

VIISAGE TECHNOLOGY INC

Form 10-Q

June 30, 2005

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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 April 3, 2005.

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 000-21559

# VIISAGE TECHNOLOGY, INC.

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**04-3320515**  
(I.R.S. Employer Identification No.)

**296 Concord Road, Third Floor, Billerica, MA**  
(Address of principal executive offices)

**01821**  
(Zip Code)

**(978) 932-2200**

Registrant's telephone number, including area code

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

Indicate by a check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act)  Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

| <u>Class</u>                   | <u>Outstanding at June 27, 2005</u> |
|--------------------------------|-------------------------------------|
| Common stock, \$.001 par value | 48,090,780                          |



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**VIISAGE TECHNOLOGY, INC.**

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS****VIISAGE TECHNOLOGY, INC.****Consolidated Balance Sheets****(in thousands)**

|  | <b>April 3,<br/>2005</b> | <b>*December 31,<br/>2004</b> |
|--|--------------------------|-------------------------------|
|  | <b>(unaudited)</b>       |                               |
| <b>Assets</b>  |                          |                               |
| Current assets:  |                          |                               |
| Cash   | \$ 10,159                | \$ 11,309                     |
| Accounts receivable  | 13,010                   | 17,075                        |
| Inventories and other costs and estimated earnings in excess of billings | 3,966                    | 3,382                         |
| Other current assets   | 784                      | 1,213                         |
| <b>Total current assets</b>  | <b>27,919</b>            | <b>32,979</b>                 |
| Property and equipment, net  | 19,262                   | 19,917                        |
| Goodwill   | 93,742                   | 93,507                        |
| Intangible assets, net   | 24,633                   | 26,046                        |
| Other assets   | 3,378                    | 3,180                         |
|  | <b>\$ 168,934</b>        | <b>\$ 175,629</b>             |
| <b>Liabilities and Shareholders Equity</b>                               |                          |                               |
| Current liabilities:   |                          |                               |
| Accounts payable and accrued expenses                                    | \$ 9,809                 | \$ 15,279                     |
| Current portion of project financing                                     | 182                      | 281                           |
| Current deferred revenue   | 2,285                    | 1,992                         |
| Other current liabilities  |                          | 194                           |
| <b>Total current liabilities</b>   | <b>12,276</b>            | <b>17,746</b>                 |
| Project financing, net of current portion                                | 128                      | 149                           |
| Deferred tax liability   | 1,157                    | 859                           |
| Deferred revenue   | 1,717                    | 1,717                         |
| Other liabilities  | 368                      | 368                           |
| <b>Total liabilities</b>   | <b>15,646</b>            | <b>20,839</b>                 |
| Shareholders equity  | 153,288                  | 154,790                       |
|  | <b>\$ 168,934</b>        | <b>\$ 175,629</b>             |

\* Derived from audited financial statements.

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

**Table of Contents****VIISAGE TECHNOLOGY, INC.****Consolidated Statements of Operations****(in thousands, except per share data)****(Unaudited)**

|  | <b>For the Three Months Ended,</b> |                       |
|--|------------------------------------|-----------------------|
|  | <b>April 3, 2005</b>               | <b>March 28, 2004</b> |
| Revenue  | \$ 16,810                          | \$ 12,259             |
| Cost of revenue  | 11,040                             | 8,906                 |
| Gross margin   | <u>5,770</u>                       | <u>3,353</u>          |
| Operating expenses:  |                                    |                       |
| Sales and marketing  | 2,216                              | 1,493                 |
| Research and development   | 1,521                              | 959                   |
| General and administrative   | 3,424                              | 2,137                 |
| Total operating expenses   | <u>7,161</u>                       | <u>4,589</u>          |
| Operating loss   | (1,391)                            | (1,236)               |
| Interest income  | 31                                 | 21                    |
| Interest expense   | (47)                               | (413)                 |
| Other income   | 123                                | 21                    |
| Loss before income taxes and cumulative effect of change in accounting principle | <u>(1,284)</u>                     | <u>(1,607)</u>        |
| Provision for income taxes   | (358)                              | (25)                  |
| Net loss   | <u>\$ (1,642)</u>                  | <u>\$ (1,632)</u>     |
| Basic and diluted net loss per share   | <u>\$ (0.03)</u>                   | <u>\$ (0.05)</u>      |
| Weighted average basic and diluted common shares outstanding                     | <u>47,901</u>                      | <u>31,362</u>         |

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

**Table of Contents****VIISAGE TECHNOLOGY, INC.****Consolidated Statements of Cash Flows****(in thousands)****(Unaudited)**

|  | <b>For the Three Months Ended</b> |                       |
|--|-----------------------------------|-----------------------|
|  | <b>April 3, 2005</b>              | <b>March 28, 2004</b> |
| <b>Cash Flow from Operating Activities:</b>  |                                   |                       |
| Net loss   | \$ (1,642)                        | \$ (1,632)            |
| Adjustments to reconcile net loss to net cash provided by (used for) operating activities: |                                   |                       |
| Depreciation and amortization  | 2,861                             | 2,279                 |
| Expenses paid in common stock  | 62                                | 120                   |
| Change in operating assets and liabilities, net of effects of acquisitions:                |                                   |                       |
| Accounts receivable  | 4,065                             | 828                   |
| Inventories and costs and estimated earnings in excess of billings                         | (584)                             | (273)                 |
| Other assets   | 74                                | (433)                 |
| Accounts payable and accrued expenses  | (5,216)                           | (303)                 |
| Net cash provided by (used for) operating activities                                       | (380)                             | 586                   |
| <b>Cash Flow from Investing Activities:</b>  |                                   |                       |
| Restricted cash  |                                   | 3,191                 |
| Cash paid for acquisitions   |                                   | (5,227)               |
| Additions to property and equipment  | (908)                             | (369)                 |
| Proceeds from sale of equipment  | 500                               |                       |
| (Increase) decrease in other assets  | (235)                             | (415)                 |
| Net cash used for investing activities   | (643)                             | (2,820)               |
| <b>Cash Flow from Financing Activities:</b>  |                                   |                       |
| Net proceeds from project financing  |                                   | 4,273                 |
| Principal payments on project financing  | (119)                             | (1,771)               |
| Net proceeds from issuance of common stock   |                                   | 2,348                 |
| Net cash provided by (used for) financing activities                                       | (119)                             | 4,850                 |
| Effect of exchange rate changes on cash  | (8)                               |                       |
| Net increase (decrease) in cash and cash equivalents                                       | (1,150)                           | 2,616                 |
| Cash and cash equivalents, beginning of period   | 11,309                            | 6,666                 |
| Cash and cash equivalents, end of period   | \$ 10,159                         | \$ 9,282              |
| <b>Supplemental Cash Flow Information:</b>   |                                   |                       |
| Cash paid for interest   | \$ 19                             | \$ 256                |
| <b>Non-cash Transactions:</b>  |                                   |                       |



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|  |    |    |    |        |
|--|----|----|----|--------|
| Directors fees paid in common stock          | \$ | 62 | \$ | 120    |
| Acquisitions paid in common stock            | \$ |    | \$ | 57,486 |
| Acquisitions paid in related party financing | \$ |    | \$ | 15,300 |
| Asset purchased with extended payment terms  | \$ |    | \$ | 800    |
| Services paid in common stock                | \$ |    | \$ | 14     |

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

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**VIISAGE TECHNOLOGY, INC.**

**Notes to Financial Statements**

1. DESCRIPTION OF BUSINESS

Viisage Technology, Inc. ( Viisage or the Company ) provides advanced technology identity solutions that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft, and protect personal privacy. The Company s identity solutions are specifically designed for identification of people and include secure credentialing, biometrics, automated document authentication and real-time identity databases, as well as systems design, development, integration and support services. These identity solutions enable Viisage s customers to manage the entire life cycle of an individual s identity for a variety of applications including civil identification, criminal identification and border management. Viisage s customers use its solutions to help solve the following three critical problems in identity verification and management:

*assurance* that an identification document is authentic and has been issued to the correct person;

*confidence* that the person holding the identification is uniquely tied to and authorized to use the document; and

*verification* of the privileges the individual is entitled to at a particular point in time.

The Company s advanced technology identity solutions enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis of Presentation*

The accompanying financial data as of April 3, 2005 and December 31, 2004, and for the three month periods ended April 3, 2005 and March 28, 2004, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2004 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These financial statements should be read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2004.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows as of April 3, 2005 and for the three month periods ended April 3, 2005 and March 28, 2004, have

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been made. The results of operations for the period ended April 3, 2005 are not necessarily indicative of the operating results for the full year.

### *Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Biometrica Systems, Inc., Viisage Technology AG, Trans Digital Technologies Corporation and Imaging Automation, Inc. as of and for the three month period ended April 3, 2005. The consolidated financial

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statements include the accounts of the Company and its wholly owned subsidiaries, Biometrica Systems, Inc., Viisage Technology AG and Trans Digital Technologies Corporation as of and for the three month period ended March 28, 2004.

*Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Stock-Based Compensation*

The Company accounts for its stock-based compensation plans using the intrinsic value method, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and comply with the disclosure provisions of Statements of Financial Accounting Standards ( SFAS ) No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation- Transition and Disclosure*. No stock-based employee compensation cost was reflected in net income (loss), as all options granted under those plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant.

