contract related costs consist of the following:

	December 31, 2006	September 30, 2007
	(in thousands)	
Materials and components	$ 2,908	$ 3,980
Inventory and costs related to long-term contracts	8,237	2,634
Deferred costs of revenue	8,294	2,412
	$ 19,439	$ 9,026

Materials and components are stated at the lower of cost or market determined using the first-in, first-out method. Inventoried costs relating to long-term contracts are stated at actual production costs incurred to date reduced by amounts identified with revenue recognized on progress completed. Deferred costs of revenue relate to contracts for which revenue has been deferred, and such costs are stated at actual production costs incurred to date, which primarily include materials, labor and subcontract costs which are directly related to the contract. Deferred costs of revenue are amortized to costs of revenue at the time revenues are recognized.

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Note 6. Net Income Per Share

Basic net income per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share reflects the effects of potentially dilutive securities, which consist of stock options. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2007	2006	2007
	(in thousands, except per share data)			
Numerator:				
Net income available to common stockholders	$ 5,733	$ 4,144	$ 16,050	$ 20,932
Denominator:				
Denominator for basic net income per share weighted average shares	94,178	94,436	94,024	94,331
Dilutive potential common stock				
Stock options	1,810	1,540	2,129	1,641
Denominator for diluted net income per share adjusted weighted average shares	95,988	95,976	96,153	95,972
Basic net income per share	$ 0.06	$ 0.04	$ 0.17	$ 0.22
Diluted net income per share	$ 0.06	$ 0.04	$ 0.17	$ 0.22

During the three months ended September 30, 2006 and 2007, options to purchase 317,000 and 274,350, shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options exercise price was greater than the average market price of the common shares for each of these respective periods. For the nine months ended September 30, 2006 and 2007, options to purchase 209,000 and 445,100, respectively, were similarly excluded.

Note 7. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes certain changes in equity that are excluded from net income. Specifically, cumulative foreign currency translation adjustments and unrealized gains or losses on the Company s investments in marketable securities are included in accumulated other comprehensive income.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2007	2006	2007
	(In thousands)			
Net income	$ 5,733	$ 4,144	$ 16,050	$ 20,932
Other comprehensive income:				
Change in unrealized loss, net of tax	414	265	523	112
Change in foreign currency translation adjustment	18	61	28	136
Total comprehensive income	$ 6,165	$ 4,470	$ 16,601	$ 21,180

Note 8. Income Taxes

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 (FIN 48). FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. For those benefits to be recognized, a tax position must be more likely than not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

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The Company had cumulative unrecognized tax benefits of $9.0 million as of January 1, 2007. As a result of the adoption of FIN 48, the cumulative effects of applying this interpretation have been recorded as a decrease of $1.5 million to retained earnings, an increase of $2.3 million to deferred income tax assets and an increase of $3.8 million to liabilities. The liability for unrecognized tax benefits is recorded in income taxes payable and other long-term liabilities in the condensed consolidated balance sheet. Included in the balance of unrecognized tax benefits at January 1, 2007 and September 30, 2007 are $1.5 million of tax benefits that, if recognized, would affect the effective tax rate. As of September 30, 2007, the Company had unrecognized tax benefits of $6.1 million. During the third quarter of 2007, the Company completed its calculations for a tax return filing in a foreign jurisdiction, and in doing so has changed its estimate of its unrecognized tax benefit in the foreign jurisdiction. As a result of the change in estimate, the Company has decreased its FIN 48 liability by $2.9 million, and has correspondingly decreased its deferred tax asset for $2.9 million related to the foreign tax credit in the United States. The result of this change in estimate had no impact upon net income. The unrecognized tax benefit balance as of the date of adoption and as of September 30, 2007 also included approximately $7.5 million and $4.6 million, respectively, related to items that would affect other tax accounts, primarily deferred income taxes, if recognized. In addition, the balance of unrecognized tax benefits as of the date of adoption and as of September 30, 2007 included approximately $6.4 million and $3.5 million, respectively, related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months as a result of ongoing activities to resolve uncertainty with respect to the Company s tax obligations in foreign jurisdictions; however, quantification of an estimated range cannot be made at this time.

The Company continues to recognize accrued interest and penalties related to unrecognized tax benefits in the income tax provision. As of January 1, 2007, the total amount of accrued income tax-related interest and penalties before tax benefits was $638,000. During the three and nine months ended September 30, 2007, an additional $308,000 and $568,000, respectively, of interest and penalties before tax benefits was accrued.

The Company files Federal income tax returns, as well as multiple state, local and foreign jurisdiction tax returns. With few exceptions, the Company is no longer subject to examination for its U.S. Federal and state, foreign and local jurisdictions for years prior to 2003. The Internal Revenue Service completed its examination of the Company s Federal consolidated tax returns for 2004 and 2005 and issued a no change letter.

Note 9. Deferred Revenues and Deferred Costs

In the second quarter of 2005, the Company entered into a contract with a total value of $31.8 million with the National Electoral Council of Venezuela (CNE). The contract required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and services. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the November 8, 2005 Venezuela local elections. The estimated relative fair value of the lease component of approximately $3.0 million, which was based upon an independent valuation, was recognized as revenue in the third quarter of 2005. Because vendor specific objective evidence (VSOE) of the maintenance element of this contract did not exist, all revenue in excess of the fair value of the lease component was amortized over the life of the contract upon customer acceptance of all deliverables which was received in the second quarter of 2006. Revenues recognized under the arrangement with the CNE were zero and $14.0 million for the three and nine months ended September 30, 2007, respectively. Deferred revenue related to the CNE contract was $11.8 million and zero as of December 31, 2006 and September 30, 2007, respectively.

In October 2005, the Company entered into an initial contract and several follow-on orders with the Royal Canadian Mounted Police (the RCMP) to replace an AFIS in conjunction with the RCMP s Real Time Identification Project. Revenues recognized under the arrangement with the RCMP were $812,000 and $8.5 million for the three and nine months ended September 30, 2007, respectively. Deferred revenue related to the RCMP contract was $6.8 million and $77,000 as of December 31, 2006 and September 30, 2007, respectively. Deferred costs related to the RCMP contract are included in inventory and will be recognized as the related services are delivered.

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Note 10. Segment Information

The Company considers its business activities to constitute a single segment. A summary of the Company s revenues by geographic area follows (in thousands):

	Three months ended September 30, 2006				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 13,899	$ 125	$ 19	$ 4,356	$ 18,399
Maintenance and services revenues	4,241	411	110	214	4,976
Total	$ 18,140	$ 536	$ 129	$ 4,570	$ 23,375

	Three months ended September 30, 2007				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 9,674	$ 69	$ 345	$ 5,928	$ 16,016
Maintenance and services revenues	5,608	646	238	4	6,496
Total	$ 15,282	$ 715	$ 583	$ 5,932	$ 22,512

	Nine months ended September 30, 2006				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 33,521	$ 2,361	$ 1,883	$ 4,821	$ 42,586
Maintenance and services revenues	14,370	1,271	475	621	16,737
Total	$ 47,891	$ 3,632	$ 2,358	$ 5,442	$ 59,323

	Nine months ended September 30, 2007				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 54,211	$ 2,863	$ 522	$ 8,118	$ 65,714
Maintenance and services revenues	15,529	1,751	699	226	18,205
Total	$ 69,740	$ 4,614	$ 1,221	$ 8,344	$ 83,919

At December 31, 2006 and September 30, 2007, the Company s property and equipment and intangible assets, net of accumulated depreciation and amortization in the United States and in other countries was as follows (in thousands):

	December 31, 2006	September 30, 2007
Property and equipment, net of accumulated depreciation in the United States	$ 31,433	$ 32,043
Property and equipment, net of accumulated depreciation in other countries	1,441	1,433
	$ 32,874	$ 33,476
Intangible assets, net of accumulated amortization in the United States	$ 500	$ 388

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Note 11. Commitments and Contingencies

The Company periodically evaluates all pending or threatened contingencies and any commitments, if any, which are reasonably likely to have a material adverse effect on its operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies (SFAS 5). If information available prior to the issuance of the Company s financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the Company s financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS 5 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

During the normal course of business, the Company may be subject to litigation involving various business matters. Management believes that an adverse outcome of any such known matters would not have a material adverse impact on the Company.

In April 2005, the Company initiated a lawsuit against Northrop Grumman, in California state court (COGENT SYSTEMS, INC., vs. NORTHROP GRUMMAN CORPORATION, NORTHROP GRUMMAN INFORMATION TECHNOLOGY OVERSEAS, INC., et al., Superior Court of the State of California, In and For the County of Los Angeles, Case No. BC 332199), based on claims of breach of contract, conversion, misappropriation of trade secrets, breach of trust, interference with prospective economic advantage, breach of the implied covenants of good faith and fair dealing and unfair competition. As of September 30, 2007, the Company had incurred $14.4 million in legal expenses related to this action, including $10.5 million incurred in the nine months ended September 30, 2007. On September 10, 2007, the Company and Northrop Grumman Corporation announced their agreement to settle the lawsuit. Under the terms of the agreement, Northrop Grumman agreed to pay Cogent $25 million to settle the litigation and $15 million for a non-exclusive license to use specified Cogent AFIS Software in certain existing programs, including IDENT1, a biometric based identification system in the U.K. In addition, Northrop Grumman and the Company agreed to enter into a five-year research and development, service and products agreement, under which Northrop will pay the Company $20 million for products and services over the term of the agreement. While Cogent and Northrop Grumman have an agreement in principle, the parties are still engaged in the negotiation and execution of definitive agreements. As such, the Company has not yet determined the classification of the amounts to be recorded, nor the timing of recognition. The Company will make such determinations upon a review and analysis of final signed definitive agreements.

Note 12. Stock Repurchase Program

In October 2007, the Company s Board of Directors authorized a program to repurchase shares of Cogent s common stock. Acting pursuant to this approval, the Company announced on November 1, 2007 that it may repurchase up to $100 million of shares over a period of 12 months following that announcement. The shares are to be purchased in the open market or in privately negotiated transactions in accordance with the requirements of the SEC, and subject to market conditions, applicable legal requirements and other factors. The repurchase of shares will be made using the Company s cash resources. The repurchase program may be suspended or discontinued at any time without prior notice.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report to conform such statements to actual results or to changes in our expectations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part II of this Quarterly Report under the Caption Risk Factors and under the captions Management s Discussion and Analysis of Financial Condition and Results of Operations, and Risk Factors and in our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006, previously filed with the U.S. Securities and Exchange Commission (SEC).

Risk factors that could cause actual results to differ from those contained in the forward-looking statements include but are not limited to: changes in government policies; uncertain political conditions in international markets; deriving a significant portion of revenues from a limited number of customers; deriving a significant portion of revenues from the sale of solutions pursuant to government contracts; failure of the biometrics market to experience significant growth; failure of our products to achieve broad acceptance; potential fluctuations in quarterly and annual results; changes in our effective tax rate; failure to successfully compete; failure to comply with government regulations; failure to accurately predict financial results due to long sales cycles; negative publicity and/or loss of clients due to security breaches resulting in the disclosure of confidential information; loss of export licenses or changes in export laws; failure to manage projects; rapid technology change in the biometrics market; loss of a key member of management team; termination of backlog orders; loss of limited source suppliers; negative audits by government agencies; failure to protect intellectual property; and exposure to intellectual property and product liability claims.

Overview

We are a leading provider of advanced Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. We were incorporated and commenced operations in 1990. We have been researching, designing, developing and marketing AFIS and other fingerprint biometrics solutions since inception. During most of our operating history, we have achieved positive income and cash flows from operations. From the fourth quarter of 2003 through the year ended December 31, 2005, we experienced significant increases in our revenues and net income as the market for our AFIS solutions expanded primarily due to increased demand by the Department of Homeland Security, or DHS, as well as the National Electoral Council of Venezuela, or CNE. We experienced a decline in revenues during the year ended December 31, 2006 due to the completion of a number of significant contracts and the timing of revenue recognition related to contracts entered into in previous periods and slowdowns in the procurement process at the U.S. government. As a result of new core customers added since the beginning of 2006, in the nine months ended September 30, 2007, we recorded revenue from an increased number of customers. We believe that this improved customer diversity will result in more consistent quarterly performance in 2007, as compared to prior years when our quarterly results often fluctuated due to the spending patterns of the DHS and the CNE, who have historically been our two largest customers. Further, we believe that we are positioned to experience an increase in revenues in 2007 over 2006 levels.

Sources of Revenue

We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator, or PMA, servers and other AFIS equipment, including workstations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. We generate maintenance revenues from maintenance contracts that are typically included with the sale of our AFIS solutions. Maintenance contracts for technical support and software updates generally cover a period of one year, and after contract expiration,

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our customers have the right to purchase maintenance contract renewals, which generally cover a period of one year. Revenues from maintenance contracts are deferred and amortized on a straight-line basis over the life of the maintenance obligation. We generate services revenues from engineering services and AFIS system operation services that are not an element of an arrangement for the sale of products. These services are typically performed under fixed-price and time-and-material agreements.

We market our solutions primarily to U.S. and foreign government agencies and law enforcement agencies. In a typical contract with a government agency for an initial AFIS deployment, we agree to design the AFIS, supply and install equipment and software and integrate the AFIS within the agency s existing network infrastructure. These initial deployment contracts frequently require significant modification and customization of our solution as part of our integration services. These contracts provide for billings up to a fixed price total contract value upon completion of agreed milestones or deliveries, with each milestone or delivery typically having a value specified in the contract. These customers usually impose specific performance and acceptance criteria that must be satisfied prior to invoicing for each milestone or delivery. When customers purchase AFIS solutions that do not require significant modification and customization of our software, whether as an initial deployment or as an expansion of an existing AFIS, we typically agree to deliver the products and perform limited installation services subject to customer-specific acceptance criteria. Certain of our customers, including the DHS, submit purchase orders under blanket purchase order agreements. Blanket purchase order agreements set out the basic terms and conditions of our arrangement with the customer and simplify the procedures for ordering our products to avoid administrative processes that would otherwise apply, particularly with the federal government. The billing of these contracts is generally tied to delivery and acceptance of specific AFIS equipment, usually our PMA servers or live-scans. Most of our contracts for AFIS solutions also include an ongoing maintenance obligation that we honor over a term specified in the deployment contract or the blanket purchase order agreement. The nature of our business and our customer base is such that we negotiate a set of unique terms for each contract that are based upon the purchaser s standard form of documentation.

