

Q4 2005 Taser International, Inc. Earnings Conference Call - Final FD (Fair Disclosure) Wire February 22, 2006
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OPERATOR: Good day, ladies and gentlemen. Welcome to the TASER International Fourth Quarter 2005 Earnings Conference Call. At this time, all participants are in a listen-only mode. We will conduct a question-and-answer session toward the end of the conference. [OPERATOR INSTRUCTIONS] I will now turn the call over to your host, Mr. Rick Smith, CEO. Please proceed, sir.

RICK SMITH, CEO, TASER INTERNATIONAL, INC.: Good morning. Thanks, everyone, for participating in our conference call. Before we get started, I'm going to turn over to Doug Klint to go through the standard Safe Harbor Statement.

DOUG KLINT, VP, CORP. SEC AND GEN. COUNSEL, TASER INTERNATIONAL, INC.: Thanks, Rick. Certain statements contained in this presentation may be deemed to be forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. And TASER International intends that such forward-looking statements be subject to the Safe Harbor created thereby. Such forward-looking statements relate to expected revenue and earnings growth. Estimations regarding the size of our target markets, successful penetration of the law enforcement market, expansion and product sales to the private, security and military self-defense markets. Growth expectations for new and existing accounts, expansion of production capabilities, new product introductions, product safety and our business model.

We caution that these statements are qualified by important factors that could cause actual results to differ materially from those reflected by the forward-looking statements. Such factors include, but are not limited to, market acceptance of our products, establishment and expansion of our direct and indirect distribution channels, attracting and retaining the endorsement of key opinion leaders in the law enforcement community, the level of product technology and [inaudible] competition for our products, the degree and rate of growth of the markets in which we compete, and the company and demand for our products. Potential delays in international domestic orders, implementation of risks through manufacturing automation, risks associated with rapid technological change, execution and implementation of aggressive new technology, new product introduction risks, ramping manufacturing and production to meet demand, litigation resulting from alleged product-related injuries and death, media publicity concerning product uses and allegations of injury and death. And the negative impact this could have on sales, product quality risks, potential fluctuation of quarterly operating results, competition, financial and budgetary constraints of prospects from customers, dependence upon sole and limited source suppliers, fluctuations in component pricing, risks that government inquiries and investigations and regulations, TASER product tests and report dependent upon key employees, employee retention risks, and other factors detailed in the Company's filings with the Securities and Exchange Commission.

RICK SMITH: Okay. Thanks, Doug. Rick Smith back with you. Let me -- Before we get into the numbers with Dan, let's take a big picture look into 2005. Thank God it's behind us. I think if you look at companies in America last year, very few faced as many exogenous challenges as TASER International did. I am extremely proud of how our people performed and we pulled through. One way to look at 2005. I think Dan, our CFO, has made the comment before. Now is not the time for this company to make a milk run, to be focusing on squeezing an extra penny out at the bottom line. We've been at war, frankly, for the long-term survival of this company and defending our brand equity. Last year that cost us \$7 million. That is what we spent incrementally on the cost of our defending our brand equity and defending our company. \$7 million of incremental legal, lobbying, public relations, travel and consultants to take on those challenges.

If you actually look back at the fourth quarter of 2004 and you annualize our SG&A rate we were at about 20 million, a little under 20 million, SG&A at the end of 2004. Now SG&A is up about \$7 million this year. I just explained to you what that was for. Those were variable costs associated with the challenges we've had. Now I should set expectations that we're not done yet. We continue to face challenges. We think we've hit the turning point. To use a war analogy, we're at Normandy. But we still have a lot of work left to do. So we're not going to see those

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costs go away. We do see opportunities to begin to drive those costs down in the future. But it's going to take time, and we need to continue to drive to the goal line in a number of areas.

Let me first talk about what some of those challenges were. Last year when the storm of negative publicity hit in the first quarter when the SEC went public -- We had 26 states last year where we had active legislative or judicial review type matters such as, for example, either legislation introduced to potentially ban the use of our products or, in the State of Wisconsin, where the Department of Justice announced they were going to do an investigation into the appropriateness of the use of the TASER. Now I am proud to report that out of the 26 states - we had very active efforts in 16 - our win-loss was 25 wins, 0 losses and 1 tie. The 1 tie, I would say, is the state of Illinois, where in the consumer market they added a new regulation that consumers have to have firearms cards. We don't view that as necessarily a loss. It's sort of a sideways move.

Let's talk about some of the wins. I mentioned Wisconsin. Early in the year there were about 68 media hits - between 60 and 70 media hits - when Wisconsin announced they were looking into TASER. The initial assumption, it was going to be a negative outcome. When the Department of Justice concluded their study, not only did they decide that TASERs would continue to be used in the State of Wisconsin, they made them mandatory training for every new police officer going through the state standard training. Tremendous positive maneuver for us. Unfortunately, that wasn't quite as newsworthy. I think there were only 4 or 5 media mentions of the outcome of the study. We had similar outcomes in Georgia. We had endorsements come from the Major City Chiefs' Association. We had policy guidelines by the International Association of Chiefs of Police, policy guidelines from The Police Executive Research Forum. So lots of work last year, and it continued to build the acceptance of our product. We think that was a good use of resources for this company. And the outcome -- Again, given the challenges we've faced, not only in the 26 states --

Let's talk about some of the other areas. The SEC inquiry. We mentioned before, when it was announced that the SEC was doing an inquiry that became an investigation into statements this company made about product safety, that severely impaired our sales. Because we're selling to government agencies -- law enforcement groups that obviously wanted to see the outcome of that investigation before many of them moved forward. After 100,000 pages of documentation supplied the SEC and an 11-month investigation, the SEC has notified us that they have concluded the investigation into the statements regarding product safety and accounting issues with our recommendation of no enforcement action. Now we're not going to see an immediate about-face in sales. This will take time to get major agencies moving forward. But you've probably seen in the public media, the public statements coming out of major agencies that they are now starting to put TASER programs back on track. So the SEC was a big win for us, I would say, to get through that process.