The following table illustrates, in accordance with the provisions of SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

|   | <b>For the Three Months Ended</b> |                       |
|---|-----------------------------------|-----------------------|
|   | <b>April 3, 2005</b>              | <b>March 28, 2004</b> |
| Net loss as reported  | \$ (1,642)                        | \$ (1,632)            |
| Add: stock based employee compensation expense included in reported net income (loss), net of tax                   | 34                                |                       |
| Deduct: total stock based employee compensation determined under fair value based method for all awards, net of tax | (319)                             | (993)                 |
| <b>Pro forma net loss</b>   | <b>\$ (1,927)</b>                 | <b>\$ (2,625)</b>     |
| <b>Earnings per share:</b>  |                                   |                       |
| Basic and diluted, as reported  | \$ (0.03)                         | \$ (0.05)             |
| Basic and diluted, pro forma  | \$ (0.04)                         | \$ (0.08)             |

The fair value of the Company's stock-based option awards to employees was estimated assuming the following weighted-average assumptions:

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|                         |          |            |
|-------------------------|----------|------------|
| Risk free interest rate | 4.26%    | 4.0%-5.0%  |
| Expected dividend yield |          |            |
| Expected lives          | 10 years | 3-10 years |
| Expected volatility     | 85%      | 80%        |

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### *Computation of Net Income (Loss) per Share*

The basic net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. The impact of approximately 5,568,000 common equivalent shares consisting of certain outstanding options and stock warrants were not reflected in the three month period ended April 3, 2005 dilutive net loss per share calculation as their effect would be anti-dilutive. The impact of approximately 5,379,000 shares of common stock consisting of certain outstanding options and stock warrants were not reflected in the three month period ended March 28, 2004 dilutive net loss per share calculation. Potentially dilutive securities are excluded from the calculation of diluted earnings per share if their effect is anti-dilutive.

### *Inventory and Suppliers*

Viisage obtains certain hardware components and complete products from a limited group of suppliers. This reliance on these suppliers involves significant risks, including reduced control over quality and delivery schedules. Any financial instability of these manufacturers or contractors could result in the Company having to find new suppliers. Due to this reliance, Viisage may experience significant delays in manufacturing and shipping products to customers if the Company loses these sources of if supplies from these sources are delayed. As a result, the Company may be required to incur additional development, manufacturing and other costs to establish alternative sources of supply. Furthermore, Viisage does not carry significant inventories of the products the Company purchases, and the Company has no guaranteed supply arrangements with its vendors. A loss of a significant vendor could delay sales and increase costs.

### *Comprehensive Income (loss)*

In accordance with SFAS No. 130, Reporting Comprehensive Income, the Company reports accumulated other comprehensive income (loss) in its Consolidated Balance Sheets. Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss), which includes current period foreign currency translation adjustments. The accumulated other comprehensive income consists of unrealized translation gains in accordance with SFAS No. 52, Foreign Currency Translation of \$10,000 for the three months ended April 3, 2005. The Company had \$312,000 and \$322,000 of accumulated other comprehensive loss as of April 3, 2005 and December 31, 2004, respectively.

## **3. INCOME TAXES**

The deferred income tax provision for the three months ended April 3, 2005 includes \$300,000 to record the deferred tax liability related to tax deductible amortization of certain goodwill. This deferred tax liability is created by taxable temporary differences related to certain goodwill for which the period the difference will reverse is indefinite. Following the adoption of SFAS 142, taxable temporary differences creating deferred tax liabilities as a result of different treatment of goodwill for book and tax purposes cannot offset deductible temporary differences that create deferred tax assets in determining the valuation allowance. In the fourth quarter of 2004, the Company made an election under Internal Revenue Tax Code Section 338(h)(10) to treat the acquisition of TDT as an asset transaction for tax purposes. This election resulted in future tax deductible amortization expense related to certain goodwill for tax purposes. As a result, a deferred tax provision was required to record the deferred tax liability of tax deductible goodwill amortization. There was no provision for federal income taxes for the three months ended April 3, 2005 and March 28, 2004 due to the net losses during those periods. The provision for state income taxes for the three months ended April 3, 2005 and March 28, 2004 was approximately \$58,000 and \$25,000, respectively.



**Table of Contents****4. RELATED PARTY TRANSACTIONS AND SHAREHOLDERS' EQUITY**

Lau Technologies, or Lau, and Mr. Buddy Beck beneficially own approximately 11.4% and 11.9%, respectively, of our outstanding common stock. Readers are referred to the "Notes to Financial Statements" section of the Company's 2004 Annual Report on Form 10-K for further discussion.

**5. BUSINESS SEGMENTS, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK**

The Company follows SFAS No. 131 "Disclosures about Segments of a Business Enterprise and Related Information", which establishes standards for reporting information about operating segments. Operating segments are defined as components of a company about which the chief operating decision maker evaluates regularly in deciding how to allocate resources and in assessing performance. At April 3, 2005, the Company operated in one business segment, the advanced technology identity solutions segment. The Company's advanced technology identity solutions segment enables governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.

During 2004, the Company completed three acquisitions which contributed intellectual property that changed the Company's product mix and service offerings. In 2004, the Company had proprietary products and service capability to deliver and did deliver fully integrated identity solutions projects across the Company's entire customer base. As a result, during the fourth quarter of 2004, the Company realigned its product and service revenues into three main categories identified by the markets which they serve: *State and Local*, *Federal*, and *Commercial/Emerging Markets*. The Company's Chief Executive Officer is the chief operating decision maker who evaluates performance based on revenues and total operating expenses of identity solutions products and services across all markets and geographic regions. This change in the structure of the Company's internal organization resulted in a change in the composition of the Company's reportable segments for 2004 into one reportable segment. The Company has restated the segment disclosure for the three months ended March 28, 2004 to conform to the segment reporting for the three months ended April 3, 2005.

Net revenues by market for the three months ended April 3, 2005 and March 28, 2004 are disclosed in the following table (in thousands):

|                             | <b>Three Months Ended</b> |                       |
|-----------------------------|---------------------------|-----------------------|
|                             | <b>April 3, 2005</b>      | <b>March 28, 2004</b> |
| State and Local             | \$ 8,983                  | \$ 9,412              |
| Federal                     | 7,627                     | 2,656                 |
| Commercial/Emerging Markets | 200                       | 191                   |
|                             | <b>\$ 16,810</b>          | <b>\$ 12,259</b>      |

The Company's operations outside the United States include a wholly-owned subsidiary in Bochum, Germany. Net revenues are attributed to each region based on the location of the customer. Revenues in North America are primarily comprised of revenues from customers in the United States. The following is a summary of net revenues, identifiable assets and goodwill by geographic areas (in thousands):



|                     | <b>Three Months Ended</b> |                       |
|---------------------|---------------------------|-----------------------|
|                     | <b>April 3, 2005</b>      | <b>March 28, 2004</b> |
| <b>Revenue</b>      |                           |                       |
| United States       | \$ 15,801                 | \$ 11,791             |
| Rest of World       | 1,009                     | 468                   |
|                     | <u>\$ 16,810</u>          | <u>\$ 12,259</u>      |
| <b>Total Assets</b> |                           |                       |
| United States       | \$ 141,331                | \$ 124,510            |
| Germany             | 27,603                    | 10,782                |
|                     | <u>\$ 168,934</u>         | <u>\$ 135,292</u>     |
| <b>Goodwill</b>     |                           |                       |
| United States       | \$ 77,781                 | \$ 57,114             |
| Germany             | 15,961                    | 6,499                 |
|                     | <u>\$ 93,742</u>          | <u>\$ 63,613</u>      |

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Of the total revenue for the three months ended April 3, 2005, \$1.0 million was earned from export sales. Of the total revenue for the three months ended March 28, 2004, \$468,000 was earned from export sales. The Company did not have significant international sales to individual countries for the periods presented.

For the three-month period ended April 3, 2005 the U.S. Department of State accounted for 28.7% of the Company's revenue. As of April 3, 2005, the accounts receivable balances for this customer was approximately \$3.3 million. As of December 31, 2004, the accounts receivable balances for this customer was approximately \$2.6 million. At March 28, 2004, U.S. Department of State accounted for 13.1% of the Company's revenue.

6. ACQUISITIONS

On January 23, 2004 Viisage acquired all outstanding shares of ZN Vision Technologies AG ( ZN ) in exchange for an aggregate of 5,221,454 newly issued shares of Viisage common stock and \$493.00 in cash. In addition, the Company agreed to assume ZN's employee share option plan, and accordingly has reserved 1,138,546 shares of Viisage common stock for issuance to the plan participants. The options under this plan were fully vested prior to the close of the transaction and accordingly have been included in the purchase price at their fair value. The purchase price for the acquisition was \$31.4 million, based on the per share price of our common stock of \$4.32 per share which is the average trading price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following March 28, 2003, the date on which the purchase agreement was signed and the acquisition was announced. The acquisition was accounted for as a purchase, and accordingly, the operations of ZN are included in the financial statements since the effective date, the close of business on January 23, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. The Company engaged an independent third party appraiser to perform a review of the acquired assets and have allocated the purchase price based on the results of their findings. The Company has recorded approximately \$603,000 in amortization related to the acquired intangible assets from the date of the acquisition through April 3, 2005. ZN is a leading German provider of face recognition and computer vision products and services. ZN, now known as Viisage Technology AG, is a wholly owned subsidiary of Viisage and serves as the base of its European operations.

On February 14, 2004 Viisage acquired all outstanding shares of Trans Digital Technologies Corporation ( TDT ) for \$56.6 million. The purchase price consisted of 5,850,000 newly issued shares of Viisage common stock, which were valued at \$5.13 per share, which is the average price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following February 14, 2004, the date on which the purchase agreement was signed and the acquisition was announced, plus \$15.3 million in notes and \$5 million in cash. The acquisition was accounted for as a purchase, and accordingly, the operations of TDT are included in the financial statements since the effective date, the close of business on February 14, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. The Company engaged an independent third party appraiser to perform a review of the acquired assets and have allocated the purchase price based on the results of their findings. The preliminary valuation is subject to further review which may result in adjustments to allocation of purchase price in the future. The Company has recorded approximately \$3.4 million in amortization related to the acquired intangible assets from the date of the acquisition through April 3, 2005. TDT is the sole source provider of high security technology and services to the U.S. Department of State for the production of U.S. passports. TDT is now a wholly owned subsidiary of Viisage.