The most significant portion of our revenues since the fourth quarter of 2003 has arisen from increased demand by the DHS and the CNE for our AFIS solutions. The DHS uses our solutions in connection with the implementation of the United States Visitor and Immigrant Status Indicator Technology, or US-VISIT, program, and the CNE uses our solutions for national, regional and local elections. We anticipate that the DHS will account for a significant portion of our revenues for the foreseeable future. Our most recent arrangement with the CNE was completed in December 2006 and revenues from all of our arrangements with the CNE were fully recognized by June 30, 2007. We do not have any long-term contracts with any of our customers, including the DHS for the sale of our products, and our future sales will depend upon the receipt of new orders. Any delay or other change in the rollout of US-VISIT or any failure to obtain new orders from the DHS could cause our revenues to fall short of our expectations.

We also expect to experience continued demand from a number of other governments as they deploy AFIS solutions in elections, at points of entry and exit, including borders, seaports and airports, and in connection with national identification programs. For example, in Canada we have been awarded an initial contract and several follow-on orders, and we believe we may receive additional follow-on orders related to the Royal Canadian Mounted Police (RCMP) s Real Time Identification Initiative. Another example is our September 2005 contract with the Direction Générale De la Sureté Nationale of Morocco (DGSN) to provide an integrated turn-key AFIS. The quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations. Government contracts for security solutions in elections, at points of entry and exit and in connection with national identification programs are typically awarded in open competitive bidding processes. Therefore, our future level of sales of AFIS solutions for deployments in elections and at points of entry and exit may vary substantially, and will depend on our ability to successfully compete for this business. In September 2006, the UKvisas unit of the Secretary of State for the Home Department of the United Kingdom selected Cogent as the supplier of biometric recording and verification software in connection with the U.K. government program to improve immigration control and border integrity (the UKvisas Contract). Under the four year framework agreement , Cogent will provide technology to be used at embassy and visa application centers worldwide to capture fingerprint and facial recognition biometric data on an order by order basis. Cogent is also providing software consulting, help desk, and incident management services. Other U.K government agencies will be able to purchase products and services under the framework agreement as well.

Cost of Revenues and Operating Expenses

Cost of Revenues. Cost of product revenues consists principally of compensation costs incurred in designing, integrating, installing and customizing AFIS solutions, the costs associated with manufacturing, assembling and testing our AFIS solutions and subcontractor costs. A substantial portion of these costs is comprised of the costs of components, such as servers, integrated circuits, workstations, live-scans and other hardware. Cost of product revenues also includes related overhead, compensation, final assembly, quality-assurance, inventory management, support costs and payments to contract manufacturers that perform assembly functions. Cost of maintenance and services revenues consists of customer support costs and training and professional service expenses, including compensation. Cost of revenues also includes share-based compensation allocable to personnel performing services related to cost of revenues. We expect our gross margin to be affected by many factors, including our mix of products and our resale of third party hardware included in our AFIS solutions. Other factors that may affect our gross margin include changes in selling prices of our products, maintenance and services, fluctuations in demand for our products, the timing and size of customer orders, fluctuations in manufacturing volumes, changes in costs of components and new product introductions by us and our competitors and agreements entered into with our subcontractors.

Research and Development. Research and development expenses consist primarily of salaries and related expenses for engineering personnel, fees paid to consultants and outside service providers, depreciation of development and test equipment, prototyping expenses related to the design, development, testing and enhancements of our products, and the cost of computer support services. We expense all research and development costs as incurred. Under our customer contracts, we typically obtain the rights to use any improvements to our technology developed on a particular customer deployment on other customer deployments. As a result, we have historically been able to moderate our research and development expenses by leveraging the improvements developed by our personnel working on customer engagements. Research and development expenses also include share-based compensation allocable to personnel performing services related to research and development.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses also include share-based compensation allocable to personnel performing services related to sales and marketing.

General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses also include share-based compensation allocable to personnel performing general and administrative services.

In April 2005, we initiated a lawsuit against Northrop Grumman, based on claims of breach of contract, conversion, misappropriation of trade secrets, breach of trust, interference with prospective economic advantage, breach of the implied covenants of good faith and fair dealing and unfair competition. On September 10, 2007 we announced that we had reached an agreement to settle this lawsuit. Under the terms of the agreement, Northrop Grumman agreed to pay Cogent $25 million to settle the litigation and $15 million for a non-exclusive license to use specified Cogent AFIS Software in certain existing programs, including IDENT1, a biometric based identification system in the U.K. In addition, Northrop Grumman and Cogent agreed to enter into a five-year research and development, service and products agreement, under which Northrop will pay Cogent $20 million for products and services over the term of the agreement. While Cogent and Northrop Grumman have an agreement in principle, the parties are still engaged in the negotiation and execution of definitive agreements. As such, we have not yet determined the classification of the amounts to be recorded, nor the timing of recognition. We will make such determinations upon a review and analysis of final signed definitive agreements.

Application of Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to percentage-of-completion, bad debts, inventories, investments, income taxes, commitments, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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We consider the following accounting estimates to be both those most important to the portrayal of our results of operations and financial condition and those that require the most subjective judgment:

- revenue recognition;
- commitments and contingencies;
- allowance for doubtful accounts;
- accounting for taxes; and
- accounting for share-based compensation.

Revenue Recognition. Because our proprietary software is essential to the functionality of our AFIS solutions and other biometrics products, we apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. For arrangements that require significant production, modification, or customization of software, we apply the provisions of Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. To the extent an element within our software arrangements falls within a level of accounting literature that is higher than SOP 97-2, we record revenue on such element in accordance with the relevant authoritative literature. For arrangements that contain the lease of equipment, we account for the lease element in accordance with Statement of Financial Accounting Standards (SFAS) No. 13, Accounting for Leases and account for the remaining elements in the arrangement in accordance with SOP 97-2. For arrangements that contain a non-software deliverable such as hardware, we apply the provisions of Emerging Issues Task Force (EITF) 03-05, Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software and recognize revenue when all other revenue recognition criteria are met. For multiple element arrangements not subject to accounting under SOP 97-2, we account for these arrangements in accordance with EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. The application of the appropriate accounting principle to our revenue is dependent upon the specific transaction and whether the sale includes systems, software and services or a combination of these items. As our business evolves, the mix of products and services sold will impact the timing of when revenue and related costs are recognized. Additionally, revenue recognition involves judgments, including estimates of costs to complete contracts accounted for using the percentage of completion method of accounting and assessments of the likelihood of nonpayment. We analyze various factors, including a review of specific transactions, the credit-worthiness of our customers, our historical experience and market and economic conditions. Changes in judgments on these factors could materially impact the timing and amount of revenue and costs recognized.

Product Revenues

The timing of product revenues recognition is dependent on the nature of the product sold.

- Revenues associated with AFIS solutions that do not require significant modification or customization of our software, exclusive of amounts allocated to maintenance for which we have vendor-specific objective evidence of fair value, or VSOE, are recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided all other criteria for revenue recognition have been met. For example, we recognize revenue in this manner from sales of our PMA servers to the DHS under our blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

- Revenues associated with AFIS solutions that require significant modification or customization of our software, are recognized using the percentage-of-completion method as described by SOP 81-1. The percentage-of-completion method reflects the portion of the anticipated contract revenue, excluding maintenance that has VSOE, which has been earned, equal to the ratio of labor effort expended to date to the anticipated final labor effort, based on current estimates of total labor effort necessary to complete the project. Material differences may result in the amount and timing of our revenue for any period if actual results differ from our judgments and estimates. We recognize revenue in this manner from sales of significant initial AFIS deployments. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period or until the time when such VSOE is established. Revenues recognized under such arrangements were $7.2 million and zero for the three months ended

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September 30, 2006 and 2007, respectively, and $9.7 million and $11.8 million for the nine months ended September 30, 2006 and 2007, respectively.

Revenue associated with the sale of our application specific integrated circuit, or ASIC applications, stand-alone live-scans and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with service offerings where we maintain and operate a portion of the AFIS systems on an outsourced application-hosting basis is recognized on a per transaction basis provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Revenue associated with contracts where sufficient VSOE cannot be established for the allocation of revenue to the various elements of the arrangement is deferred until the earlier of the point at which (i) such sufficient VSOE does exist or (ii) all elements of the arrangement have been delivered.

Cash received from customers in advance of recognition of the related revenue is recorded as deferred revenue.

Maintenance Revenues

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. We recognize all maintenance revenue ratably over the applicable maintenance period. We determine the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions contained in a particular arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. We consider substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to our normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is included in product revenues and recognized ratably over the term of the maintenance period.

Services Revenues

Professional services revenue is primarily derived from engineering services and AFIS system operation and maintenance services that are not an element of an arrangement for the sale of products. These services are generally billed on a time-and-materials basis. The majority of our professional services are performed either directly or indirectly for U.S. government organizations. Revenue from such services is recognized as the services are provided.

Consistent with EITF Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the amount of revenue recognized from commissions where we are acting as an agent is the net amount after payments are made to the primary obligor responsible for delivering the services.

Revenue Recognition Criteria

We recognize revenue when persuasive evidence of an arrangement exists, the element has been delivered, the fee is fixed or determinable and collection of the resulting receivable is probable.

Persuasive evidence of an arrangement: We use either contracts signed by both the customer and us or written purchase orders issued by the customer that legally bind us and the customer as evidence of an arrangement.

Product delivery: We deem delivery to have occurred when AFIS solutions are installed and, when required under the terms of a particular arrangement, upon acceptance by the customer. Shipments of our ASICs, stand-alone live-scans and other biometric products are recognized as revenue when shipped and title and risk of ownership has passed to the buyer.

Fixed or determinable fee: For product arrangements not accounted for using the percentage-of-completion method, we consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment and the payment terms are within normal established practices. If the fee is not fixed or determinable, we recognize the revenue as amounts become due and payable.

Collection is deemed probable: We conduct a credit review for all significant transactions at the time of the arrangement to determine the credit-worthiness of the customer. Collection is deemed probable if we expect that the customer will pay amounts under the arrangement as payments become due.

Deferred Revenue. 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 the CNE, make upfront payments resulting in cash collected prior to our recognition of revenue. These payments can be significant. 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. Deferred revenues also consist of payments received in advance from our customers for maintenance agreements, under which revenues are recognized ratably over the term of the maintenance period. However, the fluctuation in the deferred revenue balance from quarter to quarter is generally not significantly affected by the deferred maintenance revenue. Because the mix of customers who pay or are invoiced in advance of revenue recognition changes from period to period, fluctuations in our deferred revenue balance are not a reliable indicator of total revenue to be recognized in any future period. Our cash flow from operations is also affected each quarter as a result of fluctuations in the deferred revenue balance.

Commitments and Contingencies. We periodically evaluate all pending or threatened contingencies and commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position. We assess the probability of an adverse outcome and determine if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS 5, Accounting for Contingencies. If information available prior to the issuance of our financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of our financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS 5 are not met, but the probability of an adverse outcome is at least reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in a provision for bad debt expense. We determine the adequacy of this allowance by evaluating individual customer accounts receivable, through consideration of the customer s financial condition, credit history and current economic conditions. If the financial condition of our customers was to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Accounting for Taxes. In preparing our consolidated financial statements, we estimate our income tax liability in each of the jurisdictions in which we operate by estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. As of September 30, 2007, our net deferred tax assets were approximately $30.9 million. Management judgment is required in assessing the realizability of our deferred tax assets. In performing this assessment, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from our estimates or we adjust our estimates in future periods, we may need to make or adjust valuation allowances with respect to our deferred tax assets, which could materially impact our financial position and results of operations. Our income tax provision is based on calculations and assumptions that may be subject to examination by the Internal Revenue Service and other tax authorities. Should the actual results differ from our estimates, we would have to adjust the income tax provision in the period in which the facts that give rise to the revision become known. Tax law and rate changes are reflected in the income tax provision in the period in which such changes are enacted.

Our effective tax rate for the nine months ended September 30, 2007 was, and we expect our tax rate to continue to be, impacted as a result of research and development tax credits and the disqualifying disposition of incentive stock options. Our effective tax rate may continue to fluctuate from quarter to quarter primarily as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place thus impacting the effective tax rate on a quarterly basis. The benefit resulting from disqualifying dispositions results in a tax deduction on our corporate tax return with no expense recorded in our consolidated financial statements. To the extent we have previously recorded share-based compensation expense related to incentive

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stock options in our consolidated financial statements, we record the benefit from the disqualifying disposition of incentive stock options as a reduction to our provision for income taxes.

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 (FIN 48). FIN 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect our operating results.

We generate a significant portion of our revenues from contracts with foreign government agencies. Each country with which we do business has its own particular rules to determine the point at which our activities within such country will become subject to taxes, if any. To the extent our contracts with foreign government agencies are subject to income taxes and we do not generate adequate foreign tax credits for purposes of our Federal income tax return, our effective tax rate may be impacted.

Accounting for Share-Based Compensation. Effective January 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment,* (SFAS 123R) using the modified prospective transition method. Under this transition method, compensation expense recognized includes: (a) compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R.

The calculation of share-based employee compensation expense involves estimates that require management s judgment. These estimates include the fair value of each of our stock option awards, which is estimated on the date of grant using a Black-Scholes option-pricing model as discussed in Note 3 of our condensed consolidated financial statements included elsewhere in this report. The fair value of our stock option awards is expensed on a straight-line basis over the vesting life of the options. We estimate the volatility of our common stock at the date of grant based on the implied volatility of publicly traded 30-day to 270-day options on our common stock, consistent with SFAS 123R and SEC Staff Accounting Bulletin No. 107. Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our belief that implied volatility is more representative of future stock price trends than historical volatility. We base the risk-free interest rate that we use in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms. We do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. SFAS 123R requires us to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. For options granted before January 1, 2006, we amortize the fair value on an accelerated basis. For options granted on or after January 1, 2006, we amortize the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods. We may elect to use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income or loss and net income or loss per share.