In terms of litigation, we had 40 new cases filed in 2004. We're up from 14 at the end of 2004 -- I'm sorry, 48 new cases in 2005. And we ended the year with 43 still active. We've had 12 of those dismissed. Again, we've invested heavily in this area. We have 30 world-class experts. In fact, in the first quarter of 2006 we've put in an in-house litigation team. We have two in-house litigators and an in-house paralegal. Doug will talk more about our strategy. But, frankly, we see this litigation as something that's of key strategic importance to the company.

We need to win. We need to be efficient about doing it. By in-sourcing most of our litigation -- Of course, we'll still have local counsel across the country. But we ensure that we've got a team that does nothing but TASER litigation full-time, and our incremental cost to litigate should go down substantially by in-sourcing that function. We do see it as a key strategic asset long-term. As I talked about, we're currently 12-0 in these litigation cases. Let's talk a little bit about the big one, Sam Powers v. TASER International in the fourth quarter of 2005. For those of you who remember, this was the first case that the Arizona Republic probably did 2 or 3 major stories on alleging the dangers of TASER, that Deputy Sam Powers sustained a back injury during a training exercise. That went to trial in the fourth quarter. We won after a short jury deliberation.

Certainly, nobody was happy that Mr. Powers got injured. But if you actually look into the facts of the case, the source of his injuries -- Mr. Powers had a severe case of osteoporosis. He was completely unaware of it. According to his doctors, he had the most severe case of this bone degeneration disease they'd ever seen in a man his age. When he fell down after hit from the TASER, he sustained a stress fracture in his vertebrae. Unfortunately, these are very common injuries in people with osteoporosis. One out of every 3 women over age 50 will sustain a vertebral stress fracture related to osteoporosis. In the course of the trial, as sometimes happens, insurance companies have a defendant who wants to settle. And we at TASER International do not believe that settlement is in our best interest long-term nor our shareholders'. In order to avoid the potential for our insurance company settling with the plaintiff, we took a bold maneuver and we settled with our insurance provider for \$575,000.

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Let me explain, quickly, how that worked. We went to our own insurance provider and said, "Rather than settle with the plaintiff on this case, we'll settle and release you from this case only." We continue to retain our insurance coverage on other cases. They paid us \$575,000. It cost us roughly \$100,000 to finish litigating the case to victory. We won. At the end of the day, assuming that we win on the appeal, this will have been not only a good strategic move for us, but a profitable one as well. So we've booked \$475,000 as deferred income on the balance sheet until we get through the appeals process. We feel that we're in a very strong position there as well.

I think it's important that our shareholders to understand why we did this. It wasn't just purely an economic maneuver. Long-term, this is not a company that can afford to be settling lawsuits. We need to send a powerful message to the plaintiff community that if you intend to sue TASER International, you are not going to get an easy settlement. We're going to bring 30 world-class experts. We're going to bring an in-house litigation team. Our marginal cost to litigation is low. Our quality is high, and the science is on our side. We intend to win, and we will do what it takes to put the ball across the goal line each and every time. So if you're coming to sue TASER, bring your game face. Be ready to strap it on. Let's go. We're going to win. We're going to do what it takes, even if that means settling with our own insurance company so this is not a profitable venture. Plaintiff's attorneys, go somewhere else. Now, let's talk more about 2005, and then we'll move forward to the promise of 2006. We've talked about the litigation.

We talked about the SEC investigation. Now in the midst of this, we also did make a determination that it was in our best interest to shift accounting firms from the big four to Grant Thornton, a firm that is more focused on firms of our size. We thought that was a better fit long-term. Of course, given the level of scrutiny on TASER last year, shifting auditors was challenging in the middle of the year. And there were additional levels of scrutiny, I would say, within the Grant Thornton process, that everything was really getting looked at by a lot of eyes. That process took time. That meant we did miss a filing deadline in the fourth quarter. That's why we had the TASER with the E on our symbol for awhile. Rest assured. We were working around the clock to get through those challenges as quickly as possible, which we did. We got our filings in place. Grant Thornton's up to speed. We've been impressed with their capabilities and their services. We think it was a good move for the long-term although, again, the delays were painful in the short-term.

So now as we come out of 2005. Last year, I should talk about, was -- Sarbanes-Oxley cost us almost \$1 million, as well, in terms of accounting and consulting fees to get ourselves ready for SOX. We concurrently have an ISO program in place. Kathy will talk about where we're moving forward towards ISO certification as well. We believe that those things, long-term, will help build a good foundation, a more solid foundation for the future. We've increased our R&D spending in 2005, and we're starting to see the fruits of those labors. The TASERCam product will be going into beta in Q1. Expect revenue from the TASERCam in the second quarter. That's turned out to be quite complex product, a lot of software and hardware that goes into that technology. It's a near infrared imaging system that's compatible with every X26 in the field for full audio and video recording. That has really been -- I'd say the acceptance has exceeded our expectations.

Many agencies, like the Police Department that has pulled off to the side during the controversy last year, are now redeploying their TASERS, or at least avowed that they will as soon as they can outfit them with the TASERCams. So we see that as significant not only from a revenue opportunity, but we'll get a lot of agencies off the block or off the fence on TASER purchases by answering questions about accountable. Finally, in the area of R&D we announced completion of the XREP research program, which is extended range electronic projectile. Ladies and gentlemen, our engineers were able to package a TASER payload into a 12 gauge shot gun round. For those of you that missed that in the press release that we put out, think about what it means technologically. A wireless TASER shot gun round that delivers the same bio effect as the X26. I know. I've been hit personally, as have 35 other people, not with the round itself, but with the electrical output. Incredible technological breakthrough. When the military came out to review our completion of that funded program, I think they were expecting some paper reports and some Power Point. We delivered 25 shells and shot them all down range.

Now at this point, I should also temper the enthusiasm and let people know that we're at the end of a research program. It's now going into a manufacturing development program. So we're still working the design now for factorability issues, and we look forward to launching the XREP in 2007. Just to put some numbers on that. Some preliminary research we did indicate there around 50 million shot guns in the United States. And if we ballpark another 50 million worldwide, that's probably 100 million base worldwide of shot guns that are platforms that we can now upgrade with these intelligent shotgun-based projectiles. We see that as a significant new market opportunity in 2007.