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In connection with the acquisition of TDT, the Company agreed to pay the former sole shareholder of TDT an additional cash payment of up to \$2.6 million if the U.S. Department of Defense selected TDT for the production of smart cards as part of the agency's Common Access Card (CAC) program and placed orders with an aggregate value of at least \$4.0 million prior to June 30, 2004. Viisage received an initial purchase order of \$10.2 million for this program and therefore the Company has recorded this contingent purchase price of \$2.6 million related to the CAC program as additional goodwill. This additional goodwill was offset by approximately \$754,000 of identified purchase price adjustments related to certain provisions in the stock purchase agreement.

On October 5, 2004 Viisage acquired all of the outstanding capital stock of Imaging Automation, Inc. through a merger between Imaging Automation and a wholly-owned subsidiary of Viisage valued at approximately \$40.6 million. The purchase price consisted of 3,908,387 newly issued shares of our common stock approximately \$5.0 million in cash and the assumption of \$2.9 million in debt, which has subsequently been repaid in full. For accounting purposes the value of Viisage common stock was \$6.27 which was the average price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following October 5, 2004, the date on which the purchase agreement was signed and the acquisition was announced. The Company issued fully vested stock options effective as of the close of the transaction to assume the options outstanding under the Imaging Automation stock option plans for which the Company reserved approximately 565,270 shares of Viisage common stock recorded as part of the purchase price at their fair value of approximately \$3.7 million. The acquisition was accounted for as a purchase in the fourth quarter of 2004 and therefore the operations of Imaging Automation were included in the financial statements from and after the effective date of the transaction. The Company has engaged an independent third party appraiser to perform a review of the acquired assets and will allocate the purchase price based on the results of its findings. The preliminary valuation is subject to further review which may result in adjustments to the allocation of purchase price in the future.

The preliminary allocation of the purchase price for ZN, TDT and Imaging Automation, based on the purchase prices calculated for accounting purposes, is as follows (in thousands):

|                              | <u>ZN</u>        | <u>TDT</u>       | <u>iA</u>        |
|------------------------------|------------------|------------------|------------------|
| Current Assets               | \$ 1,639         | \$ 3,020         | \$ 546           |
| Software license receivable  |                  |                  | 2,303            |
| Property and equipment, net  | 140              | 42               | 183              |
| Identified intangible assets | 6,335            | 14,460           | 5,750            |
| Goodwill                     | 23,460           | 39,050           | 31,232           |
|                              | <u>\$ 31,574</u> | <u>\$ 56,572</u> | <u>\$ 40,014</u> |

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Identified intangible assets acquired in connection with the acquisitions of ZN, TDT and Imaging Automation consist primarily of completed technology, customer lists, acquired contracts, non-competition agreements, tradenames and trademarks. These intangible assets are amortized using the straight-line method over their estimated useful lives, as follows:

|                                | <u>April 3, 2005</u> | <u>Estimated<br/>Useful Life</u> |
|--------------------------------|----------------------|----------------------------------|
| Gross carrying amount:         |                      |                                  |
| Completed technology           | \$ 9,575             | 5 years                          |
| Customer lists                 | 130                  | 10 years                         |
| Acquired contracts             | 16,200               | 7 years                          |
| Non-competition agreements     | 490                  | 2 years                          |
| Tradename and trademarks       | 150                  | 3 years                          |
|                                | <u>26,545</u>        |                                  |
| Total intangible assets        | 26,545               |                                  |
| Accumulated amortization:      |                      |                                  |
| Completed technology           | (1,131)              |                                  |
| Customer lists                 | (16)                 |                                  |
| Acquired contracts             | (3,534)              |                                  |
| Non-competition agreements     | (120)                |                                  |
| Tradename and trademarks       | (22)                 |                                  |
|                                | <u>(4,823)</u>       |                                  |
| Total accumulated amortization | (4,823)              |                                  |
|                                | <u>\$ 21,722</u>     |                                  |
| Intangible assets, net         | \$ 21,722            |                                  |

|   |       |
|---|-------|
| Estimated amortization expense (intangible assets only) |       |
| For the year ended December 31, 2005                    | 5,254 |
| For the year ended December 31, 2006                    | 4,840 |
| For the year ended December 31, 2007                    | 4,633 |
| For the year ended December 31, 2008                    | 3,944 |
| For the year ended December 31, 2009                    | 1,084 |

The unaudited pro forma and combined selected operating data are presented as if the acquisitions of ZN, TDT and Imaging Automation had occurred on January 1, 2005 and 2004 for the three months ended April 3, 2005 and March 28, 2004, respectively. The unaudited pro forma data is for informational purposes only and may not necessarily reflect future results of operations or what the results of operations would have been had Viisage, ZN, TDT and iA been operating as a combined entity for the periods presented. The unaudited pro forma revenue, loss and loss per share information for the years ended April 3, 2005 and March 28, 2004 are as follows (in thousands):

|   | <u>For the Three Months Ended,</u> |                       |
|---|------------------------------------|-----------------------|
|   | <u>April 3, 2005</u>               | <u>March 28, 2004</u> |
| Revenue                                       | \$ 16,810                          | \$ 15,100             |
| Net loss                                      | \$ (1,642)                         | \$ (1,053)            |
| Basic and diluted net income (loss) per share | \$ (0.03)                          | \$ (0.03)             |



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### 7. FOREIGN CURRENCY HEDGES

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, established accounting and reporting standards requiring recognition of all derivatives as assets or liabilities in the consolidated balance sheets and measurement of those instruments at fair value. Gains and losses resulting from changes in the fair value of those derivative instruments will be recorded to earnings or other comprehensive income depending on the use of the derivative instrument and whether it qualifies for hedging accounting. The Company uses derivatives to manage foreign currency risk and not for speculative or trading purposes. The Company's objective is to reduce the risk to earnings and cash flows associated with changes in foreign currency exchange rates.

In 2005, the Company began to utilize foreign currency forward contracts. The Company elected to not use hedge accounting and all gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts were terminated prior to settlement. As of April 3, 2005, the Company had committed to four foreign currency forward contracts to purchase approximately 180,000,000 Japanese Yen for \$1,713,000. The fair value of these contracts at April 3, 2005 was a liability of approximately \$27,000. All of these contracts will be settled before July 3, 2005.

### 8. LEGAL PROCEEDINGS

In March and April 2005, eight putative class action lawsuits were filed in the United States District Court for the District of Massachusetts against us, Bernard C. Bailey, William K. Aulet and Denis K. Berube and other members of our Board of Directors. A motion has been filed by the so-called Turnberry Group to consolidate these lawsuits into one action under the case name: *Darquea v. Viisage Technology, Inc. et al.*, Civil Action No. 05-10438-MLW. This motion also seeks to have the Turnberry Group designated as lead plaintiff and its counsel designated as lead counsel. The suits allege violations of the federal securities laws by us and certain of our officers and directors arising out of purported misrepresentations in the guidance that we provided on our anticipated financial results for fiscal 2004 following the release of our 2004 second and third quarter results, which allegedly artificially inflated the price of our stock during the period May 3, 2004 through March 2, 2005. We are not able to estimate the amount of the loss allegedly suffered by members of the putative class or the amount of legal costs and internal efforts associated with defending ourselves and our officers and directors. We believe that the allegations and claims made in these lawsuits are wholly without merit and intend to defend the actions vigorously. If we are unsuccessful in defending ourselves in this litigation, these lawsuits could adversely affect our business, financial condition, results of operations and cash flows as a result of the damages that we would be required to pay. It is possible that our insurance policies either may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. In April 2005, two purported shareholder derivative actions also were filed against our directors, naming us as a nominal defendant. The suits claim that these directors breached their fiduciary duties to our shareholders and to the Company generally in connection with the same set of circumstances alleged in the class action lawsuits. The complaints are derivative in nature and do not seek relief from the Company. One of these actions has been filed in Massachusetts Superior Court and the other has been filed in the United States District Court for the District of Massachusetts. We have filed a motion to dismiss the state court action. Our response to the federal court action is not yet due. We believe that the allegations and claims made in these lawsuits are likewise wholly without merit and intend to defend the actions vigorously.

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia's Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers' license program. In July 2003, the court had issued a

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preliminary injunction prohibiting DMVS from continuing to work with us to install the State's new drivers' license system. In July 2004, we reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay us \$2.0 million in cash and the State agreed to purchase certain equipment from us for \$500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers' license system, but disallowed the \$2.0 million cash payment described above. Without this payment, we believe either that the settlement agreement with DMVS is not effective and that our contract with DMVS remains in place, or that our initial claim for an \$8.2 million settlement payment is revived. The State has paid us the \$500,000 for the equipment and we appealed the disallowance of the \$2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted in a 4-3 decision not to hear our appeal based on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge's ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, we have identified \$2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately \$2.2 million to their estimated fair value of approximately \$200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a \$2.0 million charge in the fourth quarter of 2004. In addition, we have removed the contract from our backlog, and we will lose up to \$19.7 million in revenue that we expected to recognize over the next five and one-half years, unless the contract remains in place or we are able to win the new contract for the digital drivers' license system and the revenues from such new contract are substantially similar to the prior contract. There are approximately \$2.9 million of system assets remaining on our balance sheet from the Georgia contract. These consist of approximately \$1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately \$150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately \$1.6 million of assets constituting our central production facility in Georgia. We have evaluated these assets for impairment and, based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these assets either in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

In May 2005, Viisage, Toppan Printing Co., Ltd. and Fargo Electronics, Inc. agreed to a settlement of the lawsuit Fargo had filed against Toppan and TDT in July 2004 in the U.S. District Court for the Eastern District of Virginia. The lawsuit alleged that a reverse image printer manufactured by Toppan and distributed by TDT infringed four U.S. patents owned by Fargo. The settlement agreement required Toppan to pay a settlement amount to Fargo and granted Fargo distribution rights worldwide outside Japan for the Toppan CP-400 card printer. Additionally, we and Fargo entered into a strategic distribution agreement that allows us to purchase the full line of Fargo printers, become Fargo's exclusive distributor of the Toppan CP-400 card printer to the U.S. federal government and U.S. state drivers' license markets, and distribute the Toppan CP-400 printer worldwide outside Japan. As part of this arrangement, we have committed to purchase \$1.0 million of products from Fargo over the next two years and will pay to Fargo a commission on future sales of the Toppan CP-400 printer and consumables for the Department of Defense Common Access Card program.