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Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2007	2006	2007
Consolidated Statements of Income Data:				
Revenues:				
Product revenues	78.7%	71.1%	71.8%	78.3%
Maintenance and services revenues	21.3	28.9	28.2	21.7
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product revenues	42.5	36.2	36.0	34.4
Cost of maintenance and services revenues	6.3	8.7	7.8	6.5
Total cost of revenues	48.8	44.9	43.8	40.9
Gross profit	51.2	55.1	56.2	59.1
Operating expenses:				
Research and development	9.0	11.9	10.6	9.3
Selling and marketing	8.4	10.5	9.6	7.7
General and administrative	14.9	25.2	14.9	20.9
Total operating expenses	32.3	47.6	35.1	37.9
Operating income	18.9	7.5	21.1	21.2
Other income:				
Interest income	19.9	25.6	20.8	19.7
Other, net	0.1	(0.9)	0.8	0.2
Income before income taxes	38.9	32.2	42.7	41.1
Income tax provision	14.4	13.9	15.6	16.2
Net income	24.5%	18.3%	27.1%	24.9%

Comparison of Results for the three months ended September 30, 2007 and 2006

Revenues. Revenues were $22.5 million for the three months ended September 30, 2007 compared to $23.4 million for the three months ended September 30, 2006. Product revenues were $16.0 million for the three months ended September 30, 2007 compared to $18.4 million for the three months ended September 30, 2006. The $2.4 million decrease in product revenues resulted primarily from a $7.2 million decrease in revenues from the CNE during the three months ended September 30, 2007 compared to the same period in the prior year. The effect of the decrease in revenues from the CNE was partially offset by an aggregate increase in revenues from other customers including the DHS and its logistical partners, the DGSN, the City of Houston and the RCMP of $5.2 million during the three months ended September 30, 2007 as compared to the same period of the prior year.

Maintenance and services revenues increased to $6.5 million for the three months ended September 30, 2007 from $5.0 million for the same period of the prior year. The increase of $1.5 million or 30.5% resulted primarily from the general increase in our base of customers and revenues earned under our recent arrangement to operate and maintain an AFIS used to obtain, transmit, and match finger images for applicants and recipients of food stamp benefits in the state of Texas.

Gross Profit. Gross profit as a percentage of revenues was 55.1% for the three months ended September 30, 2007 compared to 51.2% for the three months ended September 30, 2006. Product gross margins were 49.2% for the three months ended September 30, 2007 compared to 46.0% for the three months ended September 30, 2006. Margins on product revenues were fairly consistent as the mix of products sold remained significantly unchanged during the three months ended September 30, 2007 as compared to the same period of the prior year. Generally, our software intensive solutions have higher margins than hardware and third party equipment components.

Costs of maintenance and service revenues increased $491,000 or 33.5% to $2.0 million for the three months ended September 30, 2007 from $1.5 million for the three months ended September 30, 2006. Maintenance and services gross margins decreased to 69.9% during the three months ended September 30, 2007 from 70.6% during the three months ended September 30, 2006.

Research and Development. Research and development expenses increased to $2.7 million, or 11.9% of revenues, for the three months ended September 30, 2007 compared to $2.1 million or 9.0% of revenues for the three months ended September 30, 2006. The increase of $572,000 or 27.3% was primarily due to an increase in salary expense and other labor related costs driven by an increase in headcount in connection with the Company s effort to develop new products for both its core government and its commercial customers. Our research and development headcount was 113 and 81 as of September 30, 2007 and 2006, respectively.

Selling and Marketing. Selling and marketing expenses were $2.4 million, or 10.5% of revenues, for the three months ended September 30, 2007, compared to $2.0 million, or 8.4% of revenues, for the same period of the prior year. The increase in selling and marketing expenses of $406,000, or 20.8%, was primarily due to an increase in salary expenses and other labor related costs of $257,000 driven by an increase in headcount. In anticipation of a general increase in the number and size of contracts coming up for proposal in the biometric security industry, management instituted a general effort to expand its marketing and business development capabilities during 2007. This effort included an expansion in the Company s selling and marketing related headcount, including the hiring of several key executives in the U.S., Canada and the U.K. An increase in consulting fees of $142,000, to support business development and proposal activities, also contributed to the increase in selling and marketing expenses during the three months ended September 30, 2007, as compared to the same period of the prior year.

General and Administrative. General and administrative expenses increased to $5.7 million, or 25.2% of revenues, for the three months ended September 30, 2007 compared to $3.5 million or 14.9% of revenues, for the three months ended September 30, 2006. The increase of $2.2 million or 62.5% was primarily due to a $2.4 million increase in legal fees related to our lawsuit with Northrop Grumman. Legal fees incurred in connection with the Company s legal action against Northrop Grumman were $3.7 million during the three months ended September 30, 2007 compared to $1.3 million for the three months ended September 30, 2006. Our costs associated with the lawsuit increased at an accelerated rate as we approached our scheduled court date in September 2007. On September 10, 2007, we announced the general terms of our settlement agreement with Northrop Grumman.

Interest Income. We earned interest income of $5.8 million during the three months ended September 30, 2007 compared to $4.7 million during the three months ended September 30, 2006. The increase in interest income was primarily due to higher interest rates and higher cash and investment balances as a result of net cash generated from operations.

Income Tax Provision. We recognized an income tax provision of $3.1 million during the three months ended September 30, 2007 as a result of the net income earned in the period. Our effective tax rate of 43.0% for the three months ended September 30, 2007 represents federal, state and foreign taxes on our income reduced primarily as a result of research and development credits and benefits resulting from the disqualifying disposition of incentive stock options. We recognized an income tax provision of $3.4 million, with an effective tax rate of 37.0%, during the three months ended September 30, 2006 as a result of the net income earned in the period. Our effective tax rate of 37.0% for the three months ended September 30, 2006 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. The increase in the effective tax rate from 37.0% during the three months ended September 30, 2006 to 43.0% during the three months ended September 30, 2007 is primarily due to a significant decrease in disqualifying dispositions of incentive stock options and the associated tax benefit recorded during the three months ended September 30, 2007 compared to the same period of the prior year coupled with the income tax-related interest of $308,000 recorded during the three months ended September 30, 2007 in accordance with FIN 48. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding and held by our employees. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place.

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Comparison of Results for the nine months ended September 30, 2007 and 2006

Revenues. Revenues were $83.9 million for the nine months ended September 30, 2007 compared to $59.3 million for the nine months ended September 30, 2006. We experienced growth in revenues primarily due to higher revenues from the DHS, as well as contributions from an increasing number of customers, including the DGSN and the RCMP as we continued to diversify our customer base. Product revenues were $65.7 million for the nine months ended September 30, 2007 compared to $42.6 million for the nine months ended September 30, 2006. The $23.1 million increase in product revenues resulted primarily from an aggregate increase of $22.8 million in revenues from the DHS and its logistical partners, the CNE, the RCMP and the DGSN. In addition, revenue contributions from a number of other customers, such as the city of Montreal, the UKvisas, the office of the Attorney General of Ohio, the County of Oakland, Michigan and the County of Sonoma, also contributed to the increase in product revenues during the nine months ended September 30, 2007 compared to the same period in the prior year.

Maintenance and services revenues were $18.2 million for the nine months ended September 30, 2007 compared to $16.7 million for the nine months ended September 30, 2006. An increase of $1.5 million or 8.8% in maintenance and services revenues resulted primarily from the general increase in our base of customers and revenues earned under our recent arrangement to operate and maintain an AFIS used to obtain, transmit, and match finger images for applicants and recipients of food stamp benefits in the state of Texas.

Gross Profit. Gross profit as a percentage of revenues was 59.1% for the nine months ended September 30, 2007 compared to 56.3% for the same period of the prior year. Product gross margins were 56.0% for the nine months ended September 30, 2007 compared to 49.9% for the nine months ended September 30, 2006. The increase in margins on product revenues was primarily due to a change in contract mix. During the nine months ended September 30, 2007, a higher portion of our revenues was recognized on software intensive solutions which typically have higher margins than hardware and third party equipment components. During the same period of the prior year a significant portion of our revenues was earned from AFIS solutions which required significant hardware components.

Maintenance and services gross margins were 70.1% for the nine months ended September 30, 2007 and 72.5% for the nine months ended September 30, 2006. Costs of maintenance and service revenues increased to $5.4 million for the nine months ended September 30, 2007 from $4.6 million for the nine months ended September 30, 2006. As our customer base continues to diversify and grow we have increased the number of personnel engaged in providing maintenance and engineering services, contributing to the decrease in maintenance and services gross margins.

Research and Development. Research and development expenses increased to $7.8 million, or 9.3% of revenues, for the nine months ended September 30, 2007 compared to $6.3 million, or 10.6% of revenues for the nine months ended September 30, 2006. The increase of $1.5 million or 23.1% was primarily due to an increase in salary expense and other labor related costs driven by an increase in headcount. Our research and development headcount was 113 and 81 as of September 30, 2007 and 2006, respectively.

Selling and Marketing. Selling and marketing expenses were $6.4 million, or 7.7% of revenues, for the nine months ended September 30, 2007 compared to $5.7 million, or 9.6% of revenues, for the nine months ended September 30, 2006. The increase in selling and marketing expenses of $722,000 or 12.7%, was primarily due to an increase in salary expenses and other labor related costs of $638,000 driven by an increase in headcount, including the hiring of several key executives in the U.S., Canada and the U.K. The effect of the increase in salary expenses was partially offset by a reduction in share based compensation of $377,000. An increase in consulting fees of $331,000, to support business development and proposal activities, also contributed to the increase in selling and marketing expenses during the nine months ended September 30, 2007, as compared to the same period of the prior year.

General and Administrative. General and administrative expenses increased to $17.5 million, or 20.9% of revenues, for the nine months ended September 30, 2007 compared to $8.9 million, or 14.9% of revenues, for the nine months ended September 30, 2006. The $8.6 million increase was primarily due to an $8.4 million increase in legal fees related to our lawsuit against Northrop Grumman. Legal fees associated with the action were $10.5 million and $2.1 million for the nine months ended September 30, 2007 and 2006, respectively. Our costs associated with the lawsuit increased at an accelerated rate as we approached our scheduled court date in September 2007. On September 10, 2007, we announced the general terms of our settlement agreement with Northrop Grumman.

Interest Income. We earned interest income of $16.5 million during the nine months ended September 30, 2007 compared to $12.3 million during the nine months ended September 30, 2006. The increase in interest income was primarily due to higher interest rates and higher cash and investment balances as a result of net cash generated from operations.

Income Tax Provision. We recognized an income tax provision of $13.6 million during the nine months ended September 30, 2007 as a result of the net income earned in the period. Our effective tax rate of 39.4% for the nine months ended September 30, 2007 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by state research and development credits. We recognized an income tax provision of $9.3 million, with an effective tax rate of 36.6%, during the nine months ended September 30, 2006 as a result of the net income earned in the period. Our effective tax rate of 36.6% for the nine months ended September 30, 2006 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. The increase in the effective tax rate from 36.6% during the nine months ended September 30, 2006 to 39.4% during the nine months ended September 30, 2007 is primarily due to a significant decrease in disqualifying dispositions of incentive stock options and the associated tax benefit recorded during the nine months ended September 30, 2007 compared to the same period of the prior year coupled with the income tax-related interest of $568,000 recorded during the nine months ended September 30, 2007 in accordance with FIN 48.

Liquidity and Capital Resources

Since our inception, we have financed our operations by generating cash from operations. Since September 2004 we have supplemented our cash resources through public offerings of our common stock, raising $228.6 million in our initial public offering in September 2004 and $96.8 million in a subsequent public offering in June 2005. As of September 30, 2007, we had $22.6 million in cash and cash equivalents and $435.6 million in investments in marketable securities.

In addition to our net income, the key drivers of our cash flows from operations are changes in accounts receivable, accounts payable, deferred revenues, inventory and deferred taxes. The effect of these key drivers on our cash from operations for the nine months ended September 30, 2006 and 2007 was as follows:

	Nine Months Ended, September 30, 2006	Nine Months Ended, September 30, 2007
Primary Drivers of Cash from Operations		
Net income	$ 16,050	$ 20,932
Changes in :		
Billed accounts receivable	30,022	11,784
Inventory and contract related costs	1,090	10,289
Accounts payable	(116)	4,424
Deferred revenues	(7,578)	(22,077)
Deferred income taxes	8,849	11,411
Net other activity	4,628	3,161
Net cash provided by operating activities	$ 52,945	$ 39,924

A substantial portion of our revenues represents sales of multiple element software based solutions. Elements of our software based solutions may be delivered immediately or may be delivered over several years. The timing for the recognition of our revenues, as well as the related costs, is dependent on the nature of the products sold and does not necessarily coincide with cash collections. On the other hand, the timing of cash collections under our arrangements with our customers depends on our customers budgeting processes, the length of the arrangement and the competitive bidding process. The increase in accounts payable during the nine months ended September 30, 2007 was primarily due to fees related to our lawsuit with Northrop Grumman. Our costs associated with the lawsuit increased at an accelerated rate as we approached our scheduled court date in September 2007. Deferred revenue balances representing significant customers such as the CNE, the RCMP and the DGSN, as of December 31, 2006, were recognized during the nine months ended September 30, 2007. The reduction in inventory is primarily due to the recognition of the costs associated with those previously deferred revenues. We continue to benefit from substantial deferred tax assets accumulated in prior years. The deferred tax assets represent net operating losses from items such as disqualifying dispositions from stock options exercises, deferred revenue, research and development credits and foreign tax credits. While our net income includes our provision for income taxes at 36.6% and 39.4% of pre-tax income for the nine months ended September 30, 2006 and 2007, respectively, our actual cash expenditures for taxes during the nine months ended September 30, 2006 and 2007 were minimal.