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TOM SMITH, PRESIDENT, TASER INTERNATIONAL, INC.: And if I can comment on that -- This is, Tom.

We talked publicly that today we're the wired version of the Star Trek Phaser. This is a vision that risk Rick and I had when we initially started the company, and it's coming to fruition. The military has requested this challenge. They want to reach out much further, have challenged us to get out 100 yards. I think a first step, again, showing the leadership of this company. We're now firing rounds that are wireless, multishot, 30 yards. Again, continuing to push the envelope. As Rick said, we invested in R&D, had over 30 patents applied for during the course of a very rough year. And one of the big benefits was getting the XREP out there, that we're moving towards the wireless version of the Star Trek Phaser. With that, let me turn it over to Dan to talk through the numbers.

DAN BEHRENDT, CFO, TASER INTERNATIONAL, INC.: Thank you, Rick. Sales for the fourth quarter were 12.6 million. This is a 6.6 million lower than the fourth quarter of 2004, but does represent sequential improvement over the third quarter of \$932,000. Gross margins for the quarter were 65%, which is throughout the 20 basis points higher than the fourth quarter 2004 due to lower direct manufacturing expenses on a percent of sales basis. Indirect manufacturing expenses were 9% of sales for the fourth quarter, which are 56 basis points higher than the prior year, even though our absolute dollars reported \$89,000 lower than the prior year. The increase as percent to sales is really driven by the lower sales levels, which result in decreased leverage or fixed manufacturing expenses. Selling general administrative expenses for the quarter were \$7.4 million, which is \$2.5 million higher than the prior year. The increase is driven by legal, public relations, salaries and benefits, depreciation, the costs associated with implementation and testing of Sarbanes-Oxley. Sequentially we did see SG&A expenses go up \$440,000 over the third quarter due to some unique events. We had higher advertising on the X26 consumer product during the fourth quarter.

We had some costs associated with implementation and testing of Sarbanes-Oxley in the fourth quarter. And also the costs of mailing out our proxy, which is kind of a unique event in the fourth quarter as well. R&D expenses increased \$310,000 over the prior year, and were \$470,000 for the quarter. This scenario, we'll obviously only will continue to invest heavily in, and we're starting to see the fruits of those labors as Rick pointed out. Income from operations were \$375,000 for the quarter and we had interest income of an additional \$376,000, which is 120,000 higher than the same quarter the prior year even though we had lower cash invested balances. Pre-tax income for the quarter was \$748,000 and we had net income of \$93,000. Because of items like lobbying are not tax deductible, the company ends up having higher pretax income for tax purposes than book, which drives up our provisions for income taxes.

As our results improve, you'll see a reduced impact of these non-deductible items on a provision as percentage of pretax income as we move forward. Year-to-date we had sales of \$47.7 million. Gross margins year-to-date 63.28%, which is roughly 3.5% lower than the prior year. This is really mostly due to production yield and labor utilization issues earlier in the first half of 2005. We've made improvements to both of these areas, as evidenced by the fact that gross margins did improve over the fourth quarter of 2004. So we are seeing significant strides in the manufacturing area. Indirect manufacturing expenses were \$889,000 lower than the prior year, but 1.57% on a percent to sales basis. Again, this is due to lower sales levels which allowed for less leverage of our fixed manufacturing expenses. Selling General Administration expenses for the year were 27.1 million, which is 13.2 million higher than 13.9 in the prior year. The increase, again, was driven by the same items as the quarter. Increased legal, lobbying, public relations, salaries and benefits, depreciation and the costs associated with implementation and testing of Sarbanes-Oxley. To date, the company has invested roughly \$900,000 plus \$1 million in the implementation and testing of Sarbanes-Oxley. All of this expense hit in 2005. We do expect the costs to fall sharply as we go forward into 2006.

Research and development expenses increased \$750,000 over the prior year, and we were \$1.6 million for the year. Income from operations were \$1.5 million, and the the company had interest income of 1.2 million, which is \$790,000 higher than the prior year. Again, this results in pretax income for the year of 2.7 million. We had net income of 1 million, which resulted in earnings per share of \$0.02 on both a basic and fully diluted basis. As I move onto the balance sheet. Cash from investments ended year at \$43.9 million, which is roughly \$6 million lower than last year due \$7to.8 million in capital expenditures during 2005. The company did generate 1.2 million cash during the fourth quarter, 1.4 million of that was from operations. Accounts receivable is lower than the prior year due to lower sales levels and our DSO for the quarter improved over the third quarter to end the year at 40 days outstanding.

We did have an increase in inventory, driven by long lead time items ordered earlier in the year which are still be worked off, as well as a build and finish goods and work in process inventory during the fourth quarter of 2005.

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As Rick pointed out, we did record receivables from our insurance company of \$575,000 at year end related to the Samuel Powers personal injury case. We did receive that cash in the first quarter. But at year end we still had a receivable on the books for that. You can see the corresponding liability on the balance sheet under the heading of Deferred Insurance and Settlement Proceeds. We did record that as contingent gain, which means that the company will record the income from the settlement expenses with the ultimate realization held until the case is finally settled. Owners' equity did increase \$3.9 million during the year to \$103.8 million which is good, considering the challenges we faced during 2005.

On the cash flow, as I mentioned, we did generate \$1.1 million of cash from operations for the year. 1.4 million of this was in the fourth quarter. This was driven most by reductions in receivables of 3 million, depreciation expense of 1.7 million, tax benefits from stock options of 2.1 million. These positive odds are partially offset by increases of inventory of 3.4 million and reductions in accounts payable accrued liabilities of 2.3 million. As I mentioned, we did have CapEx of 7.8 million during 2005. This is obviously the largest use of the cash. The big drivers the new building of 4.5 million. We had investments in computer equipment of 1.2 million, production equipment of 1 million, and office furniture and fixtures 800,000. We do expect to have much lower capital expenditures needs in 2006, as the majority of these expenses were really related into moving into our new headquarters facility during 2005. As I mentioned, we're most of the way through our SOX work. You know we have a large contingent of auditors out here finishing the audit, as well as testing our SOX documentation procedures.