**9. PROPERTY AND EQUIPMENT**

Property and equipment are summarized as follows (in thousands):

|   | <b>April 3,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|---|--------------------------|------------------------------|
|   | <u>          </u>        | <u>          </u>            |
| System assets held under capital leases | \$ 250                   | \$ 250                       |
| System assets                           | 51,660                   | 51,216                       |
| Computer and office equipment           | 3,577                    | 3,269                        |
| Leasehold Improvements                  | 242                      | 147                          |
|   | <u>55,729</u>            | <u>54,882</u>                |
| Less accumulated depreciation           | 36,467                   | 34,965                       |

|           |           |
|-----------|-----------|
| \$ 19,262 | \$ 19,917 |
|-----------|-----------|

Included in system assets at December 31, 2004 are \$500,000 of assets held for sale to Georgia related to the state's agreement to purchase certain assets pursuant to a portion of the settlement agreement between Viisage and the state which was upheld by the Georgia court in its summary judgment ruling. In the first quarter of 2005 the Company received full payment from the state for these assets. Also included in system assets for both periods presented is approximately \$2.9 million of system assets remaining from the Georgia contract. These consist of approximately \$1.1 million of assets that the Company anticipates using in Georgia if it wins the contract based on the new request for proposals, approximately \$150,000 of assets that the Company anticipates could either be used in Georgia under a new contract or used in other projects, and approximately \$1.6 million of assets constituting the Company's central production facility in Georgia. The Company has evaluated these assets for impairment and, based upon its current probability-weighted estimate of cash flows, the Company has determined that these assets are not currently impaired. While the Company believes it can utilize these assets either in Georgia, if it wins the new contract, or on alternative projects, to the extent that it is unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with the state regarding these assets, the Company would be required to take a further charge to earnings. In the fourth quarter of 2004, the Company recorded a \$2.0 million impairment charge related to certain assets deployed within the state deemed to have no alternative use. (See Note 8).

Depreciation expense for the three months ended April 3, 2005 and March 31, 2004 was approximately \$1.5 million and \$1.6 million, respectively.

#### 10. SUBSEQUENT EVENTS

See Note 8 for a discussion of certain legal proceedings subsequent to April 3, 2005.

The Company has been subject to a delisting proceeding by the Nasdaq Stock Market as a result of its failure to timely file its Form 10-K for the fiscal year ended December 31, 2004 and its Form 10-Q for the fiscal quarter ended April 3, 2005. A Nasdaq Listing Qualifications Panel has determined to continue the listing of the Company's common stock on the Nasdaq National Market provided that the 2004 Form 10-K and first quarter 2005 Form 10-Q are filed on or before June 30, 2005. If the Company does not meet these conditions, its stock may be delisted from the Nasdaq National Market.



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**VIISAGE TECHNOLOGY, INC.**

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read in conjunction with the financial statements and accompanying notes contained in our 2004 Annual Report on Form 10-K and in this Quarterly Report on Form 10-Q.

**COMPANY BACKGROUND**

Viisage Technology, Inc. provides advanced technology identity solutions that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft, and protect personal privacy. Our identity solutions are specifically designed for identification of people and include secure credentialing, biometrics, automated document authentication and real-time identity databases, as well as systems design, development, integration and support services. These identity solutions enable our customers to manage the entire life cycle of an individual's identity for a variety of applications including civil identification, criminal identification and border management. Our customers use its solutions to help solve the following three critical problems in identity verification and management:

*assurance* that an identification document is authentic and has been issued to the correct person;

*confidence* that the person holding the identification is uniquely tied to and authorized to use the document; and

*verification* of the privileges the individual is entitled to at a particular point in time.

We generate revenue through the sale and license of products and services for verifying and managing identities. Our revenues increased from approximately \$12.3 million in the first three months of 2004 to approximately \$16.8 million in the first three months of 2005. Our net loss during the first three months of 2005 and 2004 was approximately \$1.6 million for each period.

**SEGMENTS AND GEOGRAPHIC INFORMATION**

At April 3, 2005, we operated in one business segment, the advanced technology identity solutions segment. Our advanced technology identity solutions segment enables governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.

During the fourth quarter of 2004, we have realigned our net product and services revenues into three main categories identified by the markets which they serve: *State and Local*, *Federal*, and *Commercial/Emerging Markets*. Our Chief Executive Officer is the chief operating decision maker who evaluates performance based on revenues and total operating expenses of identity solutions products and services across all markets

and geographic regions.

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Revenues by market for the three months ended April 3, 2005 and March 28, 2004 are disclosed in the following table (in thousands):

|                             | Three Months Ended |                  |
|-----------------------------|--------------------|------------------|
|                             | April 3, 2005      | March 28, 2004   |
| State and Local             | \$ 8,983           | \$ 9,412         |
| Federal                     | 7,627              | 2,656            |
| Commercial/Emerging Markets | 200                | 191              |
|                             | <u>\$ 16,810</u>   | <u>\$ 12,259</u> |

Our operations outside the United States include a wholly-owned subsidiary in Bochum, Germany. Revenues are attributed to each region based on the location of the customer. Revenues in North America are primarily comprised of revenues from customers in the United States. The following is a summary of revenues, identifiable assets and goodwill by geographic areas (in thousands):

|               | Three Months Ended |                   |
|---------------|--------------------|-------------------|
|               | April 3, 2005      | March 28, 2004    |
| Revenue       |                    |                   |
| United States | \$ 15,801          | \$ 11,791         |
| Rest of World | 1,009              | 468               |
|               | <u>\$ 16,810</u>   | <u>\$ 12,259</u>  |
| Total Assets  |                    |                   |
| United States | \$ 141,331         | \$ 135,292        |
| Germany       | 27,603             |                   |
|               | <u>\$ 168,934</u>  | <u>\$ 135,292</u> |
| Goodwill      |                    |                   |
| United States | \$ 77,781          | \$ 57,114         |
| Germany       | 15,961             | 6,499             |
|               | <u>\$ 93,742</u>   | <u>\$ 63,613</u>  |

Of the total revenue for the three months ended April 3, 2005, \$1.0 million was earned from export sales. Of the total revenue for the three months ended March 28, 2004, \$468,000 was earned from export sales. The Company did not have significant international sales to individual countries for the periods presented.

DEPENDENCE ON SIGNIFICANT CUSTOMERS

We believe for the near future that we will continue to derive a significant portion of our revenues from a limited number of large contracts. Customers who accounted for more than 10% of our total revenues are as follows:

for the three-month period ended April 3, 2005, one customer accounted for an aggregate of 28.7%; and

for the three-month period ended March 28, 2004, one customer accounted for an aggregate of 13.1%.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES

We prepare our financial statements in accordance with generally accepted accounting principles in the United States, or US GAAP. Consistent with US GAAP, we have adopted accounting policies that we believe are most

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appropriate given the facts and circumstances of our business. The application of these policies has a significant impact on our reported results. In addition, some of these policies require management to make estimates. These estimates, which are based on historical experience and analysis of current conditions, have a significant impact on our reported results and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. If actual results differ significantly from these estimates, there could be a material effect on our financial statements.

### *Valuation of Goodwill and Other Long-Lived and Intangible Assets*

Our long-lived assets include property, plant and equipment, other intangible assets and goodwill. As of April 3, 2005, the balances of property, plant and equipment, other intangible assets and goodwill, net of accumulated depreciation and amortization, were \$19.3 million, \$24.6 million, and \$93.7 million, respectively.

Where we believe that property, plant and equipment and intangible assets have finite lives, we depreciate and amortize those assets over their estimated useful lives. For purposes of determining whether there are any impairment losses, as further discussed below, our management has examined the carrying value of our identifiable long-lived tangible and intangible assets, including their useful lives where we believe such assets have finite lives, when indicators of impairment are present. For all long-lived tangible and intangible assets, if an impairment loss were identified based on the fair value of the asset, as compared to the carrying value of the asset, such loss would be charged to expense in the period we identify the impairment. Furthermore, if our review of the carrying values of the long-lived tangible and intangible assets with finite lives indicates impairment of such assets, we may determine that shorter estimated useful lives are more appropriate. In that event, we will be required to record additional depreciation and amortization in future periods, which will reduce our earnings.

Factors we generally consider important which could trigger an impairment review on the carrying value of other long-lived tangible and intangible assets include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of acquired assets or the strategy for our overall business;

underutilization of our tangible assets;

discontinuance of product lines by ourselves or our customers;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

significant decline in our market capitalization relative to net book value.

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We have evaluated the assumptions used in our assessment of goodwill impairment as of December 31, 2004 and have determined that the estimates used in the independent valuation of goodwill at that date have not materially changed after considering the above triggering events for an impairment review during the three months ended April 3, 2005. Although we believe that the carrying values of our long-lived tangible and intangible assets were realizable as of April 3, 2005, future events could cause us to conclude otherwise.