For the nine months ended September 30, 2007 and 2006, net cash used in investing activities was $36.8 million and $43.3 million, respectively. Investing activities consisted of purchases and sales of available-for-sale securities and capital expenditures, which consisted primarily of computer equipment and software for our engineering, service and information technology departments. Contractual restrictions on $585,000 in cash expired during the nine months ended September 30, 2007.

Cash of $42.3 million and $35.6 million used during the nine months ended September 30, 2006 and 2007, respectively, represented the net increase of investments in marketable securities.

Net cash provided by financing activities of $468,000 during the nine months ended September 30, 2007, represented proceeds collected from the exercise of stock options. Net cash used in financing activities of $3.0 million for the nine months ended September 30, 2006 represented $3.9 million to repurchase shares of our common stock under the stock repurchase program that was announced in August 2006 and expired in February 2007. The effect of the share repurchase was partially offset by proceeds of $834,000 collected from the exercise of stock options.

In 2005, we paid $26.0 million to acquire a facility in Pasadena, California, which we expect will eventually house our corporate headquarters. The development of such acquired property may require an expenditure of a material amount of capital resources. We currently have no other material cash commitments, except our normal recurring trade payables, expense accruals and operating leases, all of which are currently expected to be funded through existing working capital and future cash flows from operations. We believe that our cash and cash equivalent balances will be sufficient to satisfy our cash requirements for at least the next twelve months. Although we cannot accurately anticipate the effect of inflation or foreign exchange markets on our operations, we do not believe these external economic forces have had, or are likely in the foreseeable future to have, a material impact on our liquidity or capital resources.

In October 2007, our Board of Directors authorized a program to repurchase shares of our common stock. Acting pursuant to this approval, we announced on November 1, 2007 that we may repurchase up to $100 million of shares over a period of 12 months following that announcement. The shares are to be purchased in the open market or in privately negotiated transactions in accordance with the requirements of the SEC, and subject to market conditions, applicable legal requirements and other factors. The repurchase of shares will be made using our cash resources. The repurchase program may be suspended or discontinued at any time without prior notice.

At September 30, 2007, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose, or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have material relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties.

Commitments and contingencies as discussed in the Notes to the Condensed Consolidated Financial Statements do not include payments that could be made related to our unrecognized tax benefits liability, which amounted to $9.0 million as of January 1, 2007, the date we adopted FIN 48. The timing and amount of any future payments is not reasonably estimable, as such payments are dependent on the completion and resolution of examinations with tax authorities.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 does not require new fair value measurements but rather defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the impact of SFAS 157 on our consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits an entity, through an irrevocable option, to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis, at fair value with changes in fair value recorded in earnings. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007 with early adoption permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity elects to apply the provisions of SFAS 157. We are currently assessing the impact of SFAS 159 on our consolidated financial position and results of operations.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

Item 4. Controls and Procedures

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

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

There were no changes in our internal controls over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In April 2005, we initiated a lawsuit against Northrop Grumman, in California state court (COGENT SYSTEMS, INC., vs. NORTHROP GRUMMAN CORPORATION, NORTHROP GRUMMAN INFORMATION TECHNOLOGY OVERSEAS, INC., et al., Superior Court of the State of California, In and For the County of Los Angeles, Case No. BC 332199), based on claims of breach of contract, conversion, misappropriation of trade secrets, breach of trust, interference with prospective economic advantage, breach of the implied covenants of good faith and fair dealing and unfair competition. As of September 30, 2007, we had incurred $14.4 million in legal expenses related to this action, including $10.5 million incurred in the nine months ended September 30, 2007. On September 10, 2007, we announced our agreement to settle the lawsuit. Under the terms of the agreement, Northrop Grumman agreed to pay Cogent $25 million to settle the litigation and $15 million for a non-exclusive license to use specified Cogent AFIS Software in certain existing programs, including IDENT1, a biometric based identification system in the U.K. In addition we agreed to enter into a five-year research and development, service and products agreement with Northrop Grumman under which Northrop will pay Cogent $20 million for products and services over the term of the agreement. While Cogent and Northrop Grumman have an agreement in principle, the parties are still engaged in the negotiation and execution of definitive agreements.

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

Item 1A. Risk Factors

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

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

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

- changes in fiscal policies or decreases in available government funding;
- changes in government programs or applicable requirements;
- the adoption of new laws or regulations or changes to existing laws or regulations;
- changes in political or social attitudes with respect to security and defense issues;
- potential delays or changes in the government appropriations process; and

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

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

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In 2006 and for the nine months ended September 30, 2007, we derived 48% and 42%, respectively, of our revenues from a limited number of customers.

In each fiscal period we have derived, and we believe that in each future fiscal period we will continue to derive, a significant portion of our revenues from a limited number of customers. We had three customers that collectively accounted for 42% of revenues during the nine months ended September 30, 2007, including the DHS, the CNE and the RCMP, which accounted for 15%, 17% and 10% of revenues, respectively. For the year ended December 31, 2006, the DHS and the CNE collectively accounted for 48% of revenues, or 11% and 37%, respectively. The success of our business is substantially dependent on the continuation of our relationships with, and additional sales to, our significant customers. In addition, our business is dependent upon entering into relationships with additional significant customers. To the extent that any significant customer reduces or delays its purchases from us or terminates its relationship with us, our revenues would decline significantly and our financial condition and results of operations would suffer substantially. None of our customers are obligated to purchase additional solutions from us. As a result, the amount of revenue that we derive from a specific customer may vary from period to period, and a significant customer in one period may not be a significant customer in any subsequent period. For example, our most recent arrangement with the CNE was completed in December 2006 and revenues from all of our arrangements with the CNE were fully recognized by June 30, 2007. We do not have any agreements to sell additional solutions to the CNE.

In 2006 and for the nine months ended September 30, 2007, we derived 42% and 51%, respectively, of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

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

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

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

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

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

- the cost, performance and reliability of our solutions and the products and services offered by our competitors;
- customers perceptions regarding the benefits of biometrics solutions;
- the development and growth of demand for biometric solutions in markets outside of government and law enforcement;

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

- public perceptions regarding the confidentiality of private information;

- proposed or enacted legislation related to privacy of information;

- customers satisfaction with biometrics solutions; and

- marketing efforts and publicity regarding biometrics solutions.

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

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

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

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

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

- the terms of customer contracts that affect the timing of revenue recognition;

- the size and timing of our receipt of customer orders;

- significant fluctuation in demand for our solutions;

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

- cancellations, delays or contract amendments by government agency customers;

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

- unforeseen legal expenses, including litigation and/or administrative protest costs;
- expenses related to acquisitions or mergers;
- potential effects of providing services as a prime contractor that may not carry gross margins as high as those of our core solutions;
- impairment charges arising out of our assessments of goodwill and intangibles; and
- other one-time financial charges.

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

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

- diversified technology providers such as Motorola (through its Motorola Biometrics Solutions division), NEC and Safran Group (through its wholly owned subsidiary Sagem Morpho) that offer integrated AFIS solutions to governments, law enforcement agencies and other organizations;

- companies that are AFIS component providers, such as Cross Match Technologies, L-1 Identity Solutions;

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

- companies focused on other fingerprint biometric solutions, such as AuthenTec, BioScrypt, Dermalog and UPEK.

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

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

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

Among the most significant regulations affecting our business are:

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

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

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

- the Foreign Corrupt Practices Act; and laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

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

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

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

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

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

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

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

We must comply with U.S. laws regulating the export of our products. In some cases, explicit authorization from the U.S. government is needed to export our products. The export regimes and the governing policies applicable to our business are subject to changes. We cannot assure you that such export authorizations will be available to us or for our products in the future. For example, U.S. export restrictions currently restrict the sale of fingerprint technology to China, which limits our ability to pursue opportunities there that are open to many of our competitors. In some cases where we act as a subcontractor, we rely upon the compliance activities of our prime contractors, and we cannot assure you that they have taken or will take all measures necessary to comply with applicable export laws. If we or our prime contractor partners cannot obtain required government approvals under applicable regulations, we may not be able to sell our products in certain international jurisdictions.

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

Deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the projects and deploy appropriate resources, including our own project managers and third party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in reputational damage or even claims for substantial monetary damages against us. In addition, we sometimes guarantee customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit from a particular project. Moreover, 57% of our revenues in 2006 and 50% of our revenues for the nine months ended September 30, 2007 were derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing solutions in order to address the changing and sophisticated needs of the marketplace. Frequently, technical development programs in the biometrics industry require assessments to be made of the future direction of technology, which is inherently difficult to predict. Delays in introducing new products and enhancements, the failure to choose correctly among technical alternatives or the

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failure to offer innovative products or enhancements at competitive prices may cause customers to forego purchases of our solutions and purchase our competitors solutions. We may not have adequate resources available to us or may not adequately keep pace with appropriate requirements in order to effectively compete in the marketplace.

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

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

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

Historically, our business and products have been focused on the government and law enforcement markets. Sales to customers in these markets accounted for 98% of our revenues in 2006 and 99% during the nine months ended September 30, 2007. A component of our strategy is to develop and grow our sales of other fingerprint biometrics solutions. The market for these solutions is at an early stage of development compared to the market for law enforcement and other government sector biometrics products. We cannot assure you that other fingerprint biometrics products and solutions will gain wide market acceptance, that this market will develop and grow as we expect, that we will successfully develop products for this market or that we will have the same success in this market as we have had in the government and law enforcement markets. In addition, we cannot assure you that our strategy of expanding our business to cover biometric solutions and products based on biometrics other than fingerprints will be successful.

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

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

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

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

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

Government agencies may audit us as part of their routine audits and investigations of government contracts. As part of an audit, these agencies may review our performance on contracts, cost structures and compliance with applicable laws, regulations and standards. These agencies may also review the adequacy of, and our compliance with, our internal control systems and policies, including our purchasing, property, estimating, compensation and management information systems. If any of our costs are found to be improperly allocated to a specific contract, the costs may not be reimbursed and any costs already reimbursed for such contract may have to be refunded. An audit could materially affect our competitive position and result in a material adjustment to our financial results or statement of operations. If a government agency audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with the federal government. In addition, we could suffer serious reputational harm if allegations of impropriety were made against us. While we have never had a negative audit by a governmental agency, we cannot assure you that one will not occur. If we were suspended or debarred from contracting with the federal government generally, or if our reputation or relationships with government agencies were impaired, or if the government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenues and prospects would be materially harmed.

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

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

We may be required to expend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any such litigation, whether or not it is ultimately resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel. For example, in April 2005, we initiated a lawsuit against Northrop Grumman which asserted that Northrop caused us harm by misappropriating our trade secrets. We spent a substantial amount of funds in connection with this lawsuit and our management devoted a significant amount of time to this lawsuit.

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

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

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

Ming Hsieh, our Chief Executive Officer, controlled approximately 54% of our outstanding common stock as of September 30,

2007. As a result, he is able to exercise control over matters requiring stockholder approval, such as the election of directors and the

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approval of significant corporate transactions. These types of transactions include transactions involving an actual or potential change of control of our company or other transactions that the non-controlling stockholders may deem to be in their best interests and in which such stockholders could receive a premium for their shares. We are a controlled company under the Nasdaq corporate governance rules, and therefore we are entitled to exemptions from certain of the Nasdaq corporate governance rules. These requirements are generally intended to increase the likelihood that boards will make decisions in the best interests of stockholders. Specifically, we are not required to have a majority of our directors be independent or to have compensation, nominating and corporate governance committees comprised solely of independent directors. We do not intend to avail ourselves of the controlled company exemptions, but our intentions may change and in such event, if our stockholders interests differed from those of Mr. Hsieh, our stockholders would not be afforded the protections of these Nasdaq corporate governance requirements.

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

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

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

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

For the year ended December 31, 2006 and for the nine months ended September 30, 2007, revenues outside of the Americas accounted for approximately 14% and 17%, respectively, of our total revenues. We also currently have international operations, including offices in Austria, Canada, China, Taiwan and the United Kingdom. Our international revenues and operations are subject to a number of material risks, including, but not limited to:

- difficulties in building and managing foreign operations;
- regulatory uncertainties in foreign countries;
- difficulties in enforcing agreements and collecting receivables through foreign legal systems and other relevant legal issues;
- longer payment cycles;
- foreign and U.S. taxation issues;
- potential weaknesses in foreign economies;

- fluctuations in the value of foreign currencies;
- general economic and political conditions in the markets in which we operate; and
- unexpected domestic and international regulatory, economic or political changes.

Our sales, including sales to customers outside the United States, are primarily denominated in U.S. dollars, and therefore downward fluctuations in the value of foreign currencies relative to the U.S. dollar may make our solutions more expensive than local solutions in international locations. This would make our solutions less price competitive than local solutions, which could harm our

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business. We do not currently engage in currency hedging activities to limit the risks of currency fluctuations. Therefore, fluctuations in the value of foreign currencies could harm our profitability.

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

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

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

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

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

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

- difficulties in integrating operations, technologies, accounting and personnel;
- difficulties in supporting and transitioning customers of our acquired companies;
- diversion of financial and management resources from existing operations;
- risks of entering new markets;
- potential loss of key employees; and
- inability to generate sufficient revenues to offset acquisition costs.

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

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

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

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The trading price of our common stock is volatile.

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

- variations in our financial results;
- announcements of technological innovations, new solutions, strategic alliances or significant agreements by us or by our competitors;
- recruitment or departure of key personnel;
- changes in the estimates of our financial results or changes in the recommendations of any securities analysts that elect to follow our common stock; and
- market conditions in our industry, the industries of our customers and the economy as a whole.

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

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

All of our outstanding shares are eligible for sale in the public market, subject in certain cases to volume limitations under Rule 144 of the Securities Act of 1933, as amended. Also, shares subject to outstanding options and rights under our 2000 Stock Option Plan and 2004 Equity Incentive Plan are eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements and Rules 144 and 701 under the Securities Act. If these shares are sold, or if it is perceived that they will be sold in the public market, the trading price of our common stock could decline.