We are absolute addressing any of the issues as they arise. For example, we recently hired a manager of [inaudible] reporting. Some of the challenges are bigger than others. Getting our lawyers to go on a timely basis has been more of a challenge -- As any of you that have dealt with lawyers know know,= that they're not shy about billing large amounts of money. They're just not good at billing on a timely business. We are working actively to address that with them. We do expect to have our audit results files with our 10-K on or before March 16. And with that, I'll turn the call back over to Kathy Hanrahan, our Chief Operating Officer.

KATHY HANRAHAN, COO, TASER INTERNATIONAL, INC.: Good morning. 2005 was a year of opportunity for the operations division of TASER. We began with the challenge of managing a 50% drop in revenue, and ended with a much leaner, organized and quality-focused department. During 2005 we improved margins from 59.9% of product sales in Q1 to 65.6% by the end of the year. We reduced our average turn time for new orders. We improved production yields. In Q1 of 2005, we had line yields of 95% or higher on 93% of our production lines. But a key X26 assembly line running an average of 69%. By the fourth quarter we increased line yields to greater than 98% on 16 of 19 lines running, and had improved the X26 coil line to 98% - a 42% improvement in approximately 6 months.

We introduced lean manufacturing techniques on the majority of the cartridge assemblies, improving parts per man hour by 17% on the final assembly and as much as 74% on its subassemblies. We automated labor intensive operations, including gluing stages, weapon firing and burn-in fixtures. We reduced production-related scraps by 11% of material consumption and .9% of sales over 2004. In the first quarter of 2005, we expensed approximately \$650,000. This was reduced to our fourth quarter figure of 46,000, a reduction of nearly \$600,000 for the same level of production. We initiated our ISO implementation team to ensure our quality system and business practices meet the international standards for manufacturing. We completed our requirements to ensure SOX compliance and operations by year-end 2005. We implemented employee training programs geared towards quality improvement, safety practice in the workplace and job enrichment. We implemented an automated RMA system, allowing our customers to go online to process material returns. We implemented a prevention maintenance program to reduce downtime for production and improve line through-put. We began implementation of a full MRP system to improve our control over material and inventory planning. This will be fully implemented the by year-end 2006.

We reorganized our division to improve our efficiency and focus employees in their area of strength. And we worked with R&D and quality to test and develop manufacturing processes for new products which will begin shipping in 2006. These include our new 35-foot cartridge and the TASERcam. But 2005 also brought some significant challenges for our team, the most significant being inventory management. We began the year with approximately \$6.8 million in net inventory, and inventory turns of 3 times per year. This grew to 10.3 million by year-end 2005, and reduced our inventory turns to just one time per year. A large component of the increase in inventory occurred as a result of an unexpected decline in revenue in 2005. Compounded by lifetime buy of TASER-specific parts and safety reserves scheduled for delivery in early 2005 that were pushed back to late in the

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year. In addition, we began ordering parts for our new 35-foot cartridge and our TASERcam. We are working diligently to reduce our inventory as we move into 2006.

We hired an experienced materials manager in early 2006 whose primary focus is the completion of our MRP implementation and the institution of programs to streamline and reduce our physical inventory by year-end. We established new purchasing relationships for production assemblies, pushing safety requirements back to our vendors. And we're working on smaller, more consistent delivery of components. We expect 2006 to have new challenges for our team. We'll be launching our TASERcam in the coming months, continuing to work on process improvements for existing products, and working with R&D on new products for the market. With that, I'd like to turn the call over to Doug Klint, our VP and General Counsel.

DOUG KLINT: Thank you, Kathy. Rick discussed the conclusion of the SEC investigation after the accounting and safety issue. I want to address this in more detail, but I would like to note that the investigation does remain open on the possible unauthorized acquisition of material non-public information by individuals outside the company in an effort to manipulate the company's stock price. The shareholder class action suit was consolidated in Arizona federal district court. We have filed motions for dismissal in both the derivative lawsuit and the shareholder class action lawsuit. These motions are pending, and we hope to have a decision in the next couple of months.

In fourth quarter we filed a lawsuit against James Ruggieri for defamation based on false and outrageous statements he has made regarding the safety of the TASER device. Mr. Ruggieri is a high school drop-out with no engineering degree, and whose opinions violate basic laws of physics. We have filed this litigation in order to hold Mr. Ruggieri accountable for his outrageous statements. **Our lawsuit against Gannett Company incorporated was dismissed with the understanding that, in the future, the USA Today and the Arizona Republic newspapers would review their TASER stories with the company prior to publishing in order to ensure accuracy.**

In other litigation, we have contract disputes pending with two former distributors. In the Hennigan litigation, which is one of those contract disputes we moved for a directed verdict at the conclusion of the plaintiff's case, and the court's decision is pending at this time. In the product liability area, we have 14 training demonstration injury cases pending, with 5 cases being dismissed. It's important to note that the injuries complained of in this litigation were secondary physical exertion-type injuries which are common in place training, and for which we give adequate warning. We're beginning to see these type of lawsuits abating ever since we started using release forms for any person volunteering to experience a TASER discharge. We hope that at some point before too long, these lawsuits are going to go away. We currently have 25 in-custody death lawsuits pending, with 7 cases being dismissed. And 6 excessive use of force cases where criminal suspects alleged injured in the course of arrest or while in police custody. In all of these cases, there has not been shown that there has been a product defect on the part of the TASER. And also the TASER device not shown to be the proximate cause of injury or death.

As Rick mentioned, we have over 30 world-class medical and scientific experts who have all concluded that the TASER device is medically safe and was not the cause of these injuries or death. We intend to vigorously defend these lawsuits, and our policy is not to settle these cases. A key component of our strategy going forward is to bring litigation in-house to save outside legal fees, and to leverage our in-house expertise in these cases. It's important to note that although we have over lawsuits pending, we actually only have two types of cases. It's fairly easy to standardize our litigation strategy on these two types of cases. In fourth quarter we implemented this will litigation strategy by hiring two full-time litigators and a litigation paralegal. We are standardizing our pleadings, our discovery, our experts and our motions to ensure consistency and to save expenses. We are firmly committed to a strategy of defending our company and our products. Our objective is to leverage our legal expertise and capabilities, our world class experts, our product safety record and our winning defense record to make TASER International an unattractive target for plaintiff's attorney's going forward. I would now like to turn the call over to Tom Smith, our President.