In the fourth quarter of 2004, we recorded an impairment charge of \$2.0 million related to a write-down of certain system assets associated with our contract to produce drivers licenses in the state of Georgia. This impairment was the result of a Georgia court's grant of summary judgment, during that quarter, in favor of Georgia's Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by one of our competitors in March 2003 alleging that the DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. The summary judgment negated a prior settlement between us and the state that would have provided us with a payment of \$2.0 million upon the cancellation of its contract. Due to the uncertainty of the cash settlement as a result of the judge's ruling and the uncertainty of future cash flows from this contract to support the book value of the system assets installed, we have identified \$2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately \$2.2 million to their estimated fair value of approximately \$200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a \$2.0 million charge in the fourth quarter of 2004. We also have evaluated for impairment the remaining \$2.9 million in assets being retained by us from the Georgia contract. These consist of approximately \$1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately \$150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately \$1.6 million of assets constituting our central production facility in Georgia. Based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these assets either in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

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Due to our three acquisitions in 2004, goodwill and other intangible assets were created as a result of the allocation of the purchase price to identified intangible assets of the acquired businesses. The values recorded for goodwill and other intangible assets represent estimates of fair values calculated by independent third-party appraisers and are subject to further review and finalization. Such valuations require us to provide significant estimates and assumptions, which are derived from information obtained from the management of the acquired businesses, and our business plans for the acquired businesses or intellectual property. Critical estimates and assumptions used in the initial valuation of goodwill and other intangible assets include, but are not limited to:

future expected cash flows from product sales, customer contracts and acquired developed technologies and patents;

expected costs to complete any in-process research and development projects and commercialize viable products and estimated cash flows from sales of such products;

the acquired companies' brand awareness and market position;

assumptions about the period of time over which we will continue to use the acquired brand; and

discount rates.

These estimates and assumptions may be incomplete or inaccurate because unanticipated events and circumstances may occur. If estimates and assumptions used to initially value goodwill and intangible assets prove to be inaccurate, ongoing reviews of the carrying values of such goodwill and intangible assets may indicate impairment which will require us to record an impairment charge in the period in which we identify the impairment.

As of April 3, 2005, we have recorded goodwill of \$93.7 million. We will perform impairment reviews on the carrying values of goodwill arising from the aforementioned acquisitions at least annually. Because future cash flows and operating results used in the impairment review will be based on management's projections and assumptions, future events could cause such projections to differ from those used to originally value the acquisitions, which could lead to significant impairment charges of goodwill in the future.

### *Revenue and Cost Recognition*

We deliver document issuance solutions primarily to federal and state government customers. We recognize revenue when persuasive evidence of a sales arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectibility is reasonably assured.

Product revenue on contracts where title to the products pass to the customer consist mainly of printing system components and consumables including printers, secure coating, ribbon, film and other parts. Revenue on products is recognized when the products are shipped and accepted by the customer. Services revenue under these contracts consists of preventative and remedial maintenance on printing systems. We also provide on-site technical support and consulting services to our customers. Revenue on fixed price services is recognized over the service period and approximates the timing of the services rendered. Revenue on time and material services is recognized as the services are rendered. Expenses on all services are recognized when the costs are incurred.

When elements such as products and services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such



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element meets the criteria for treatment as a separate unit of accounting. The price charged when the element is sold separately generally determines fair value.

We have contracts, generally with state governments for the production of drivers licenses and other identification credentials, where we have determined that we have multiple elements and where the title to equipment installed to produce these credentials does not pass to the customer. Under these contracts, the first element consists of hardware, system design, implementation, training, consumables management, maintenance and support which is accounted for as equipment and related executory services under lease in accordance with SFAS No. 13. The second element consists of customized software which is accounted for as a long term contract in accordance with AICPA Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2, and Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, or SOP 81-1, on a units of delivery method of measurement.

Costs related to the hardware element of these contracts are capitalized on the balance sheet and are depreciated over the contract term beginning when the system goes into service. The delivery of these credentials typically requires us to customize, design, and install equipment and software at customer locations, as well as perform training, supply consumables, maintain the equipment and provide support services. Nonperformance of training, consumables management, maintenance and support services would prevent us from receiving payment for the costs incurred in the customization, design and installation of the system. EITF 00-21 limits the amount of revenue allocable to the customization, design and installation of the system to the amount that is not contingent upon the production of credentials. Revenue on these contracts under EITF 00-21 is earned based on, and is contingent upon, the production of credentials from the system. Due to the contingent performance of credential production in our secure credentials contracts, we defer revenue recognition for the system design and installation phase of our contracts, including customized software and equipment, and recognize revenue as credentials are produced.

Costs related to the customized software element of our secure credentials contracts where title to the hardware element does not pass to the customer are capitalized on the balance sheet during the period in which we are designing and installing the system and are amortized over the contract term beginning when the system goes into service. Costs related to this element of our secure credentials contracts incurred after the system is in service are expensed as incurred. Revenue related to this element of our secure credentials contracts is recorded as credentials are produced by the system.

Our contracts related to the delivery of drivers licenses and identification credentials typically provide that the state department of transportation, or similar agency, will pay a fixed price per credential produced utilizing a system we design, implement and support. Our fixed pricing includes charges for the use of the system, materials and the data that is stored on the credentials. Prices under these contracts vary depending on, among other things:

design and integration complexities;

nature and number of workstations and sites installed;

projected number of secure credentials to be produced;

size of the database;

level of post-installation involvement that will be required of us; and

competitive environment.

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Other identity solutions contracts typically provide for the development, customization and installation of face recognition systems for government agencies, law enforcement agencies and businesses. These contracts are generally fixed price, and include milestones and acceptance criteria for the various deliverables under the contract. Contract prices vary depending on, among other things, design and integration complexities, the nature and number of workstations and sites, the size of the database, the level of post-installation support and the competitive environment. In certain cases, we provide licenses of off-the-shelf versions of our face recognition software on a per user basis.

We recognize revenue under these contracts using the percentage-of-completion methodology in accordance with SOP 81-1. We use the percentage-of-completion methodology to account for revenue under these contracts because:

a high level of certainty exists regarding expected cash flows from these contracts; and

a reliable basis exists for determining the percentage of the contract that will be completed at the end of the accounting period.

We measure the percentage complete as costs are incurred or for contracts based on milestones, revenue is recognized when scheduled performance milestones and customer acceptance criteria have been achieved. These milestones are specific events or deliverables clearly identified in the contract. We recognize revenue based on the total milestone billable to the customer less revenue related to any future maintenance requirements. Billings occur under these contracts when the milestone is delivered and accepted by the customer. On contracts where milestones are not used, we generally recognize revenue on a cost-to-cost basis using direct labor dollars as the method of measurement.

We record costs and estimated earnings in excess of billings under these contracts as current assets. When elements such as products and services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. The price charged when the element is sold generally determines fair value.

Revenue related to software licenses of off-the-shelf face recognition software is recognized in accordance with SOP 97-2. For these software licenses we recognize revenue when:

persuasive evidence of an arrangement exists;

delivery has occurred;

the sales price is fixed and determinable;

collection is probable; and

there are no post delivery obligations.

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On identity solutions contracts where the arrangement consists of build-to-suit software and solution design during the installation phase of the project, as well as ongoing services under a long-term contract, we apply the criteria in EITF 00-21 to separate the SOP 81-1 deliverables, the installation services, from the non SOP 81-1 deliverables, ongoing maintenance and support service. On these contracts we allocate revenue to each element

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based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. The price charged when the element is sold separately generally determines fair value.

### *Derivative Instruments and Hedging Activities*

In 2005, the Company began to utilize foreign currency forward contracts. The Company elected to not use hedge accounting and all gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts were terminated prior to settlement. As of April 3, 2005, the Company had committed to four foreign currency forward contracts to purchase approximately 180,000,000 Japanese Yen for \$1,713,000. The fair value of these contracts at April 3, 2005 was a liability of approximately \$27,000. All of these contracts will be settled before July 3, 2005.

## **RESULTS OF OPERATIONS**

### *Revenue*

Revenues in the state and local market of our business are derived principally from multi-year contracts for systems implementation, credential production and related services. Secondly we derived state and local revenues from the sale of our document authentication products and services which were acquired from Imaging Automation, Inc. in October 2004. Revenues from our federal market are derived principally from products and solutions delivered to the Department of State and the Department of Defense. Revenues for the first three months of 2005 increased 37.1% from approximately \$12.3 million for the first three months of 2004 to approximately \$16.8 million for the first three months of 2005. State and local market revenue decreased by \$428,000 primarily due to decreases in revenue of approximately \$500,000 from our drivers license contract in Ohio, \$325,000 and \$110,000 from our welfare card contracts with New York and Massachusetts, respectively. The contracts in Ohio and New York ended in the first quarter 2005 and the contract in Massachusetts is ending in the second quarter 2005 and therefore card volumes in all three states were lower than the comparable period in the prior year. There was also a decrease in revenue from our contract in Alaska of approximately \$270,000 as a result of our entering the maintenance phase of this contract in late 2004. These decreases in revenue in the state and local market were offset by an increase in revenues of approximately \$775,000 generated from sales of new document authentication products and services. The remaining increase in revenues was the result of increased revenues in the federal market of our business, which increased by \$4.9 million from \$2.7 million in the first quarter of 2004 to \$7.6 million in the first quarter of 2005 primarily from \$1.3 million of new sales of services to the Department of Defense as well as an increase in revenues of approximately \$3.0 million from services provided to the Department of State.

### *Gross Margin*

Gross margin increased to 34.3% in the first quarter of 2005 from 27.4% in the first quarter of 2004. We sold products with a higher average gross margin during the first quarter of 2005 compared to the comparable period in the prior year. The products and services delivered in the federal market of approximately \$4.9 million in the first quarter of 2005 were delivered with a margin in excess of 38%. In addition, the increase in document authentication product and service sales of \$775,000 contributed margin in excess of 40%. Overall the change in our product mix improved our margin in the first quarter of 2005 by approximately 10.5%. This increase was offset by a decrease in margin from our drivers license contracts where we experienced decrease in sales in Ohio, New York and Massachusetts that all contributed higher than average gross margins. We expect that our gross margins will continue to improve in 2005 as we expand our product portfolio.