In addition, Ming Hsieh, who was our sole stockholder prior to our initial public offering, continues to hold a substantial number of shares of our common stock. Sales by Mr. Hsieh of a substantial number of shares, or the expectation that such sales may occur, could significantly reduce the market price of our common stock.

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

Effective internal controls are necessary for us to prgin-top:0pt;margin-right:0pt;margin-bottom:0pt;margin-left:10.0pt;
margin-bottom:.0001pt;text-indent:-10.0pt'>External sales

$

1,890

$

594

$

494

$

394

$

-

$

3,372

Intersegment sales

263

182

247

1

(693

)

-

Net sales

2,153

776

741

395

(693

)

3,372

Investee equity, royalty and other income

24

5

3

26

-

58

Interest income

6

1

1

1

-

9

Segment EBIT

155

83

34

46

(12

)

306

Three months ended October 1, 2006

External sales

$

1,619

$

487

$

361

$

342

$

-

$

2,809

Intersegment sales

223

137

203

4

(567

)

-

Net sales

1,842

624

564

346

(567

)

2,809

Investee equity, royalty and other income

16

4

2

15

-

37

Interest income

11

2

1

-

-

14

Segment EBIT

183

57

19

38

(1

)

296

Nine months ended September 30, 2007

External sales

$

5,267

$

1,730

$

1,465

$

1,070

$

-

$

9,532

Intersegment sales

760

490

690

2

(1,942

)

-

Net sales

6,027

2,220

2,155

1,072

(1,942

)

9,532

Investee equity, royalty and other income

66

12

1

67

-

146

Interest income

20

4

2

1

-

27

Segment EBIT

469

248

106

131

(51

)

903

Nine months ended October 1, 2006

External sales

$

4,898

$

1,365

$

1,079

$

987

$

-

$

8,329

Intersegment sales

661

393

603

12

(1,669

)

-

Net sales

5,559

1,758

1,682

999

(1,669

)

8,329

Investee equity, royalty and other income

51

10

6

38

-

105

Interest income

25

5

1

2

-

33

Segment EBIT

552

158

84

105

(23

)

876

(1) Includes intercompany eliminations and unallocated corporate expenses.

A reconciliation of our segment information to the corresponding amounts in the *Condensed Consolidated Financial Statements* is shown in the table below:

	Three months ended		Nine months ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
	Millions			
Segment EBIT	$ 306	$ 296	$ 903	$ 876
Less:				
Interest expense	14	23	44	76
Earnings before income taxes and minority interests	$ 292	$ 273	$ 859	$ 800

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Certain prior year amounts included in this section have been reclassified to conform to the current year presentation.

When used in this report the terms "Cummins," "the Company," "the registrant," "we," "our," or "us" mean Cummins Inc. and all entities included in our consolidated financial statements.

ORGANIZATION OF INFORMATION

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our *Consolidated Financial Statements* and related *Notes to Consolidated Financial Statements* in the "Financial Statements" section of our 2006 Annual Report on Form 10-K. All references to earnings per share amounts are diluted per share amounts. Our discussion contains forward-looking statements based upon current expectations that involve risks and uncertainties, such as our plans, objectives, expectations and intentions. Actual results and the timing of events could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth under "RISK FACTORS RELATING TO OUR BUSINESS" included in Part I of our 2006 Annual Report on Form 10-K and "Disclosure Regarding Forward-Looking Statements" presented at the end of this section. This overview summarizes the MD&A which includes the following sections:

- *Executive Summary and Financial Highlights* - a brief discussion providing an overview of our Company, highlighting the significant events affecting our Company and summary of our Company's financial performance.
- *Results of Operations* - an analysis of our consolidated results of operations for the periods presented in our *Condensed Consolidated Financial Statements*.
- *Operating Segment Results* - an analysis of the performance of each of our reportable operating segments for the periods presented in our *Condensed Consolidated Financial Statements*.
- *Liquidity and Capital Resources* - an analysis of cash flows, sources and uses of cash, off balance sheet arrangements and contractual obligations.
- *Application of Critical Accounting Estimates* - a summary of our critical accounting estimates and our policies relating to the application of those estimates.
- *Disclosure Regarding Forward-Looking Statements* - cautionary information about forward-looking statements and a description of certain risks and uncertainties that could cause our actual results to differ materially from our historical results or our current expectations or projections.

EXECUTIVE SUMMARY AND FINANCIAL HIGHLIGHTS

We are a global power leader that designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related products, including filtration and aftertreatment devices, fuel systems and controls and air handling systems. We sell our products to Original Equipment Manufacturers (OEMs), distributors and other customers worldwide. We have long-standing relationships with many of the leading manufacturers in the markets we serve, including Chrysler LLC, Daimler AG, Volvo AB, PACCAR Inc., International Truck and Engine Corporation (Navistar International Corporation), CNH Global N.V., Komatsu Scania AB, Ford Motor Company and Volkswagen . We serve our customers through a network of more than 550 company-owned and independent distributor locations and approximately 5,000 dealer locations in more than 160 countries and territories.

Our reportable operating segments consist of the following: Engine, Power Generation, Components, and Distribution. This reporting structure is organized according to the products and markets each segment serves. This type of reporting structure allows management to focus its efforts on providing enhanced service to a wide range of customers. The Engine segment produces engines and parts for sale to customers in on-highway and various industrial markets. The engines are used in trucks of all sizes, buses and RVs, as well as various industrial applications including construction, mining, agriculture, marine, oil and gas, rail, and military. The Power Generation segment is an integrated provider of power systems selling engines, generator sets and alternators and providing rental of power equipment for both standby and prime power uses. The Components segment includes sales of filtration products, exhaust and aftertreatment systems, turbochargers and fuel systems. The Distribution segment includes wholly-owned and partially-owned distributorships engaged in wholesaling engines, generator sets, and service parts, performing service and repair activities on our products and maintaining relationships with various OEMs throughout the world.

Our financial performance depends in large part, on varying conditions in the markets we serve, particularly the on-highway, construction and general industrial markets. Demand in these markets tends to fluctuate in response to overall economic conditions and is particularly sensitive to changes in interest rate levels. Our sales may also be impacted by OEM inventory levels and production schedules and stoppages. Economic downturns in markets we serve generally result in reductions in sales and pricing of our products. As a worldwide business, our operations are also affected by political, economic and regulatory matters, including environmental and emission standards, in the countries we serve. However, our geographic diversity and broad product and service offerings have helped limit the impact of any one industry and the economy of any single country upon our consolidated results. This was effectively demonstrated through the first nine months of 2007 as we continue to experience strong sales and earnings despite the continued softness in the North American heavy-duty truck engine market where the industry forecast for trucks in that market is down approximately 50 percent from 2006 levels. More than half of our 2007 sales come from countries other than the United States. The diversity of our business portfolio has contributed to the significant organic growth we have experienced over the past several years continuing into the third quarter of 2007.

Financial highlights for the three and nine months ended was as follows:

	Three months ended		Nine months ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
	Millions			
Consolidated Results	(except earnings per share)			
Net sales	$ **3,372**	$ 2,809	$ **9,532**	$ 8,329
Gross margin	**652**	617	**1,874**	1,829
Investee equity, royalty and other income	**58**	37	**146**	105
Operating earnings	**289**	278	**853**	835
Net earnings	**184**	171	**541**	526
Diluted earnings per share	$ **1.84**	$ 1.69	$ **5.39**	$ 5.23

Net earnings for the three months ended September 30, 2007, were $184 million, or $1.84 per diluted share, on sales of $3.4 billion, compared to net earnings of $171 million, or $1.69 per diluted share, on sales of $2.8 billion in the corresponding period of 2006. Net earnings for the nine months ended September 30, 2007, were $541 million, or $5.39 per diluted share, on sales of $9.5 billion, compared to net earnings of $526 million, or $5.23 per diluted share, on sales of $8.3 billion in the corresponding period of 2006. Our third quarter 2007 net sales increased $563 million, or 20 percent, over third quarter 2006 led by record sales in the Engine, Power Generation and Distribution segments while the Components segment also experienced a strong sales performance. For the nine months ended September 30, 2007, net sales increased $1,203 million, or 14 percent, over the corresponding period of 2006. For the three and nine months ended September 30, 2007, Power Generation, Components and Distribution all generated double digit earnings increases over the corresponding 2006 periods while the Engine segment earnings declined 15 percent in both periods as the business was negatively impacted by higher material and warranty costs for new emissions-compliant engines, higher material costs related to the introduction of new products and lower cost-leverage in markets affected by the change in emissions regulations in the U.S.

During the first nine months of 2007, we continued our commitment to building a strong balance sheet, investing in profitable growth around the globe and returning value to our shareholders. Some of the transactions and events that highlight this are as follows:

- The Board of Directors authorized a two-for-one split of Cummins common stock on March 8, 2007, which was distributed on April 9, 2007, to shareholders of record as of March 26, 2007. All share and per share amounts in this filing have been adjusted to reflect the two-for-one stock split.

- Approximately $62 million of our $120 million 6.75% debentures were repaid on February 15, 2007, at the election of the holders.

- In July 2006, the Board of Directors authorized the acquisition of up to two million shares (adjusted to four million shares as a result of the two-for-one stock split) of Cummins common stock in addition to what has been acquired under previous authorizations. For the quarter ended September 30, 2007, we repurchased approximately $174 million of common stock, representing approximately 1.5 million shares and for the nine months ended September 30, 2007, we repurchased approximately $210 million of common stock, representing approximately 1.9 million shares. As a result, at September 30, 2007, there were approximately 1.1 million shares (adjusted for the impact of the two-for-one stock split) available to be acquired. As of December 31, 2006, one million shares (adjusted for the impact of the two-for-one stock split) had been purchased under the plan.

- Over the first nine months of 2007 we contributed $144 million to our pension plans as we move closer to fully funded status on our global pension plans and exceeding our stated goal of achieving 90 percent funded status on a projected benefit obligation basis by the end of 2007.

RESULTS OF OPERATIONS

Three and Nine Months Ended - 2007 versus 2006

	Three Months Ended September 30, 2007	Three Months Ended October 1, 2006	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent	Nine Months Ended September 30, 2007	Nine Months Ended October 1, 2006	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent
	$ in millions				$ in millions			
Net sales	**$ 3,372**	$ 2,809	$ 563	20%	**$ 9,532**	$ 8,329	$ 1,203	14%
Cost of sales	**2,720**	2,192	(528)	(24)%	**7,658**	6,500	(1,158)	(18)%
Gross margin	**652**	617	35	6%	**1,874**	1,829	45	2%
Operating expenses and income								
Selling and administrative expenses	**340**	291	(49)	(17)%	**937**	853	(84)	(10)%
Research and engineering expenses	**82**	81	(1)	(1)%	**236**	243	7	3%
Investee equity, royalty and other income	**58**	37	21	57%	**146**	105	41	39%
Other operating income (expense), net	**1**	(4)	5	NM	**6**	(3)	9	NM
Operating earnings	**289**	278	11	4%	**853**	835	18	2%
Interest income	**9**	14	(5)	(36)%	**27**	33	(6)	(18)%
Interest expense	**14**	23	9	39%	**44**	76	32	42%
Other income, net	**8**	4	4	100%	**23**	8	15	NM
Earnings before income taxes and minority interests	**292**	273	19	7%	**859**	800	59	7%
Provision for income taxes	**97**	92	(5)	(5)%	**284**	244	(40)	(16)%
Minority interests in earnings of consolidated subsidiaries	**11**	10	(1)	(10)%	**34**	30	(4)	(13)%
Net earnings	**$ 184**	$ 171	$ 13	8%	**$ 541**	$ 526	$ 15	3%

Net Sales

For the three and nine months ended September 30, 2007, net sales increased over the same periods in 2006 in all segments led by record quarterly sales in the Engine, Power Generation and Distribution segments.

Net sales changes by segment, compared with the same periods in 2006, were as follows:

	Three Months Ended 2007 vs. 2006 Change	Three Months Ended 2007 vs. 2006 % Change	Nine Months Ended 2007 vs. 2006 Change	Nine Months Ended 2007 vs. 2006 % Change
Engine	$ 311	17%	$ 468	8%
Power Generation	152	24%	462	26%
Components	177	31%	473	28%
Distribution	49	14%	73	7%

Engine net sales were higher due to improved pricing on our emission compliant engines, strong demand in almost all on-highway and off-highway markets and the favorable impact of foreign currency translation for both the three and nine months ended. The increased engine sales were partially offset by decreased demand in our North American heavy-duty on-highway market as a result of the 2007 change in emissions standards, although, heavy-duty on-highway engine sales were stronger than previously anticipated as the result of market share gains in 2007. Engine and parts sales to industrial markets were 30 percent and 29 percent higher compared to the three and nine months ended over the same period in 2006, with increased volumes in most market segments. Net sales increases in the Power Generation segment were due to improved pricing and strong organic growth led primarily by increases in commercial generator sales and alternator sales. Net sales in our Components segment improved due to increased organic sales growth in our filtration, turbocharger, and emission solutions businesses. Distribution segment net sales were up primarily due to increased demand for power generation products followed by increased parts and engine sales which were partially offset by the deconsolidation of one of our North American joint ventures beginning in 2007. The net sales of this joint venture were approximately $39 million and $119 million for the three and nine months ended compared to the same periods during 2006. See our "Operating Segment Results" section for further details on sales by segment.

Gross Margin

For the three and nine months ended September 30, 2007, gross margins increased over the same periods in 2006 primarily due to new pricing and increased volumes which were partially offset by increased costs for new products, increased warranty expenses and the deconsolidation of one of our North American joint ventures. Significant drivers impacting quarterly and year-to-date margins, as compared to the same period in 2006 were as follows:

	Three Months Ended 2007 vs. 2006 Change	Nine Months Ended 2007 vs. 2006 Change
Price	$ 123	$ 350
Volume	79	85
Incremental product cost	(96)	(288)
Deconsolidation of a joint venture	(18)	(49)
Warranty expense	(35)	(38)
Other	(18)	(15)
Total	$ 35	$ 45

Gross margin as a percentage of sales declined by 2.7 percentage points and 2.3 percentage points for the three and nine months ended, September 30, 2007, as compared to the same periods in 2006, as margin percentages declined in three of our segments primarily driven by the Engine and Components segments. In the Engine segment, price increases for new products were offset by higher new product costs, increased warranty costs and the decreased heavy-duty engine volumes. In the Components segment two of our businesses are experiencing low margins as the result of costs associated with meeting extremely strong demand.