TOM SMITH: Thank you, Doug. 2005 -- Obviously we've hit on it a few times. It's a great year to be behind us. We all had a great New Year's Eve coming into 2006 because we are very excited about what this year holds. We had a lot of exciting news that ended 2005 with the SEC going away, with getting our accounts back on board, getting [inaudible] and the Attorney General resolving their issues, the winning of the Powers case. A lot of those activities, though, didn't occur until late December. So it wasn't in time to have an impact on the fourth quarter. We did see a stabilization of the business during the latter half of the year, especially if you look at and take the military order out of Q2. We were pretty stable between Q2, 3 and 4. We even showed some growth in Q4 over Q3. During the fourth quarter -- We are now over -- We added over 380 new agencies, up to over the 8,750 agencies that are

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now testing or using the TASER technology. During that same time we also added over 165 agencies that are now at full deployment bringing the total to 2,158, which is roughly -- 24% of the agencies using our technology have one on every officer.

Obviously, we'd like to see those trends both continue in the positive direction and I think you'll see that in 2006 with the good news out of the way. I think if you take the perspective of looking at it from the customer's perspective with the police chief having to go to an elected official being a city council or mayor, and make a pitch to buy a product from a company that's under a federal investigation being accused of basically lying about their medical statements and having accounting problems. That's a very, very tough sell. We had numerous chiefs say, "Look, guys. I love the technology, but until this black cloud is over you -- or away from you guys, it's very difficult for us to push forward." I think with that going away at the end of year, we've seen a marked increase on a number of quote requests and the number of activities. Now it is going to take some time to prime the pump here, because these people have to get that information, get it back as part of their budgetary process and get the processes going again.

What really carried us during 2005 was our existing customers' expanding programs, while new customers towards the latter half of the year started coming on board. Talked about the San Diego County Sheriff's Office placing an order in November. That was an agency that basically had been really slowed down by the negativity and, after doing very thorough research and investigation on their own, they went ahead and expanded the program with one on every officer. So we do believe that there is going to be a positive growth impact in 2006. It's just going to take some time to get that pump primed again. And some of our analysts seen as well, in talking to the agencies out there, there has been a marked increase in the activity in pushing for quotes and for funding of TASER programs. During the fourth quarter we attended 12 different trade shows, bringing the total attended during the 2005 year to 77. Our market penetration now with those numbers is running at roughly 18%, while we've still just barely scratched the surface internationally.

As Dan mentioned and Rick mentioned, our total sales during the fourth quarter was roughly 12.6 million. During the quarter we processed over 5,490 orders, which brings our average sales per order to \$2,291.00. Again, I think that really indicates that our bread and butter are the small orders that are out there, the smaller agencies that can react much more quickly. And that we process a number of orders. We're not reliant on one customer out there to make or break a quarter. The blue birds are very difficult to predict when they're going to land, when that city council's going to vote, when the funding is going to come in. It's even more so internationally, a much more challenging event. We are very dependent on purchase orders being received and shipping against those order. We don't receive long-term contracts. So forward visibility has been challenging, especially with the political environment in which the company exists and finds itself, especially at the end of 2005.

During the fourth quarter on M26 unit sales, we sold 667 units. That's down from 866 in the third quarter. However, we did see an increase in X26 sales up from 10,492 in the third quarter to 11,720, an increase of roughly 12%. That brings the total number of M26 units in the field to 68,983, with total X26 units in the field of roughly 115,000. To put that in a grand total number, we have over 183,930 units in the hands of law enforcement and military. We also increased consumer units in the hands during 2005 to 115,000. We have seen continued growth in units that are out there in the field. I think it's important to note that with 115,000 TASER X26's already in the field and the TASERCam coming online in the second quarter, it is a back backward compatible product. It's not something that you have to buy a new TASER to get. You can buy the camera accessory on its own, which will have a retail of price of roughly \$400. That can be retro-fitted to all 115,000 units that are out there in the field. So in addition to new units going forward, as Rick mentioned, Birmingham is going to be putting them on their units. It will be an upgrade, an accessory item, for the TASERs that they have in place.

I think some of the other things that you've noticed, that got a lot of coverage, was Ft. Wayne, Indiana. This was an agency that had decided to stop a purchase and halt their program. And just recently because of the TASERCam and other issues being investigated and looked at by their chief, they have now started to push forward again. Again, a trend that we're seeing. The TASERCam, for us, is that next level in accountability. It's going to help the command staff address those issues of why a certain individual was TASEd. What were their actions at the time of being TASEd. So, for us, in addition to the [inaudible] and in addition to the data port download capabilities, we're now going to give you a picture of what that individual was doing at the time they got hit. It's integrated with the TASER, so there is no additional button to be pressed. When you arm it, it automatically turns on the video. It records an hour and a half of video, and I think it's a very powerful item that, as Rick mentioned before, I think we underestimated a little bit the response we're getting from the agencies. It will allow them to see what's going on with their officers in

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the field. As they say a picture worth a thousand words, we're going to give you a whole lot of pictures about how this product is being used.

During the fourth quarter, our TASER cartridge sales were 175,958. That's up from almost 173,000 in the third quarter, slightly with the ratio of roughly 14 to 1 cartridges going out the door per TASER. Rick mentioned we had 26 states that introduced various forms of legislation. That was another political risk that some chiefs wanted to wait and see the results of. Obviously, if you're looking at implementing a TASER program and your state was evaluating whether or not they would pass legislation to ban it, that's going to put a little ice water on whether you're going to move forward with this program. We're happy to report that we won those fights last year. We are going to continue to see those this year, although the activity level is definitely down from where we were a year ago. Our PR side. The activity we had during the course of the year was pretty amazing. Our peak was -- We had over 3,800 stories written on TASER in a single month. That has dropped back to 2,800 stories written just during the fourth quarter.