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### *Sales and Marketing Expenses*

Sales and marketing expenses increased by approximately \$723,000, from \$1.5 million in the first quarter of 2004 to \$2.2 million in the first quarter of 2005. Approximately \$500,000 of this increase was related to personnel and resources from the three acquisitions that we completed in 2004. The ZN and TDT acquisitions were both closed in the first quarter of 2004 represented a partial quarter of expense. In addition, we continue to invest in sales and marketing to support our products organization and our federal government sales initiatives in 2005. As a percentage of revenue, sales and marketing expenses increased from 12.1% in the first quarter of 2004 to 12.7% in the first quarter of 2005. We expect that we will continue to invest in sales and marketing resources primarily in the federal market and in emerging markets in 2005.

### *Research and Development Expenses*

Research and development expenses increased by approximately \$562,000, from \$959,000 in the first quarter of 2004 to \$1.5 million in the first quarter of 2005. Approximately \$530,000 of this increase was related to personnel and resources from the three acquisitions that we completed in 2004. We continue to invest in biometric technologies and new product development to broaden our product offering of advanced identity solutions technology. This investment included enhancing existing products as well as contributing new products with the intellectual property and product offerings that were acquired through our acquisitions in 2004. As a percentage of revenue, research and development expenses increased from 7.8% in the first quarter of 2004 to 9.0% in the first quarter of 2005. We expect to continue to invest in research and development to add functionality to our current advanced technology identity solutions offerings, as well as to develop new offerings in 2005.

### *General and Administrative Expenses*

General and administrative expenses increased by approximately \$1.3 million, from \$2.1 million in the first quarter of 2004 to \$3.4 million in the first quarter of 2005. The increase in general and administrative expenses was the result of an increase in salary and related costs of approximately \$200,000 from new headcount additions in information technology, finance and accounting. Consulting fees increased by approximately \$275,000 primarily related to our Sarbanes Oxley IT project that was completed in the first quarter of 2005 as well as recruiting expenses. Audit fees increased by approximately \$500,000 in the first quarter of 2005 compared to the comparable period in the prior year. The remaining increase of approximately \$325,000 resulted from resources and other general and administrative costs from the acquisitions in 2004. As a percentage of revenue, general and administrative expenses increased from 17.4% in the first quarter of 2004 to 20.4% in the first quarter of 2005.

### *Interest Income and Expense*

Interest income increased by \$10,000 from \$21,000 in the first quarter of 2004 to \$31,000 in the first quarter of 2005. The increase in interest income is related to a higher average cash balance during the first quarter of 2005 compared to the comparable period in 2004. Interest expense decreased by \$366,000 from \$413,000 in the first quarter of 2004 to \$47,000 in the first quarter of 2005. The decrease in interest expense is related to our repayment prior to the first quarter of 2005 of approximately \$31.4 million of debt that was on our balance sheet as of March 28, 2004.

### *Income Taxes*

The deferred income tax provision for the three months ended April 3, 2005 includes \$300,000 to increase the deferred tax valuation allowance. This deferred tax liability is created by taxable temporary differences related



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to certain goodwill for which the period the difference will reverse is indefinite. Following the adoption of SFAS 142, taxable temporary differences creating deferred tax liabilities as a result of different treatment of goodwill for book and tax purposes cannot offset deductible temporary differences that create deferred tax assets in determining the valuation allowance. In the fourth quarter of 2004, the Company made an election under Internal Revenue Tax Code Section 338(h)(10) to treat its acquisition of TDT as an asset transaction for tax purposes. This election resulted in future tax deductible amortization expense for tax purposes. As a result, a deferred tax provision is required to increase the Company's valuation allowance. There was no provision for federal income taxes have been made for the three months ended April 3, 2005 and March 28, 2004 during those periods. The provision for state income taxes for the three months ended April 3, 2005 and March 28, 2004 was approximately \$58,000 and \$25,000, respectively.

## LIQUIDITY AND CAPITAL RESOURCES

Cash was approximately \$10.2 million at April 3, 2005. As of April 3, 2005, there were no restrictions on the Company's cash. Cash at December 31, 2004 was approximately \$11.3 million.

In the three-month period ended April 3, 2005, cash used in operating activities was approximately \$380,000 which stems from our net loss of approximately \$1.6 million, offset by non-cash charges for depreciation and amortization of approximately \$2.9 million, and cash used by the net change in operating assets and liabilities of approximately \$1.7 million.

Accounts receivable decreased approximately 23.8% from \$17.1 million at December 31, 2004 to \$13.0 million at April 3, 2005. The decrease of approximately \$4.1 million is primarily due to the collection of approximately \$4.4 million of accounts receivable from Telos Corporation (U.S. Department of Defense) and the U.S. Department of State. The remaining fluctuation is due to the timing of billings and collections.

Inventories and other costs and estimated earnings in excess of billings increased approximately 17.3% from \$3.4 million at December 31, 2004 to \$4.0 million at April 3, 2005. This increase of approximately \$585,000 was primarily due to additional inventory of document authentication products for delivery on future contracts.

Accounts payable and accrued expenses decreased approximately 35.8% from \$15.3 million at December 31, 2004 to \$9.8 million at April 3, 2005. This decrease was the result of payments to certain vendors related to our U.S. Department of State and U.S. Department of Defense contracts of \$5.0 million as well as obligations to employees of approximately \$800,000. The remainder of the change is due to the timing of payables.

On December 14, 2004, we entered into a Loan and Security Agreement with Citizens Bank of Massachusetts. The Loan and Security Agreement permits us to borrow up to \$25,000,000, subject to certain financial covenants which may restrict the amounts borrowed. As of April 3, 2005, we estimate that the amount available to us under the Loan and Security Agreement was approximately \$5.7 million based on the financial covenants. Any amounts borrowed under the Loan and Security Agreement bear interest at the rate of Citizens' prime rate minus 0.25% or the London Interbank Offered Rate (LIBOR) plus 2.5%, at our option, and must be repaid on or before May 30, 2007. In March 2005, we entered into an amendment to the Loan and Security Agreement to modify the financial covenants and make certain other changes. Although we are in compliance with the amended financial covenants for the quarter ended April 3, 2005, we are not in compliance with the covenant that requires us to make timely required filings with the Securities and Exchange Commission as a result of our failure to timely file this Form 10-Q and our Form 10-K for the year ended December 31, 2004. Once we have made these filings, we will be in compliance with all of the covenants under the Loan and Security Agreement. If we do not remain in compliance with the applicable covenants, Citizens could refuse to lend funds to us and could require repayment of any amounts outstanding at the time that we are not in compliance with such



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covenants. Currently, there are no borrowings outstanding under the Loan and Security Agreement other than a commitment of \$2.3 million in letters of credit issued by Citizens to certain of our customers.

In April 2003 we entered into an arrangement for approximately \$1.5 million of equipment financing with three of our suppliers. These project lease arrangements are accounted for as capital leases. There are no financial covenants associated with these leasing arrangements. As of April 3, 2005 we had outstanding approximately \$207,000 under these arrangements. The interest rates on these capital leases are between 6% and 8% and are fixed. The terms of these leases range from 12 months to 60 months. In August 2003 we entered into an arrangement for financing of database licenses with another vendor. As of April 3, 2005, we had outstanding approximately \$103,000 under this arrangement.

In the first quarter of 2004, we purchased an asset totaling \$800,000 which is payable in installments over four years. As of April 3, 2005, \$369,000 is included in other liabilities which represent the unpaid principal balance net of imputed interest. Total remaining installment payments due total \$400,000.

We believe that our existing cash balances and anticipated cash flows from operations will be sufficient to meet our operating and debt service requirements for the next 12 months. However, if we cannot achieve our operating goals in 2005 or if we win additional drivers license contracts in 2005, we may be required to seek additional financing. There can be no assurance that such financing will be available on commercially reasonable terms, or at all. Due to our failure to timely file this Form 10-Q and our Form 10-K for the year ended December 31, 2004, we are subject to a delisting proceeding by the Nasdaq Stock Market. If our common stock is delisted from the Nasdaq National Market, this may have an adverse effect on our ability to raise funds in the capital markets or may adversely affect the price and terms at which we are able to raise such funds. Our ability to meet our business forecast is dependent on a number of factors, including those described in the section of this report entitled Factors that May Affect Future Results.

**CONTRACTUAL OBLIGATIONS**

The following table sets forth our contractual obligations as of April 3, 2005.

|                             | <u>Total</u> | <u>Less Than<br/>1 Year</u> | <u>1-3<br/>Years</u> | <u>3-5<br/>Years</u> | <u>More than<br/>5 Years</u> |
|-----------------------------|--------------|-----------------------------|----------------------|----------------------|------------------------------|
| Capital Lease Obligations   | \$ 335       | \$ 196                      | \$ 139               | \$                   | \$                           |
| Operating Lease Obligations | \$ 3,366     | \$ 510                      | \$ 1,416             | \$ 1,140             | \$ 300                       |

We have standby letters of credit issued by Citizens Bank for approximately \$2.3 million to certain of our customers.

In addition, in May 2005, we made certain purchase commitments of \$1.0 million with respect to printer purchases from a vendor.

**CONTINGENT OBLIGATIONS**

Our principal contractual commitments involve payments under capital leases, term notes and operating leases.

#### INFLATION

Although some of our expenses increase with general inflation in the economy, inflation has not had a material impact on our financial results to date.