Warranty expense as a percent of sales increased to 3.4 percent in the third quarter of 2007 from 2.9 percent in 2006 and remained flat at 3.0 percent for the nine month periods in both years. The increase in warranty expense was expected as the mix of 2007 emissions compliant engines and components increase. As has been our practice and as described in our Critical Accounting Estimates in our 2006 Annual Report on Form 10-K, new product launches require a greater use of judgment in developing estimates until historical experience becomes available. Product specific experience is typically available four or five quarters after product launch, with a clear experience trend evident eight quarters after launch. We generally record warranty expense for new products upon shipment using a factor based upon historical experience only in the first year, a blend of actual product and historical experience in the second year and product specific experience thereafter

Selling and Administrative Expenses

For the three and nine months ended September 30, 2007, selling and administrative expenses increased over the same periods in 2006 primarily as a result of annual salary increases, higher volumes across most businesses, the adverse impact of foreign currency translation and increases in infrastructure investments including the number of employees to provide for our growing business. Overall selling and administrative expenses, as a percent of sales, improved to 10.1 percent in 2007 compared to 10.4 percent in 2006, and 9.8 percent in 2007, compared to 10.2 percent in 2006, for the three and nine month periods, respectively, due to our lower cost structure. Both the Power Generation and Components segments had improved selling and administrative expenses as a percentage of sales while the Engine segment was relatively flat for the three and nine month periods. The Distribution segment's selling and administrative expense as a percentage of sales was relatively flat for the three month period and improved for the nine month period.

Research and Engineering Expenses

For the three months ended September 30, 2007, research and engineering expenses were relatively flat compared with the same period in 2006. For the nine months ended September 30, 2007, research and engineering expenses decreased in 2007 compared to 2006 due to heavy development of a number of new products and critical technologies in 2006 in addition to higher levels of customer funding for new product development in 2007. For the nine months ended October 1, 2006, we had significant research and engineering expenses across the Engine and Components segments related to new product development for 2007 and beyond as well as research and engineering expenses for growth platforms across geographies. For the nine months ended, September 30, 2007, the Engine segment accounted for $8 million of the decrease in research and engineering expenses. Fluctuations in other miscellaneous research and development expenses were not significant individually or in the aggregate.

Investee Equity, Royalty and Other Income

For the three and nine months ended September 30, 2007, investee equity, royalty and other income improved over the same periods in 2006 primarily due to an increase in earnings from our North American distributors of $9 million and $25 million for the three and nine month periods, respectively. The increased earnings at our North American distributors were the result of organic growth, acquisitions and the deconsolidation of a North American joint venture in 2007. In addition, Dongfeng Cummins Engine Company, Ltd. (DCEC) increased $8 million and $13 million compared to the quarter and year-to-date periods in the prior year, respectively. Cummins Mercruiser Diesel also showed strong increases for the quarter and year-to-date, while the other joint ventures remained relatively flat or had slight decreases.

Other Operating Income (Expense), Net

For the three and nine months ended September 30, 2007, other operating income increased over the same periods in 2006 primarily due to gains on the sale or disposal of fixed assets of $2 million and $11 million in 2007 compared with a $2 million loss and a $2 million gain in 2006 for the three and nine month periods, respectively. The increase also included gains in royalty income. Other fluctuations in other operating income were not significant individually or in the aggregate.

Interest Expense

For the three and nine months ended September 30, 2007, interest expense decreased over the same periods in 2006 due to significantly lower debt balances as we continue to strengthen our balance sheet in 2007 by paying down our debt obligations.

Other Income, Net

The major components of other income include foreign currency exchange gains and losses, bank charges and other miscellaneous income and expenses. For the three and nine months ended September 30, 2007, other income increased over the same periods in 2006 primarily due to an increase in foreign currency exchange gains of approximately $3 million and $10 million for the three and nine month periods, respectively. The quarterly increases were partially offset by a decrease in various other income and expense items.

Provision for Income Taxes

Our effective tax rate for the three and nine months ended September 30, 2007, was 33 percent. This rate was less than the 35 percent U.S. income tax rate primarily due to research tax credits and lower taxes on foreign earnings. In July 2007, the United Kingdom passed tax legislation which reduces our U.K. tax rate from 30 percent to 28 percent beginning in 2008. While the reduced tax rate will benefit future operations, we had an additional charge to our third quarter tax provision of approximately $2 million to reduce the value of our U.K. deferred tax assets. Our effective tax rate for the three and nine months ended October 1, 2006, were 34 percent and 31 percent, respectively. Our 2006 provision was reduced in the second quarter by $28 million due to the favorable resolution of tax uncertainties related to prior years. In addition, our 2006 provision was increased in the first quarter by $12 million for the effect of new Indiana tax legislation. The effective tax rate for the remainder of 2007 is expected to approximate 33 percent absent any discrete period activity. On January 1, 2007, we adopted FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." The adoption of FIN 48 did not have a material impact on our consolidated financial position or results of operations. See Note 6 to the *Condensed Consolidated Financial Statements* for further details.

OPERATING SEGMENT RESULTS

Our reportable operating segments consist of the following: Engine, Power Generation, Components and Distribution. This reporting structure is organized according to the products and markets each segment serves. We use segment EBIT (defined as earnings before interest expense, income taxes and minority interests) as the primary basis for the chief operating decision-maker to evaluate the performance of each operating segment. Following is a discussion of operating results for each of our business segments.

<u>Engine Results and Updated Outlook</u>

Three and Nine Months Ended - 2007 versus 2006

Financial data for the Engine segment was as follows:

	Three Months Ended	Favorable/ (Unfavorable)	Nine Months Ended	Favorable/ (Unfavorable)

	September 30, 2007	October 1, 2006	Amount	Percent	September 30, 2007	October 1, 2006	Amount	Percent
	$ in millions				$ in millions			
External sales	$ **1,890**	$ 1,619	$ 271	17%	$ **5,267**	$ 4,898	$ 369	8%
Intersegment sales	**263**	223	40	18%	**760**	661	99	15%
Net sales	**2,153**	1,842	311	17%	**6,027**	5,559	468	8%
Investee equity, royalty and other income	**24**	16	8	50 %	**66**	51	15	29%
Interest income	**6**	11	(5)	(45)%	**20**	25	(5)	(20)%
Segment EBIT	**155**	183	(28)	(15)%	**469**	552	(83)	(15)%
Segment EBIT as a percentage of net sales	**7.2** %	9.9 %	(2.7) percentage points		**7.8** %	9.9 %	(2.1) percentage points	

Net Sales

For the three and nine months ended September 30, 2007, net sales increased over the same period in 2006 for the Engine segment due to improved demand across most markets, excluding the on-highway heavy-duty truck market, and improved pricing on our new emissions compliant engines. The North American on-highway heavy-duty truck market was down as a result of the 2007 emissions standards change. Total on-highway-related sales were 59 percent and 56 percent of Engine segment net sales compared with 63 percent in 2006 for both the three and nine month periods, respectively. Industrial markets were strong compared to the same period in 2006, with increased volumes in most markets, led by construction, agriculture and government markets for the three month period and construction, government, marine, and mining for the nine month period.

Segment EBIT

For the three and nine months ended September 30, 2007, Engine segment EBIT decreased over the same periods in 2006 primarily due to the lower engine volumes in the on-highway markets, the accompanying gross margin impact of lower absorption of fixed manufacturing costs, higher costs for new emissions compliant products, and increased selling and administrative expenses. Gross margin decreased $8 million, or two percent and $63 million, or six percent and the gross margin percentage decreased 3.1 and 2.5 percentage points for the three and nine month periods over the same periods in 2006, respectively. Gross margin was lower due to higher material and warranty costs associated with the new 2007 engines. The increase in warranty expense was expected as the mix of 2007 emissions compliant engines and components increase. As has been our practice and as described in our Critical Accounting Estimates in our 2006 10-K, new product launches require a greater use of judgment in developing estimates until historical experience becomes available. Selling and administrative expense increased $26 million, or 21 percent and $48 million, or 13 percent for the three and nine month periods over the same periods in 2006, respectively, while the change as a percentage of net sales remained flat for both periods. The 2007 increases in selling and administrative expenses were primarily due to higher payroll costs as the result of 2007 salary increases and an increase in infrastructure investments including the number of employees to provide for the Engine segment's growing business for both the three and nine month periods. Research and engineering expenses increased by $2 million, or 4 percent and decreased by $8 million, or 5 percent for the three and nine month periods over the same periods in 2006, respectively, while, the change as a percentage of net sales remained flat for both periods. These increased segment expenses were partially offset by higher earnings from joint ventures over the same periods of 2006 primarily due to an $8 million and a $13 million improvement in earnings at DCEC for the three and nine month periods, respectively, due to strong demand in the Chinese truck market.

Engine Net Sales by Market

A summary and discussion of Engine segment net sales by market follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	October 1, 2006	Amount	Percent	September 30, 2007	October 1, 2006	Amount	Percent
	$ in millions				$ in millions			
Heavy-duty truck	$ **520**	$ 632	$ (112)	(18)%	$ **1,417**	$ 1,858	$ (441)	(24)%
Medium-duty truck and bus	**359**	253	106	42%	**885**	715	170	24%
Light-duty automotive and RV	**388**	267	121	45%	**1,094**	939	155	17%
Total on-highway	**1,267**	1,152	115	10%	**3,396**	3,512	(116)	(3)%
Industrial	**661**	507	154	30%	**1,943**	1,504	439	29%
Stationary power	**225**	183	42	23%	**688**	543	145	27%

Total net sales	**2,153**	1,842	311	17%	**6,027**	5,559	468	8%

A summary of unit shipments by engine classification (including unit shipments to Power Generation) follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	**October 1, 2006**	**Amount**	**Percent**	**September 30, 2007**	**October 1, 2006**	**Amount**	**Percent**
Midrange	**130,500**	104,800	25,700	25%	**371,200**	341,100	30,100	9%
Heavy-duty	**24,800**	31,000	(6,200)	(20)%	**67,600**	92,500	(24,900)	(27)%
High-horsepower	**4,600**	4,100	500	12%	**13,600**	11,800	1,800	15%
Total unit shipments	**159,900**	139,900	20,000	14%	**452,400**	445,400	7,000	2%

A summary of changes in unit shipments by market follows:

Unit Shipments by Market
Percent Change 2007 vs. 2006

	Three Months Ended			Nine Months Ended		
	North American	**International**	**Global**	**North American**	**International**	**Global**
Heavy-duty	(38)%	40%	**(27)%**	(46)%	46%	**(34)%**
Medium-duty truck	0%	42%	**23%**	2%	24%	**15%**
Bus	20%	79%	**47%**	27%	46%	**38%**
Light-duty truck	42%	9%	**38%**	0%	11%	**1%**
RV	(11)%	(100)%	**(11)%**	(17)%	(74)%	**(18)%**
Industrial	(2)%	37%	**16%**	(1)%	30%	**14%**
Total unit shipments	**5%**	**37%**	**15%**	**(11)%**	**29%**	**1%**

Note: The total percent of shipments in 2007 for both the three and nine months ended were 63% to North America and 37% to International.

Heavy-Duty Truck

For the three and nine months ended September 30, 2007, heavy-duty truck market sales decreased over the same periods in 2006 primarily due to the North American truck market as OEMs experienced reduced demand from truck fleets, following increased purchases in 2006 to replace trucks ahead of the 2007 change in emissions standards, the softer U.S. economy, and the weak freight environment. The decline in the North American truck market sales was partially offset by strong growth in our international sales and North American market share gains.

Medium-Duty Truck and Bus

For the three and nine months ended September 30, 2007, medium-duty truck and bus sales increased over the same periods in 2006 due to increased demand for medium-duty truck engines internationally and increased shipments of bus engines in North America and internationally compared to last year. The increase in overall North American bus sales is being driven by market share gains within the school bus market. For the nine months ended September 30, 2007, increased medium-duty truck revenues also improved due to increased market share related to our growing position with North American OEMs in the medium-duty truck market which was partially offset by reduced shipments at the beginning of the year as a result of the effect of the change in emissions regulations in North America.

Light-Duty Automotive and RV

For the three and nine months ended September 30, 2007, light-duty automotive sales increased over the same periods in 2006 primarily due to higher pricing for the 2007 emission compliant product. Third quarter total light-duty automotive unit shipments increased over the same period driven by higher shipments to Chrysler of approximately 13,100 units, or a 42 percent increase compared to the third quarter of 2006. Global engine shipments to recreational vehicle OEMs decreased for the three and nine months ended September 30, 2007, compared with the same periods in 2006, as a result of increased engine purchases in 2006 ahead of the 2007 change in emissions standards.

Industrial

For the three and nine months ended September 30, 2007, industrial sales increased in most markets over the same periods in 2006 primarily due to stronger demand in those markets. A summary and discussion of changes in Industrial unit sales by market follows:

Industrial Unit Shipments by Market
Percent Change 2007 vs. 2006

	Three Months Ended			Nine Months Ended		
	North American	**International**	**Global**	**North American**	**International**	**Global**
Agriculture	13%	20%	**14%**	(8)%	3%	**(6)%**
Construction	(6)%	39%	**16%**	1%	31%	**16%**
Government	28%	132%	**60%**	30%	183%	**75%**
Marine	(38)%	28%	**11%**	(11)%	25%	**15%**
Mining	(11)%	25%	**16%**	(2)%	27%	**19%**
Oil & Gas	3%	(50)%	**2%**	5%	124%	**7%**
Rail	142%	(10)%	**10%**	268%	35%	**51%**
Total unit shipments	**(2)%**	**37%**	**16%**	**(1)%**	**30%**	**14%**

The total percent of shipments to North America in 2007 were 44 percent and 46 percent as compared to 52 percent and 53 percent in 2006 for the three and nine month periods, respectively. The overall quarterly and year-to-date change in the geographic sales mix is due to the continued strength of the international construction market which is being driven by strong demand in Europe, East Asia, and Latin America. The international mining market demand is up as the strength in commodity prices is driving investment in mining capacity. Sales to the oil and gas market and the commercial marine market have increased as sustained oil and natural gas prices continue to drive activity and investments in new equipment and offshore supply vessels. Commercial marine also experienced share gains in the third quarter of 2007. The rail market is up due to increased demand in North America for the three months ended, September 30, 2007, and both North America and China for the nine months ended September 30, 2007. The government market is up due to increased North American demand in the third quarter of 2007.