I have been spending a lot of my time going out and addressing a lot of those issues, meeting with city councils, meeting with political groups and with local community groups, and really providing the education on TASER. And I think we're seeing the fruits of that labor with some of the community groups now discussing the benefits of this product. There was a recent story in the USA Today just within the last week discussing the emergency medical services group looking at the benefits of this product and the implementation. I think we're seeing a lot of the police chiefs really acknowledging and more, publicizing, the policy. Because with good policy and good training, this is a great benefit to our communities, a benefit to society in saving lives and reducing injuries every day. I think we've definitely seen a turn in the interest here. We're not out of the woods yet. It is going to take time to prime the pump here. Time to prime the pump here. But we've definitely seen a marked increase in the positive news being written about TASER instead of all negative, which is what we were seeing during the last year.

Dan mentioned we spent some money advertising the consumer TASER during the fourth quarter. Again, we're continuing to test that market. At the beginning of last year with the negativity focused on the company, we really came back and refocused our efforts to make sure we're focused on the law enforcement and the military markets. We didn't spend too much energy on the consumer areas, other than some press conferences and some advertising to continue to test that market place. Again, it's a market we've been in since 1994. I mentioned over 115,000 TASERS out there in the hands of civilians. So it's a market that's out there. Don't count on a lot out of it in 2006. We're still remaining focused on our core business, which is law enforcement, military and international.

Shining light for us in 2005 was our international group. Sales grew by over 120% to roughly 6 million, representing roughly 12.5% of our sales during the course of the year. So despite all the negativity that was going on here domestically, we saw the United Kingdom approve and implement the TASER X26 for their firearms officers. We saw some very high-profile uses in the United Kingdom beginning last summer with the use on catching one of the London bombers. We also had a use in September about the Manchester police catching what, they thought at the time, was a terrorist running around the airport in Manchester. It later turned out that this was a mental patient, but they didn't have to deploy lethal technology because the TASER was available and they were able to end that very successfully. There's been recent articles publicizing the push to expand this beyond firearms officers in the country, which we believe is a very large opportunity for us. Those discussions are ongoing. And we expect to see continued growth in that market.

France is the other country that we've had a lot of interest in. With the riots last fall the Minister of Interior, Nicolas Sarkozy, mentioned in numerous public speeches about upgrading the law enforcement abilities within his country, specifically mentioning the TASER. France has basically been on hold awaiting the view of the TASERCam. He has said he's not going to implement a TASER program or an electronic control device program without the TASERCam or the camera abilities. So we believe that that program will get jump started and start to push forward with the initial orders coming once we provide them a camera late this quarter or in the second quarter. Again that's a huge opportunity for us, because once you get the Minister to decide, it's going to effect an entire country. In his words, it could potentially be tens of thousands of units. But nailing down exactly when that's going to happen has been very, very challenging for us.

I think, again, we've survived a very, very rough year - a very challenging year. I think we've met those challenges head on. I don't think we're out of the woods totally yet, but we definitely see a trend change in the activity from our law enforcement market. They are all excited about the TASERCam. The XREP is generating interest as we look forward to 2007. Again, we provide products that save lives and reduce injuries to our communities. And we're going to continue to press this program forward. I think you're going to see continued growth in 2006. So with that, I'd like to turn it over to Rick, who will wrap up the call.

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RICK SMITH: Okay.

One last thing to talk about. You may have noticed if you get TASER PR and news alerts, that we instituted a program middle of last year where we're issuing -- Aside from the press releases that come from the Company, we actually have a medium monitoring firm, Dish Communications, that is helping us with the program of TASER news alerts. What those are -- are regular alerts of high-profile uses of the TASER, where it's saving somebody's life or other dramatic uses of our technology. We were really, frankly, somewhat frustrated last year that the public media was so focused on negative stories or the very few situations with negative outcomes, missing the hundreds if not thousands of stories where TASERS do save lives and improve the quality of life. So we started promoting a program to make sure that those are getting more visibility. Those are dramatic life-saving events. They deserve more attention. I think we've been very happy with the results.

We think partially because of that program there has been much more positive press on TASER. In fact, in our current media monitoring, I think we're seeing three-quarters of the stories recently are positive whereas last year three-quarters of the stories were negative. So we are seeing a shift there. Last thing to sort of end on. I may have mentioned this in our previous conference call. But in 2002, with the coming of [inaudible] We were for awhile as sort of a homeland aviation security stock. And 2002 when Congress passed the bill to arm pilots of firearm, so our stock was hit pretty hard. People said, "They're not going to use TASERS so much in aircraft because they have guns now." Our stock fell 83% in 2002. One thing I'm proud that this team did, is we stayed focused on our core business. We didn't get distracted by what was going on in the market for our stock. We stayed focused. We brought the X26 to market. The company's valuation went from \$10 to \$15 million up to a peak of 2 billion. Obviously, I think that was tied into the extraordinary increase in sales and profitability through 2004. Whereas in the latter half of 2004 we had operating income over 50%.

Certainly 2005 dealt us some serious challenges. Again, this time not just in the market for the stock, but also in the company's core operations. Our stock, again, has fallen in 2005. It was down over 80%. One thing you can expect from us. We're going to stay focused on our core business. We are not going to be out trying to do anything that -- No smoke and mirrors here. This is about execution, bring the TASERCam to market, the XREP and we've got more where that came from. New products, better customer service, the foreign markets. We've taken some heat, frankly, from folks saying "Hey! You've been talking about foreign markets for a long time." Well, they were up 120% last year. And it's still relatively small part of our business at 12.5%. There's lots of opportunities, and this is a multi-year process.

Sometimes the Americans get criticized for being quarter-focused. We're not focused on short-term. We're focused on the long-term. That's what we believe builds a long-term successful business. And our shareholders should understand that as well. That this is a business for people that are focused on the long-term, a company that's going to change the way people defend themselves around the world. So we've worked through a lot of the issues. We have more challenges yet to come, more great technology. It continues to be an exciting place to work. Our new headquarters has worked out very well. We invite people to come out for our shareholder meeting, which will be coming up this -- in May. Did we announce a formal date yet, Doug?

DOUG KLINT: Not yet.

RICK SMITH: We'll be announcing a formal date in May. We look forward to seeing our shareholders. Thanks for sticking with us. More exciting times are ahead. With that, let's open it up to questions.