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### FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management's beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by or on our behalf. Words such as expect, anticipate, intend, plan, believe, seek, estimate, variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. We have included important factors in the cautionary statements below under the heading Factors That May Affect Future Results that we believe could cause our actual results to differ materially from the forward-looking statements we make. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

### FACTORS THAT MAY AFFECT FUTURE RESULTS

The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties, including those not presently known to us or that we currently deem immaterial, may also impair our business.

#### **We have a history of operating losses.**

We have a history of operating losses. Our business operations began in 1993 and, except for fiscal years 1996 and 2000, have resulted in net losses in each fiscal year, including a net loss of \$7.0 million in 2004 and \$1.6 million for the quarter ended April 3, 2005. At April 3, 2005, we had an accumulated deficit of approximately \$50.7 million. We will continue to invest in the development of our secure credential and biometric technologies. Accordingly, we cannot predict when or if we will ever achieve profitability on an annual basis.

#### **We may be unable to obtain additional capital required to fund our operations and finance our growth.**

The installation of our secure credentials systems requires significant capital expenditures. While we have been successful in the past in obtaining financing for working capital and capital expenditures, we will have ongoing capital needs as we expand our business. We may be unable to obtain additional funds in a timely manner or on acceptable terms, which would render us unable to fund our operations or expand our business. If we are unable to obtain capital when needed, we may have to restructure our business or delay or abandon our development and expansion plans.

#### **We derive over 90% of our revenue from government contracts, which are often non-standard, involve competitive bidding, may be subject to cancellation with or without penalty and may produce volatility in earnings and revenue.**

More than 90% of our business involves providing products and services under contracts with U.S. federal, state, local and foreign government agencies. Obtaining contracts from government agencies is challenging, and government contracts often include provisions that are not standard

in private commercial transactions. For example, government contracts may:

include provisions that allow the government agency to terminate the contract without penalty under some circumstances;

be subject to purchasing decisions of agencies that are subject to political influence;

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contain onerous procurement procedures; and

be subject to cancellation if government funding becomes unavailable.

Foreign government contracts generally include comparable provisions relating to termination for the convenience of the relevant foreign government. Securing government contracts can be a protracted process involving competitive bidding. In many cases, unsuccessful bidders may challenge contract awards, which can lead to increased costs, delays and possible loss of the contract for the winning bidder.

### **We derive a significant portion of our revenue from a few customers, the loss of which could have an adverse effect on our revenues.**

For the three-month period ended April 3, 2005, one customer, the U.S. Department of State, accounted for an aggregate of 28.7% of our revenue. Since a small number of customers in our secure credentials segment account for a substantial portion of our revenues, the loss of any of our significant customers would cause revenue to decline and could have a material adverse effect on our business.

### **We derive revenue from only a limited number of products and services and we do not have a diversified product or service base.**

Substantially all of our revenues are derived from the sale of products and services comprising our identity solutions. We anticipate that substantially all of the growth in our revenue, if any, will also be derived from these sources. If for any reason our sale of these products or services is impeded, and we have not diversified our product and service offerings, our business and results from operations could be harmed.

### **We could face adverse consequences as a result of our late SEC filings.**

We failed to timely file our Annual Report on Form 10-K for the year ended December 31, 2004 and this Form 10-Q. As a result, we will not be eligible to use a short form registration statement on Form S-3 for a period of 12 months after becoming current in our filings. Our inability to use a short form registration statement for a period of 12 months after becoming current in our SEC reporting obligations may impair our ability or increase the costs and complexity of our efforts, to raise funds in the public markets or use our stock as consideration in acquisitions should we desire to do so during this one year period. In addition, if we are unable to remain current in our future filings, we may face additional adverse consequences, including (1) an inability to have a registration statement under the Securities Act of 1933 covering a public offering of securities declared effective by the SEC, (2) an inability to make offerings pursuant to existing registration statements (including registration statements on Form S-8 covering employee stock plans) or pursuant to certain private placement rules of the SEC under Regulation D to any purchasers not qualifying as accredited investors, (3) the possible delisting of our common stock from the Nasdaq National Market, and (4) limitations on the ability of our affiliates to sell our securities pursuant to Rule 144 under the Securities Act. These restrictions may adversely affect our ability to attract and retain key employees and may further impair our ability to raise funds in the public markets should we desire to do so or use our stock as consideration in acquisitions.

In addition, our future success depends largely upon the support of our customers, suppliers and investors. The late SEC filings have resulted in negative publicity and a Nasdaq delisting proceeding, and may have a negative impact on the market price of our common stock. The effects of the late SEC filings could cause some of our customers or potential customers to refrain from purchasing or defer decisions to purchase our products and services. Additionally, current or potential suppliers may re-examine their willingness to do business with us, to develop critical

interfaces to our products or to supply products and services if they lose confidence in our



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ability to fulfill our commitments. Any of these losses could have a material adverse effect on our financial and business prospects.

**Our common stock may be delisted from the Nasdaq National Market, which may, among other things, reduce the price of our common stock and the levels of liquidity available to our stockholders.**

In April 2005, we were advised by Nasdaq that our common stock may be delisted from the Nasdaq National Market because we were no longer in compliance with Nasdaq's continued listing requirements as a result of our failure to timely file our Annual Report on Form 10-K for the year ended December 31, 2004. We received a similar notice in May 2005 with respect to our failure to timely file this Form 10-Q. A Nasdaq Listing Qualifications Panel has determined to continue the listing of our common stock on the Nasdaq National Market provided that we file our 2004 Form 10-K and this Form 10-Q on or before June 30, 2005, and have evidenced compliance with all other requirements for continued listing on the Nasdaq National Market. If we fail to timely file such reports, our common stock could be delisted from the Nasdaq National Market, in which event our common stock would be listed on some other quotation medium, such as the pink sheets, depending upon our ability to meet the specific listing requirements of those quotation systems. In the event our common stock is delisted from the Nasdaq National Market, the visibility, liquidity and price of our common stock may be reduced, and our stockholders may find it more difficult to dispose of, or to obtain accurate price quotations for, our shares. In addition, if our common stock is delisted from the Nasdaq National Market, it may also result in other negative implications, including the inability to raise funds in the capital markets, the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest and fewer business development opportunities.

**We have been named as a defendant in eight putative class action lawsuits, an adverse outcome in which could have a material adverse effect on our business, financial condition and results of operations by adversely affecting our cash position.**

As described below in Part II, Item 1, Legal Proceedings, in March and April 2005, eight putative class action lawsuits were filed against us in the United States District Court for the District of Massachusetts. The suits allege violations of the federal securities laws by us and certain of our officers and directors arising out of purported misrepresentations in the guidance that we provided on our anticipated financial results for fiscal 2004 following the release of our 2004 second and third quarter results, which allegedly artificially inflated the price of our stock during the period May 3, 2004 through March 2, 2005. We are not able to estimate the amount of the loss allegedly suffered by members of the putative class or the amount of legal costs and internal efforts associated with defending ourselves and our officers and directors. If we are unsuccessful in defending ourselves in this litigation, these lawsuits could adversely affect our business, financial condition, results of operations and cash flows as a result of the damages that we would be required to pay. It is possible that our insurance policies either may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. While we believe that the allegations and claims made in these lawsuits are wholly without merit and intend to defend the actions vigorously, we cannot be certain that we will be successful in this litigation.

**We have taken an impairment charge to assets of \$2.0 million due to the Georgia litigation; if we are unable to use the remaining assets from that contract, we may be required to take further impairment charges which could negatively affect our earnings.**

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia's Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers' license program. In July 2003, the court had issued a

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preliminary injunction prohibiting DMVS from continuing to work with us to install the State's new drivers' license system. In July 2004, we reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay us \$2.0 million in cash and the State agreed to purchase certain equipment from us for \$500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers' license system, but disallowed the \$2.0 million cash payment described above. Without this payment, we believe that either the settlement agreement with DMVS is not effective and that our contract with DMVS remains in place, or that our initial claim for an \$8.2 million settlement payment is revived. The State has paid us the \$500,000 for the equipment and we appealed the disallowance of the \$2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted not to hear our appeal of the summary judgment ruling on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge's ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, we have identified \$2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately \$2.2 million to their estimated fair value of approximately \$200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a \$2.0 million charge in the fourth quarter of 2004. In addition, we have removed the contract from our backlog, and we will lose up to \$19.7 million in revenue that we expected to recognize over the next five and one-half years, unless the contract remains in place or we are able to win the new contract for the digital drivers' license system and the revenues from such new contract are substantially similar to the prior contract. We also have evaluated for impairment the remaining \$2.9 million in assets being retained by us from the Georgia contract. These consist of approximately \$1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately \$150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately \$1.6 million of assets constituting our central production facility in Georgia. Based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these either in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

**If we are unable to successfully address the material weaknesses in our internal controls, our ability to report our financial results on a timely and accurate basis may be adversely affected. As a result, current and potential stockholders could lose confidence in our financial reporting which could have a material adverse effect on our business, operating results and stock price.**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 10-K for the year ended December 31, 2004, we are required to furnish a report by our management on our internal control over financial reporting. Such report must contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. Such report must also contain a statement that our auditors have issued an attestation report on management's assessment of such internal controls. Management's report and our auditors' attestation report for 2004 were included in our Annual Report on Form 10-K for the year ended December 31, 2004 under Item 8.

Our external auditors notified management and the audit committee of our board of directors that they believed there were material weaknesses due to insufficient personnel resources and technical accounting expertise within the accounting function to effect a timely financial close process and to evaluate and resolve non-routine and/or complex accounting transactions, and in the control processes around information technology systems. These material weaknesses could result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Management has determined that it is in agreement with the auditors' initial assessment that these control deficiencies constituted a material weakness as of December 31, 2004.

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Because of these material weaknesses, management has concluded that we did not maintain effective internal control over financial reporting as of December 31, 2004. Our management has identified the steps necessary to address the material weaknesses described above, and has begun to execute remediation plans, as discussed in Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2004.