Stationary Power

The increase in sales to stationary power markets for the three and nine months ended, September 30, 2007, is due to the increased net sales to our Power Generation segment. These net sales are eliminated in our *Condensed Consolidated Statements of Earnings*. See the *Power Generation Results* for a discussion of the increase in net sales.

Updated Outlook for 2007

Based on the strong performance in the first nine months of 2007, we now expect Engine segment net sales to increase approximately 7 percent for the year. In addition to the sustainable demand in all of our industrial markets, our forecasted revenue from on-highway markets has improved based on market share gains. Segment earnings for the full year are now expected to be within the targeted range of 7 to 10 percent of sales.

<u>Power Generation Results and Updated Outlook</u>

Three and Nine Months Ended - 2007 versus 2006

Financial data for the Power Generation segment was as follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	**October 1, 2006**	**Amount**	**Percent**	**September 30, 2007**	**October 1, 2006**	**Amount**	**Percent**
	$ in millions				**$ in millions**			
External sales	$ **594**	$ 487	$ 107	22%	$ **1,730**	$ 1,365	$ 365	27%
Intersegment sales	**182**	137	45	33%	**490**	393	97	25%
Net sales	**776**	624	152	24%	**2,220**	1,758	462	26%
Investee equity, royalty and other income	**5**	4	1	25 %	**12**	10	2	20%
Interest income	**1**	2	(1)	(50)%	**4**	5	(1)	(20)%
Segment EBIT	**83**	57	26	46%	**248**	158	90	57%
Segment EBIT as a percentage of net sales	**10.7** %	9.1 %	1.6 percentage points		**11.2** %	9.0 %	2.2 percentage points	

Our Power Generation segment includes the following primary businesses: commercial, alternators, and consumer.

Net Sales

For the three and nine months ended, September 30, 2007, Power Generation segment net sales increased over the same periods in 2006 primarily driven by a 34 percent and 32 percent increase in our commercial business a 40 percent and 41 percent increase in our alternator business for the three and nine month periods as compared to the same periods in 2006, respectively, and a 10 percent increase in our consumer business for both the three and nine month periods as compared to the same periods in 2006. Our commercial business, the largest line of business in this segment, increased as the result of strong demand across most regions, especially North America and Europe for the three and nine months ended September 30, 2007, the quarter also had increased demand in Latin America. The alternator business also experienced strong international sales growth for the three and nine month periods. Quarterly and year-to-date sales also increased as the result of improved pricing in the commercial and alternator lines of business and the favorable impact of foreign currency translation.

Segment EBIT

For the three and nine months ended September 30, 2007, Power Generation segment EBIT improved over the same period in 2006 largely driven by the gross margin line as significant price realization, net of increased material costs, and the absorption benefit from higher volumes improved segment earnings. Gross margin improved $32 million, or 28 percent and $98 million, or 30 percent, and the gross margin percentage improved by 0.5 and 0.6 percentage points for the three and nine month periods over the same periods in 2006, respectively. Selling and administrative expenses increased $8 million, or 14 percent and $19 million or 12 percent, however, selling and administrative expenses improved as a percentage of net sales by 0.8 and 1.1 percentage points for the three and nine month periods as compared to the same periods in 2006, respectively. The increase in selling and administrative expenses was primarily due to higher payroll costs and increases in infrastructure investments including the number of employees to provide for the growing Power Generation business. Research and engineering expenses remained flat and increased by $4 million, or 19 percent for the three and nine month periods over the same periods in 2006, respectively, and remained flat as a percentage of net sales for both periods.

Net Sales by Engine Category

A summary of engine shipments used in power generation equipment by engine classification follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	**October 1, 2006**	**Amount**	**Percent**	**September 30, 2007**	**October 1, 2006**	**Amount**	**Percent**
Midrange	**7,400**	7,100	300	4%	**22,800**	21,100	1700	8%
Heavy-duty	**2,100**	1,700	400	24%	**5,700**	5,200	500	10%
High-horsepower	**2,600**	2,300	300	13%	**7,700**	6,800	900	13%
Total unit shipments	**12,100**	11,100	1,000	9%	**36,200**	33,100	3,100	9%

Updated Outlook for 2007

Based on the strong performance in the first nine months of 2007 and an improved outlook, we now expect full year Power Generation segment net sales to grow approximately 27 percent. Demand for commercial generator equipment, including alternators, remains strong due to construction spending on data centers in North America and India and on general infrastructure development in the Middle East. Consumer sales are projected to increase primarily on the strength of portable gensets. Continued significant price realization and clear visibility to strong second half orders are forecasted to sustain earnings for the segment above the top end of its targeted range of 7 to 9 percent of sales for the year.

<u>Components Results and Updated Outlook</u>

Three and Nine Months Ended - 2007 versus 2006

Financial data for the Components segment was as follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	**October 1, 2006**	**Amount**	**Percent**	**September 30, 2007**	**October 1, 2006**	**Amount**	**Percent**
	$ in millions				**$ in millions**			

External sales	$ **494**	$ 361	$ 133	37%	$ **1,465**	$ 1,079	$ 386	36%
Intersegment sales	**247**	203	44	22%	**690**	603	87	14%
Net sales	**741**	564	177	31%	**2,155**	1,682	473	28%
Investee equity, royalty and other income	**3**	2	1	50 %	**1**	6	(5)	(83)%
Interest income	**1**	1	-	NA	**2**	1	1	100%
Segment EBIT	**34**	19	15	79%	**106**	84	22	26%
Segment EBIT as a percentage of net sales	**4.6** %	3.4 %	1.2 percentage points		**4.9** %	5.0 %	(0.1) percentage points	

Our Components segment includes the following businesses: filtration, turbochargers, fuel systems and emissions solutions.

Net Sales

For the three and nine months ended September 30, 2007, the increase in Components segment net sales was driven by a 219 percent increase in our emissions solutions business sales for both periods, a 47 percent and 40 percent increase in our turbocharger business sales, an 8 percent increase for both periods in our filtration business sales due to growth in the emerging markets of Eastern Europe and the Middle East, and a six percent and two percent increase in our fuel systems business sales for the three and nine month periods over the same periods in 2006, respectively. All of our businesses benefited from sales of new products to allow their customers to meet new on-highway emissions standards in the U.S. and Europe.

Segment EBIT

For the three and nine months ended September 30, 2007, Components segment EBIT improved over the same periods in 2006 primarily due to increased volumes and gross margins in most Component businesses. Gross margin improved $20 million, or 24 percent and $36 million, or 13 percent, however the gross margin percentage decreased 0.8 and 1.9 percentage points for the three and nine month periods over the same periods in 2006, respectively. Gross margin percentages were unfavorably impacted by higher metal costs, new product introduction costs and both our emissions solutions and turbo technologies businesses experiencing low margins as the result of costs associated with meeting extremely strong demand. Selling and administrative expenses increased $6 million, or 13 percent and $13 million, or 9 percent for the three and nine month periods as compared to the same periods in 2006, respectively. Selling and administrative expenses improved as a percentage of net sales by 1.2 percentage points for both the three and nine month periods as compared to the same periods in 2006. The increase in selling and administrative expenses was primarily due to higher payroll costs and increases in infrastructure investments including the number of employees to provide for the growing Components business. Research and engineering expenses increased by $1 million, or 6 percent and decreased by $2 million, or 4 percent for the three and nine month periods compared to the same periods in 2006, respectively. Research and engineering expenses improved as a percentage of net sales by 0.6 and 0.8 percentage points for the three and nine month periods, respectively.

Updated Outlook for 2007

Based on improvements in performance in the first nine months of 2007 and an improved outlook, particularly from our emissions solutions and turbocharger businesses, we now expect full year Components segment net sales to grow approximately 25 percent and earnings to reach the targeted range of approximately 7 percent of sales for the year.

<u>Distribution Results and Updated Outlook</u>

Three and Nine Months Ended - 2007 versus 2006

Financial data for the Distribution segment was as follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 30, 2007	October 1, 2006	Amount	Percent	September 30, 2007	October 1, 2006	Amount	Percent
	$ in millions				$ in millions			
External sales	$ **394**	$ 342	$ 52	15%	$ **1,070**	$ 987	$ 83	8%
Intersegment sales	**1**	4	(3)	(75)%	**2**	12	(10)	(83)%
Net sales	**395**	346	49	14%	**1,072**	999	73	7%
Investee equity, royalty and other income	**26**	15	11	73 %	**67**	38	29	76%
Interest income	**1**	-	1	NA	**1**	2	(1)	(50)%

Segment EBIT	**46**	38	8	21%	**131**	105	26	25%
Segment EBIT as a percentage of net sales	**11.6** %	11.0 %	0.6 percentage points		**12.2** %	10.5 %	1.7 percentage points	

Net Sales

For the three and nine months ended September 30, 2007, Distribution segment net sales increased as the result of strong overall demand in Europe and the Middle East despite the deconsolidation of one of our North American joint ventures in 2007. The net sales of this previously consolidated joint venture accounted for approximately $39 million, or 11 percent, and $119 million, or 12 percent of net sales for the Distribution segment for the three and nine months ended in 2006. The strong organic growth was led by increases in power generation volumes in Europe and the Middle East followed by parts and engine volumes and the favorable impact of foreign currency translation.

Segment EBIT

For the three and nine months ended September 30, 2007, Distribution segment EBIT improved over the same periods in 2006 primarily due to investee equity, royalty and other income led by a $9 million and $25 million increase from our North American Distributors for the three and nine month periods, respectively. Gross margin improved $4 million, or 5 percent for the three month period and was unchanged for the nine month period, however, the gross margin percentage decreased 1.7 and 1.5 percentage points for the three and nine month periods as compared to the same periods in 2006, respectively. Selling and administrative expenses increased $9 million, or 16 percent and $4 million, or 2 percent for the three and nine month periods as compared to the same periods in 2006. Selling and administrative expenses as a percentage of sales were flat and improved by 0.8 percentage points for the three and nine month periods, respectively. The increase in selling and administrative expenses was primarily due to higher payroll costs as the result of 2007 salary increases and an increase in infrastructure investments including the number of employees to provide for the growing Distribution business.

Updated Outlook for 2007

Based on the strong performance in the first nine months of 2007 and an improved outlook, particularly in Europe and the Middle East, we now expect full year Distribution segment net sales to grow approximately 22 percent, excluding the deconsolidation. Global non-residential construction and economic expansion will drive distribution revenue. We expect segment earnings to exceed the top end of its targeted range of 8 to 10 percent of sales for the year.

<u>Geographic Markets</u>

Sales to international markets for the three and nine months ended September 30, 2007, over the same periods in 2006, were both 52 percent of total net sales in 2007, compared with 51and 49 percent of total net sales in 2006, respectively. A summary of net sales (dollar amount and percentage of total) by geographic territory follows:

	Three Months Ended				Nine Months Ended			
$ in millions	**September 30, 2007**		**October 1, 2006**		**September 30, 2007**		**October 1, 2006**	
United States	$ 1,603	48 %	$ 1,384	49 %	$ 4,524	48 %	$ 4,212	51 %
Asia/Australia	621	18 %	452	17%	1,727	18%	1,314	16 %
Europe/CIS	550	16 %	399	14%	1,656	17%	1,169	14 %
Mexico/Latin America	309	9 %	228	8%	844	9%	652	8 %
Canada	104	3 %	199	7%	288	3%	574	6 %
Africa/Middle East	185	6 %	147	5%	493	5%	408	5 %
Total international	1,769	52 %	1,425	51%	5,008	52%	4,117	49 %
Total consolidated net sales	$ 3,372	100 %	$ 2,809	100%	$ 9,532	100%	$ 8,329	100 %

LIQUIDITY AND CAPITAL RESOURCES

Overview of Capital Structure

Cash and cash equivalents decreased $216 million during the period to $624 million at the end of the first nine months compared to $840 million at the beginning of the period. Cash and cash equivalents were higher at the end of 2006 due to lower accounts receivable at the end of 2006. We have focused much of our efforts on improving our balance sheet through debt reduction. We believe our net debt position is a strong indicator of how much progress we have made in this area. This measure is not defined under U.S. GAAP and may not be computed in the same manner as similarly titled measures used by other companies. Our net debt position is as follows:

	September 30, 2007	December 31, 2006	October 1, 2006
		$ in millions	
Total debt	$ 664	$ 811	$ 1,061
Less: cash, cash equivalents and marketable securities	(744)	(935)	(1,109)
Net debt	$ (80)	$ (124)	$ (48)

In the first quarter of 2007, approximately $62 million of our $120 million 6.75% debentures were repaid on February 15, 2007, at the election of the holders. Total debt as a percent of our total capital, including total debt, was 17.2 percent at September 30, 2007, compared with 22.4 percent at December 31, 2006 and 28.4 percent at October 1, 2006.

Management's Assessment of Liquidity

We assess our liquidity in terms of our ability to generate adequate cash to fund our operating, investing and financing activities. Cash provided by operations is our principal source of liquidity. We believe our future operating cash flows together with our current cash and cash equivalents of $624 million, marketable securities of $120 million, $619 million available under our revolving credit facility, $291 million, based on eligible receivables, available under our accounts receivable program and $149 million available under international credit facilities provide us with the financial flexibility needed to fund working capital, debt service obligations, capital expenditures, projected pension obligations, dividend payments, common stock repurchases and expansion in emerging markets.