OPERATOR: [OPERATOR INSTRUCTIONS] Our first question comes from the line of Eric Wold. Please go ahead.

ERIC WOLD, ANALYST, MERRIMAN CURHAN FORD AND CO: Hey, good morning.

RICK SMITH: Good morning.

ERIC WOLD: First of all, questions on the TASERCam. You mentioned -- Also you talked about it on the call, and you talked a little bit in the press release, about your significant revenue potential in the second quarter. Is that coming from a variety of customers? Or is it from one big customer that you're getting one order from? And talk a little bit about margins on that, in near-term and how those should ramp?

RICK SMITH: I think it's coming from a variety of customers. We've seen a number of chiefs around the country that have seen the technology. Rick and I mentioned Birmingham, Alabama putting them back with the camera and Fort Wayne, Indiana moving ahead because of the camera. And even installed bases where chiefs that

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have the TASERs on the streets today are excited about upgrading it. So we're seeing new orders that are interested in it. Even France overseas said they're not going to do it without that capability. But we're also seeing existing customers. So I think we're seeing it across the broad spectrum of all of our current customers. I think I should also add -- This is, Rick. It's more qualitative than quantitative at this point because we don't yet have units in the field. We're not out actually writing a lot of physical orders yet. It's more qualitative feed feedback that the demand is going to be there. I don't want to mislead you that we have a huge order booking. We're not out pushing for firm orders until we at least get the beta units out in the field and can be out doing demos. But we know qualitatively it's been very well received.

ERIC WOLD: Okay. Just to follow up on that. I know you're not giving guidance, but can you give any indication of what significant revenue from that in Q2 could be about?

RICK SMITH: Let me me turn it over to Dan to address the margin issue and --

DAN BEHRENDT: Yeah, in regards to the margins. The margins of all of our products range from the mid-50s to the mid-70s. The TASERCam we'd expect to be somewhere in the middle of that range. We do expect it will have certain significant fall through potential for us for those incremental sales.

RICK SMITH: And I think trying to put a real number on what it's going to be in the second quarter, I mean, we have to ramp up the production and get those things out there. So obviously we can expect to see that occur, but we really have no feel for how quickly we're going to be able to get true through that. The manufacturing, we've got to train all the new people and get that into production. So it's going to be -- We'll see revenue there. But to really put a fix on how many we'll get the door, we don't know at this point.

ERIC WOLD: Okay. And then shifting to SG&A. The 27 million or so that was spent last year. You know, 2 million on SOX -- Anything else that you can kind of -- maybe say is kind of one-time that won't translate into this year? Would it be unreasonable to see total SG&A go down in '06?

RICK SMITH: Yeah. First of all, I guess the stock expenses were not 2 million. It was a little less than 1 million for the year. We do expect -- A lot of the incremental SG&A expenses were things like legal that we do expect to make improvements to in 2006. So, you know, our view of the SG&A is we certainly don't expect to see large increases over the 205 levels. We're going to actively work to reduce those costs as we move forward. But the SOX is certainly an area for improvement. Legal is going to be an area of improvement. So we do have some areas that should drive that down over time.

DOUG KLINT: I think, you know, it's something we have talked about here, and I've been asked about quite a bit recently is -- The infrastructure we have in place was really, as Rick mentioned before, we were -- At the end of 2004, we had a certain cost level on SG&A and then we had roughly 8 million this year that was kind of variable expense to go out there and fight the war. And we didn't want to take the infrastructure and cut it back because we knew we were going to get through these tough times. We refined ourselves and we're better prepared to handle the growth as we go forward, so I think you'll see it reduce as a percent of sales. But we really wanted to make sure that the company was well-positioned for the growth when it comes back in 2006.

DAN BEHRENDT: Short answer is, I think, for modeling purposes, look at it as flat in 2006. We do see some opportunities that we're working to improve it. But also, there is exogenous drivers, legal and depending on what happens in some of the different states this year that could bring some of the those costs back. We'd say flat is the right way to think of it.

ERIC WOLD: Okay. That helps. Just two more quick questions. What should we think about for a tax rate for '06? And any guidance on CapEx spending for the year?

DAN BEHRENDT: Really, if you look at the differences between the tax rates for 2004 and 2005 as a percentage of pre-tax, that's the difference is really primarily driven by these non-deductible expenses. And I think that certainly we'll expect that tax rate to be reduced over the near term as our results improve. I think a long-term tax rate of roughly 40% is probably the right rate.

ERIC WOLD: Okay. And CapEx?

DAN BEHRENDT: CapEx we expect significant reductions going into 2006. I think, again, it's going to depend a little bit on our sales levels. Whether we need to invest in new production lines and things like that as we expand the sales efforts. But certainly I would expect a 75% or so reduction over the 2005 levels.

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ERIC WOLD: Perfect. Thanks, guys.

RICK SMITH: Thank you, Eric.

OPERATOR: Our next question comes from the Matthew McKay.

MATTHEW MCKAY, ANALYST, JEFFERIES & COMPANY, INC: Good morning, guys.

RICK SMITH: Good morning.

MATTHEW MCKAY: Just going back to the TASERCam. Is that actually in production now? If so, how much inventory have you built up? Or are you still in the process of ramping that up?

KATHY HANRAHAN: Okay. This is Kathy. In terms of TASERCam, we're actually building the beta units now. So that's a combination between our research and development team and our manufacturing team. We're expecting to have those completed in the next week to 10 days, and depending on the results of that beta test will determine when that goes full-steam into production. We do have -- Our board house is working now on production for the printed circuit boards so we have a jump start moving forward. But right now our inventory is maybe \$50,000 associated with that.

MATTHEW MCKAY: Okay. And once you do ramp up to full production on the TASERCam, what your capacity on them?

KATHY HANRAHAN: Wow. We haven't even thought that far. I know that we've got predictions that are forecast for us internally for 2006, and that's not going to be a problem for us at all. And knowing this company and what we do when we get the push from sales, I would say it's unlimited. We will continue to add lines in our manufacturing structure to support it.