Dividend Policy

On July 10, 2007, the Board of Directors approved an increase in the quarterly cash dividend on our common stock from $0.18 per share to $0.25 per share. The dividend was paid on August 31, 2007, to shareholders of record on August 17, 2007.

Working Capital Summary

	September 30, 2007	December 31, 2006	October 1, 2006
		$ in millions	
Current assets	$ 4,947	$ 4,488	$ 4,662
Current liabilities	2,704	2,399	2,609
Working capital	$ 2,243	$ 2,089	$ 2,053
Current ratio	1.83	1.87	1.79
Days' sales in receivables	55	52	55
Inventory turnover	6.1	6.7	6.3

Cash Flows

The following table summarizes the key elements of our cash flows for the nine month periods:

	September 30, 2007	October 1, 2006
	Millions	
Net cash provided by operating activities	$ 523	$ 613
Net cash used in investing activities	(323)	(185)
Net cash used in financing activities	(427)	(183)
Effect of exchange rate changes on cash	11	3
Net (decrease) increase in cash and cash equivalents	$ (216)	$ 248

Operating Activities. Net cash provided by operating activities declined $90 million in the first nine months of 2007 compared to the first nine months of 2006, primarily due to a $72 million decrease in deferred income tax provision, a $15 million increase in cash used for working capital partially offset by a decrease in pension contributions of $10 million. Net changes in working capital utilized $245 million in cash during the first nine months of 2007 compared to utilizing $230 million in the first nine months of 2006. Cash utilized for working capital tends to fluctuate from period to period based on various factors including sales and production volumes as well as timing. We continued making additional pension contributions towards our goal of reaching 90 percent funded status by the end of 2007. In the first nine months of 2007 we contributed $144 million to our pension plans. We presently anticipate contributing $240 million to $250 million to our pension plans in 2007 and paying approximately $55 million in claims and premiums. The $240 million to $250 million of pension contributions for the full year includes voluntary contributions of $160 million to $170 million. These contributions and payments include payments from Company funds to either increase pension plan assets or to make direct payments to plan participants.

Investing Activities. Net cash used in investing activities increased $138 million in the first nine months of 2007 compared to 2006. The increase was primarily due to a $52 million outflow for the purchase of long-term investments, a $30 million increase in capital expenditures, an outflow of $20 million for the acquisition of businesses, the majority of which was to acquire the remaining 50 percent equity ownership in a 50/50 joint venture, and an increase of $17 million in cash used for investments in and advances to equity investees.

Capital expenditures for 2007 will increase to support our growth, and will include investments to increase capacity and to fund development of our new products. Our investments in capacity improvement are accelerating across all of our businesses and are designed for future growth opportunities. We continue to invest more of our capital in low-cost regions of the world to further leverage our opportunities for cost reduction. We currently expect capital expenditures for all of 2007 to be between $320 million and $340 million to support these initiatives.

Financing Activities. Net cash used in financing activities was $427 million in the first nine months of 2007 compared to $183 million in the first nine months of 2006, or a net increase in cash outflows of $244 million. The majority of the increase in cash outflows is due to the increase in repurchases of common stock of $134 million and a decrease in the proceeds from borrowings of $77 million.

In July 2006, the Board of Directors authorized us to acquire up to two million shares (adjusted to four million shares as a result of the two-for-one stock split) of Cummins common stock in addition to what has been acquired under previous authorizations. For the nine months ended September 30, 2007, we repurchased approximately $210 million of common stock, at an average cost of $107.54 per share, representing approximately 1.9 million shares. As of December 31, 2006, one million shares (adjusted for the impact of the two-for-one stock split) had been purchased under the plan. As a result, at September 30, 2007, there were approximately 1.1 million shares available to be acquired. The share repurchase program is expected to be a significant use of our cash flows in 2007 and 2008. We anticipate completing the repurchase of the 1.1 million remaining shares sometime in 2008. However, total repurchases may vary quarter to quarter depending on other investing and financing activities, market conditions, or restrictions.

Credit Ratings

On July 20, 2007, Fitch upgraded our senior unsecured debt ratings from "BBB"- to "BBB" and revised our outlook to stable. On August 16, 2007, Standard & Poor's upgraded our outlook from stable to positive. Our current ratings and outlook from each of the credit rating agencies are shown in the table below.

Credit Rating Agency	Senior L-T Debt Rating	S-T Debt Rating	Outlook
Moody's Investors Service, Inc.	Baa3	Non-Prime	Stable
Standard & Poor's	BBB-	NR	Positive
Fitch	BBB	BBB	Stable

Off Balance Sheet Financing

Sale of Accounts Receivable

In January 2004, we entered into a three-year facility agreement with a financial institution to sell a designated pool of trade receivables to Cummins Trade Receivables, LLC (CTR), a wholly-owned special purpose subsidiary. In July 2007, we amended the agreement to extend the facility until July 2010, and raised the purchase limitation from $200 million to $400 million. The agreement also provides us with an option to increase the purchase limitation up to $500 million upon approval. As necessary, CTR may transfer a direct interest in its receivables, without recourse, to the financial institution. To maintain a balance in the designated pools of receivables sold, we sell new receivables to CTR as existing receivables are collected. Receivables sold to CTR in which an interest is not transferred to the financial institution are included in "Receivables, net" on our *Consolidated Balance Sheets*. The maximum interest in sold receivables that can be outstanding at any point in time is limited to the lesser of $400 million or the amount of eligible receivables held by CTR. There are no provisions in this agreement that require us to maintain a minimum investment credit rating; however, the terms of the agreement contain the same financial covenants as our revolving credit facility. There was no activity under this program in the first nine months of 2007. At this time, we do not intend to utilize any funds from this facility in the foreseeable future.

Financing Arrangements for Related Parties

In accordance with the provisions of various joint venture agreements, we may purchase products and components from the joint ventures, sell products and components to the joint ventures and the joint ventures may sell products and components to unrelated parties. The transfer price of products purchased from the joint ventures may differ from normal selling prices. Certain joint venture agreements transfer product to us at cost, some transfer product to us on a cost-plus basis and other agreements provide for the transfer of products at market value.

Distributors

We have an extensive worldwide distributor and dealer network through which we sell and distribute our products and services. Generally, our distributors are divided by geographic region. Some of our distributors are wholly-owned by Cummins, some partially-owned and the majority are independently owned. We consolidate all wholly-owned distributors and partially-owned distributors where we are the primary beneficiary and account for other partially-owned distributors using the equity method of accounting.

We are contractually obligated to repurchase new engines, parts and components and signage from our North American distributors following an ownership transfer or termination of the distributor. In addition, in certain cases where we own a partial interest in a distributor, we are obligated to purchase the other equity holders' interests if certain events occur (such as the death of the distributor principal or a change in control of Cummins Inc.). The purchase price of the equity interests is determined based on the fair value of the distributor's assets. Outside of North America, repurchase obligations and practices vary by region. All distributors that are partially-owned are considered to be related parties in our *Condensed Consolidated Financial Statements*.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

A summary of our significant accounting policies is included in Note 1 to the *Consolidated Financial Statements* of our 2006 Annual Report on Form 10-K which discusses accounting policies that we have selected from acceptable alternatives.

Our *Condensed Consolidated Financial Statements* are prepared in accordance with generally accepted accounting principles that often require management to make judgments, estimates and assumptions regarding uncertainties that affect the reported amounts presented and disclosed in the financial statements. Our management reviews these estimates and assumptions based on historical experience, changes in business conditions and other relevant factors they believe to be reasonable under the circumstances. In any given reporting period, our actual results may differ from the estimates and assumptions used in preparing our *Condensed Consolidated Financial Statements.*

Critical accounting estimates are defined as follows: the estimates require management to make assumptions about matters that were highly uncertain at the time the estimates were made; different estimates reasonably could have been used; or if changes in the estimates are reasonably likely to occur from period to period and the change would have a material impact on our financial condition or results of operations. Our senior management has discussed the development and selection of our accounting policies, related accounting estimates and the disclosures set forth below with the Audit Committee of the Board of Directors. We believe our critical accounting estimates include those addressing the estimation of liabilities for warranty programs, accounting for income taxes, pension benefits and annual assessment of recoverability of goodwill. A discussion of these critical accounting estimates may be found in the "Management's Discussion and Analysis" section of our 2006 Annual Report on Form 10-K under the caption "APPLICATION OF CRITICAL ACCOUNTING ESTIMATES." Within the context of these critical accounting estimates, we are not currently aware of any reasonably likely events or circumstances that would result in different policies or estimates being reported in the first nine months of 2007.

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains certain forward-looking statements that are based on current expectations, estimates and projections about the industries in which we operate and management's beliefs and assumptions. Forward-looking statements are generally accompanied by words, such as "anticipates," "expects," "forecasts," "intends," "plans," "believes," "seeks," "estimates" or similar expressions. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which we refer to as "future factors," which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Future factors that could cause our results to differ materially from the results discussed in such forward-looking statements are discussed below. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Future factors that could affect the outcome of forward-looking statements include the following:

- price and product competition by foreign and domestic competitors, including new entrants;
- rapid technological developments of diesel engines;
- the ability to continue to introduce competitive new products in a timely, cost-effective basis;
- the sales mix of products;
- the achievement of lower costs and expenses;
- domestic and foreign governmental and public policy changes, including environmental regulations;
- protection and validity of patent and other intellectual property rights;
- reliance on large customers;
- technological, implementation and cost/financial risks in increasing use of large, multi-year contracts;
- the cyclical nature of some of our businesses;
- the outcome of pending and future litigation and governmental proceedings;
- continued availability of financing, financial instruments and financial resources in the amounts, at the times and on the terms required to support our future business; and

- other risk factors described in Part I of our 2006 Annual Report on Form 10-K under the caption "RISK FACTORS RELATING TO OUR BUSINESS."

In addition, such statements could be affected by general industry and market conditions and growth rates, general domestic and international economic conditions, including the price of crude oil (diesel fuel), interest rate and currency exchange rate fluctuations and other future factors.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

A discussion of quantitative and qualitative disclosures about market risk may be found in Item 7A of our 2006 Annual Report on Form 10-K. There have been no material changes in this information since the filing of our 2006 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

a.) Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is (1) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

b.) Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the quarter ended September 30, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

We are at any one time party to a number of lawsuits or subject to claims arising out of the ordinary course of our business, including actions related to product liability, patent, trademark or other intellectual property infringement, contractual liability, workplace safety and environmental claims and cases, some of which involve claims for substantial damages. We and our subsidiaries are currently defendants in a number of pending legal actions, including actions related to use and performance of our products. While we carry product liability insurance covering significant claims for damages involving personal injury and property damage, we cannot assure you that such insurance would be adequate to cover the costs associated with a judgment against us with respect to these claims. We also establish reserves for matters in which losses are probable and can be reasonably estimated. We have also been identified as a potentially responsible party at several waste disposal sites under federal and state environmental statutes, as more fully described in Item 1 of our 2006 Annual Report on Form 10-K under "Environmental Compliance-Other Environmental Statutes and Regulations." We deny liability with respect to many of these legal actions and environmental proceedings and are vigorously defending such actions or proceedings. While we believe we have established adequate accruals for our expected future liability with respect to our pending legal actions and proceedings, we cannot assure you that our liability with respect to any such action or proceeding would not exceed our established accruals. Further, we cannot assure that litigation having a material adverse affect on our financial condition will not arise in the future. The information in Item 1 "Other Environmental Statutes and Regulations" referred to above should be read in conjunction with this disclosure. See also Note 12, "Commitments and Contingencies" of the Notes to *Consolidated Financial Statements* included in our 2006 Annual Report on Form 10-K. There has been no material change in this information since the filing of our 2006 Annual Report on Form 10-K.

ITEM 1A. Risk Factors

In addition to other information set forth in this report, you should consider other risk factors discussed in Part I, "Item 1A. Risk Factors Relating to our Business" in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K or the Disclosure Regarding Forward-Looking Statements in this Quarterly Report are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently judge to be immaterial also may materially adversely affect our business, financial condition or operating results.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following information is provided pursuant to Item 703 of Regulation S-K:

ISSUER PURCHASES OF EQUITY SECURITIES(1)

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 2 - August 5, 2007	200,000	$ 121.23	200,000	2,365,100
August 6 - September 2, 2007	1,266,716	113.04	1,265,100	1,100,000
September 3 - September 30, 2007	487,441	119.88	50,000	1,050,000
Total	1,954,157 (2)	$ 115.58	1,515,100	

(1) Number of shares and average price per share has been adjusted for the impact of the two-for-one stock split that took place during the first quarter of 2007.

(2) The September share purchases include 433,803 shares purchased from our Employee Benefit Trust and converted to treasury stock. These shares are not considered purchases under the Board authorized purchase plan.

In July 2006, the Board of Directors gave authorization to the Company to acquire up to two million shares (adjusted to four million shares due to the two-for-one stock split) of Cummins common stock in addition to what has been acquired under previous authorizations.

During the third quarter of 2007, we purchased 5,254 shares from employees in connection with the Company's Key Employee Stock Investment Plan which allows certain employees, other than officers, to purchase shares of common stock of the Company on an installment basis up to an established credit limit. Loans are issued for five-year terms at a fixed interest rate established at the date of purchase and may be refinanced after its initial five-year period for an additional five-year period. Participants must hold shares for a minimum of six months from date of purchase and after shares are sold, must wait six months before another share purchase may be made.

During the third quarter of 2007, the Company issued 112 shares of restricted stock as compensation to the Company's non-employee directors, all of whom are accredited investors. These shares were not registered under the Securities Act of 1933 (the "Securities Act") pursuant to the exemption from the registration provided by Section 4(2) of the Securities Act.

ITEM 6. Exhibits

12 Calculation of Ratio of Earnings to Fixed Charges.

31(a) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31(b) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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.

Cummins Inc.
Date: November 2, 2007

By:	/s/ Jean S. Blackwell JEAN S. BLACKWELL *Executive Vice President and Chief Financial Officer (Principal Financial Officer)*	By:	/s/ Marsha L. Hunt MARSHA L. HUNT *Vice President-Corporate Controller (Principal Accounting Officer)*