RICK SMITH: This is Rick. The TASERCam -- The way we've designed it, it's -- Basically the PCB drops into a housing. It's a fairly manual assembly. There's really no hard constraints other than running the injection mold day and night to make the parts. So for -- We should be reasonably meet just about any demand. It's not real labor intensive, not capital intensive. The big thing right now is we're being very careful in terms of when we kick off full production. We want to get these beta units out into the field, get some feedback and testing on them, make sure they're working properly before we go building them by the thousands.

MATTHEW MCKAY: Okay. And then are there a number of orders that are waiting for full production to go into place? Or is it -- You get into full production and then we get through this beta and then we start to push on the sales a little bit more?

RICK SMITH: Yeah. In law enforcement, rarely do you get written orders until they've had an evaluation unit. Especially on a new product. So as I mentioned before, it was really qualitative. We've heard things like -- The LAPD has even made some public statements in the media that they are evaluating the X26 and the TASERCam with an eye towards full deployment. So we're really going on qualitative feedback until we can get units out with our salespeople and T&E units out to the agencies. With the X26, if we go back in history --

Our last major product introduction -- With the X26, obviously, we didn't have many orders when we rolled that into production because we didn't have test units out in the field. As soon as we were actually in production, our first quarter we were swamped. The X overtook the M in its first full quarter of production by a factor of 2 or 3 to 1. So based on that history, knowing that -- What we're seeing right now, qualitatively we can look at that and say know there is significant demand. It is being well-received even by those agencies that were somewhat more skeptical on the TASER product. But we're not going to be able to quantify that until we get units in the field and we start writing orders.

MATTHEW MCKAY: Yep. Nice problem to have, to get swamped on them. [Laughter] Moving over -- You've talked qualitatively about the SEC investigation and what that's meant to the business. Is there any way to give a better sense, a little more quantitative in terms of increased number of price quote requests you've received since the SEC investigation has gone away?

RICK SMITH: No. It's really challenging for a variety of reasons. Number one, we put it in a process that actually can be done online. They can get a cost benefit analysis. Certainly we can see those. But we also have them contacting a lot of our distributors, where they are getting information from the distributors. Again, it's a feel thing. We don't get the distributors reporting quotes back to us, especially on the number of smaller ones. So we don't -- it's something we just don't track.

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We can just tell from the activity levels between the website, the requests for quotes from there, and the activity -- Just discussing it with our distributors when we're out visiting with them. They've seen a marked increase in requests for quotes. We are putting -- Right now we're working on putting in a new CRM model to our ERP system. And in the future that will give us the capability to track quotes more directly. We'll establish a baseline from what we're quoting. But like Tom mentioned, a lot of that goes through distributors. I should mention also, that if you do want to see the new online marketing and quotation tool, anybody who is on the call go with to www.WHYTASER.com/1TSR. And that will actually take you in and you can -- Please don't act like a real agency unless you want our sales people showing up at your door.

But when you fill it out, you can act like you're a police agency. Put the name Test Police Agency. It will actually run you through and do a cost benefit analysis. You can see how we generate online quotes. And then you'll get a mailed package as well, just like our customer's are receiving, showing the relative costs and benefits of TASERs. Based on prorating the financial results at other agencies, on average we see the break even is 6 months on a TASER purchase. It pays for itself in reduced injury and liability costs. We have received about, I think, 600 or 700 requests for quotation through that at this point. That's not something we'll report regularly.

DAN BEHRENDT: I also believe if you look at the number of dollars per order being around \$2200 -- A smaller agency is more going to call up a guy and say, "What's it going to cost me to do this?" So there a lot of verbal quotes going on, too. Not everything is being done written, making it much more challenging. But with the average dollars per order being \$2000 during the fourth quarter, I think that's the other reason it's very challenging to capture how many quotes are actually being done between the verbal and the written.

MATTHEW MCKAY: Okay. Fair enough. And then on the XREP. Any idea of what kind of price point what be on that?

RICK SMITH: No. We're not going to release any further information until we're further down the field on it. We really need to get firmed up what it's going to take to produce these. And we're going to save any further technology pricing or marketing data until we're in a product launch.

MATTHEW MCKAY: Okay. And then just one thing on the deferred insurance settlement. It looks -- You put the 575,000 on the balance sheet. So if I understand that correctly, you took -- It was a \$100,000 expense that you took in the December quarter. And now you're going to take 575,000 over the next year or so in income? Just explain to me why it went on the balance sheet as opposed to just being recognized as income in the December quarter?

DOUG KLINT: Basically, we decided to take a conservative approach and recognize this as a gain contingency. So because there's still a potential for appeal, we hung up the benefit of that on the balance sheet. So we've got 575,000 as a receivable at year end. We'll receive that cash in the first quarter. And then we had about \$100,000 of cost to complete the trial that we offset against that 575. So, you see on the liability section of the balance sheet there's 475, roughly, of deferred legal settlement. We'll recognize that as we have expenses for appeal, if any. Then once the case is ultimately settled, we'll recognize the remaining balance on that.

MATTHEW MCKAY: Okay.

DOUG KLINT: It's a more conservative approach, and certainly one we thought that was the most prudent thing to do.

MATTHEW MCKAY: Yes. When do you expect that to be resolved? First quarter? second quarter? Later than that?

DOUG KLINT: The judgment is about to be entered in that case. The reason it hasn't been entered yet is that we've been going back and forth, trying to get the right amount of costs settled against that case. The plaintiff has 15 days once the judgment is entered. So we should know sometime in the next 4 to 5 weeks if they're going to appeal.

MATTHEW MCKAY: How long we anticipate the appeal process to take?

DOUG KLINT: The appeal process could take up to two years.

MATTHEW MCKAY: Okay. So that could be on the balance sheet for a fairly extensive period of time.

DAN BEHRENDT: Yes.

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MATTHEW MCKAY: Great. Thanks, guys.

DOUG KLINT: Thank you, Matt.

RICK SMITH: Okay. With that, I assume we'll wrap up the call. We appreciate -- We're just coming on an hour here. Appreciate everyone giving us an hour of your day. Again, keep your eye on the future. A lot of good stuff going on here. We look forward to seeing you all at our shareholder meeting. And talking to you in April. All right. Thank you.

OPERATOR: Ladies and gentlemen, this concludes the conference. [OPERATOR INSTRUCTIONS]

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