Any failure to implement in a timely manner and maintain the improvements in the controls over our financial reporting that we are currently putting in place, or difficulties encountered in the implementation of these improvements in our controls, could cause us to fail to meet our reporting obligations, to fail to produce reliable financial reports or to prevent fraud. Any failure to improve our internal controls to address these identified weaknesses could also cause investors to lose confidence in our reported financial information, which could have a negative impact on our business, operating results and stock price.

**We are investing significant time and resources to implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, which may increase our operating expenses and reduce our profitability in the near future.**

Changes in the laws and regulations that have recently been enacted, including regulations under of the Sarbanes-Oxley Act of 2002, are likely to continue to increase our expenses as we devote resources in response to them. For example, we already have deployed significant resources to document, implement and test our financial processes as part of our implementation of the requirements under Section 404 of the Sarbanes-Oxley Act of 2002, and we expect to incur additional time and expenses in connection with the requirements under Section 404 for our management to report on, and our independent registered public accounting firm to attest to, our internal control over financial reporting. Moreover, compliance with these rules could also cause us to further modify our existing review processes or divert our management's time and attention away from otherwise running our business, either of which could result in our company experiencing additional costs and expenses without corresponding increases in revenue. Consequently, as we take steps to further improve and strengthen our financial management and controls, we anticipate corresponding increases in our operating expenses that may reduce our profitability in the near future.

**Our strategy of expanding our face recognition business could adversely affect our business operations and financial condition.**

Part of our strategy is to enhance our leadership in face recognition technology. Pursuing this strategy involves risks. For instance, to date, face recognition security solutions have not gained widespread commercial acceptance. Some of the obstacles to widespread acceptance of face recognition security solutions include a perceived loss of privacy and public perceptions as to the usefulness of face recognition technologies. Whether the market for face recognition security solutions will expand will be dependent upon factors such as:

the success of our marketing efforts and publicity campaigns and those of our competitors; and

customer satisfaction with our products and services, as well as those of our competitors.

We do not know when, if ever, face recognition security solutions will gain widespread commercial acceptance. In addition, our face recognition business segment has not achieved profitability, and it may never achieve profitability.

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**We face intense competition, which could result in lower revenues and higher research and development expenditures and could adversely affect our results of operations.**

The events of September 11, 2001 and subsequent regulatory and policy changes in the U.S. and abroad have heightened interest in the use of biometric security solutions, and we expect competition in this field, which is already substantial, to intensify. Competitors are developing and bringing to market biometric security solutions that use face recognition as well as eye, fingerprint and other forms of biometric verification. Our products also will compete with non-biometric technologies such as certificate authorities and traditional keys, cards, surveillance systems and passwords. Widespread adoption of one or more of these technologies or approaches in the markets we intend to target could significantly reduce the potential market for our systems and products. Many of our competitors have significantly more cash and resources than we have. Our competitors may introduce products that are competitively priced, have increased performance or functionality or incorporate technological advances that we have not yet developed or implemented. To remain competitive, we must continue to develop, market and sell new and enhanced systems and products at competitive prices, which will require significant research and development expenditures. If we do not develop new and enhanced products or if we are not able to invest adequately in our research and development activities, our business, financial condition and results of operations could be negatively impacted.

**Unless we keep pace with changing technologies, we could lose customers and fail to win new customers.**

Our future success will depend upon our ability to develop and introduce a variety of new products and services and enhancements to these new products and services in order to address the changing needs of the marketplace. We may not be able to accurately predict which technologies customers will support. If we do not introduce new products, services and enhancements in a timely manner, if we fail to choose correctly among technical alternatives or if we fail to offer innovative products and services at competitive prices, customers may forego purchases of our products and services and purchase those of our competitors.

**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. The protective measures that we use in these systems may not prevent security breaches, and failure to prevent security breaches may disrupt our business, damage our reputation, and expose us to litigation and liability. A party who is able to circumvent security measures used in these systems could misappropriate sensitive or proprietary information or materials or cause interruptions or otherwise damage our products, services and reputation, and the property of our customers. If unintended parties obtain sensitive data and information, or create bugs or viruses or otherwise sabotage the functionality of our systems, we may receive negative publicity, incur liability to our customers or lose the confidence of our customers, any of which may cause the termination or modification of our contracts. Further, our insurance coverage may be insufficient to cover losses and liabilities that may result from such events.

In addition, we may be required to expend significant capital and other resources to protect ourselves against the threat of security breaches or to alleviate problems caused by these breaches. However, protective or remedial measures may not be available at a reasonable price or at all, or may not be entirely effective if commenced.

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

We obtain certain hardware components and complete products from a limited group of suppliers. Our reliance on these suppliers involves significant risks, including reduced control over quality and delivery schedules. In particular, we obtain all of the printers and consumables for the U.S. Department of State passport contract and the Department of Defense common access card contract from Toppan Printing Co. Ltd. Moreover, any financial instability of 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 supplies from these sources are delayed. 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 have a severe negative impact on our business, financial condition and results of operations.

### **The market for our solutions is still developing and if the industry adopts standards or a platform different from our platform, then our competitive position would be negatively affected.**

The market for identity solutions is still emerging. The evolution of this market is in a constant state of flux that may result in the development of different technologies and industry standards that are not compatible with our current products or technologies. In particular, the face recognition market lacks industry-wide standards. Several organizations, such as the International Civil Aviation Organization, which sets standards for travel documents that its member states then put into effect, and the National Institute for Standards and Testing, which is part of the U.S. Department of Commerce, have recently selected face recognition as the biometric to be used in identification documentation. It is possible, however, that these standards may change and that any standards eventually adopted could prove disadvantageous to or incompatible with our business model and product lines.

### **Legal claims regarding infringement by us or our suppliers of third party intellectual property rights could result in substantial costs, diversion of managerial resources and harm to our reputation.**

Although we believe that our products and services do not infringe the intellectual property rights of others, we might not be able to defend successfully against a third-party infringement claim. A successful infringement claim against us or our suppliers could subject us to:

liability for damages and litigation costs, including attorneys' fees;

lawsuits that prevent us from further use of the intellectual property;

having to license the intellectual property from a third party, which could include significant licensing fees;

having to develop a non-infringing alternative, which could be costly and delay projects;

having to indemnify clients with respect to losses they incurred as a result of the alleged infringement; and

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having to establish alternative sources for products supplied to us by third parties, as discussed above in the risk factor regarding our dependence on limited source suppliers.

Even if we are not found liable in a claim for intellectual property infringement, such a claim could result in substantial costs, diversion of resources and management attention, termination of customer contracts and harm to our reputation.

See Part II, Item 1, Legal Proceedings, below for a description of the settlement of a patent infringement action that had been filed against one of our subsidiaries.

### **Uncertainties in global economic markets could cause delays in customer purchases.**

Many customers and potential customers have delayed purchase intentions as a result of uncertainties in global economic markets. Government budgets, particularly at state and regional levels, have been or are expected to be reduced notably. Government contracts result from purchasing decisions made by public sector agencies that are particularly sensitive to budget changes and cutbacks during economic downturns, and variations in appropriations cycles. Many U.S. state customers are facing budget cuts, and some international customers are facing debt crises, introducing added uncertainty. Any shift in the government procurement process, which is outside of our control and may not be predictable, could impact the predictability of our quarterly results and may potentially have a material negative effect on our financial position, results of operation or cash flows.

### **If we do not successfully expand our direct sales and services organizations and partnering arrangements, we may not be able to increase our sales or support our customers.**

In the fiscal years ended December 31, 2003 and 2004, and three-month periods ended April 3, 2005 and March 28, 2004, we sold substantially all of our services and licensed substantially all of our products through our direct sales organization. Our future success depends on substantially increasing the size and scope of our direct sales force and partnering arrangements, both domestically and internationally. We will face intense competition for personnel, and we cannot guarantee that we will be able to attract, assimilate or retain additional qualified sales personnel on a timely basis. Moreover, given the large-scale deployment required by some of our customers, we will need to hire and retain a number of highly trained customer service and support personnel. We cannot guarantee that we will be able to increase the size of our customer service and support organization on a timely basis to provide the high quality of support required by our customers. Failure to add additional sales and customer service representatives could result in our inability to increase our sales and support our customers.

### **Integration of acquired businesses may be difficult and will consume significant financial and managerial resources, which could have an adverse effect on our results of operations.**

On January 23, 2004, we completed the acquisition of ZN Vision Technologies AG, or ZN, a leading German provider of face recognition and computer vision products and services. On February 14, 2004, we completed the acquisition of TDT. On October 5, 2004, we completed the acquisition of Imaging Automation, Inc., a market leader in identity document authentication. The integration of the products and services of these acquired companies with ours will be challenging and will consume significant financial and managerial resources. The challenges involved with this integration include, among others:

challenges related to technology innovation;

possible difficulty implementing uniform standards, controls, procedures and policies and



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possible loss of key employees

In addition, the differences between U.S. and German business cultures and the geographic distance between the companies could present significant obstacles to our timely, cost-effective integration of ZN.

**The significant direct and indirect costs of our acquisition and integration of ZN, TDT and Imaging Automation could adversely affect our financial performance.**

To date, we have incurred approximately \$4.7 million of costs in connection with the acquisitions of ZN, TDT and Imaging Automation, including:

costs associated with integrating personnel, products and services;

financial advisory fees; and

costs and expenses for services provided by our lawyers and accountants.

The transaction costs and expenses attributable to financial advisory, legal and accounting services that we incurred will be capitalized as a component of the purchase price. Goodwill associated with the acquisition will be required to be tested at least annually for impairment, and we will be required to record a charge to earnings if there is an impairment in the value of such goodwill at a later date. Other intangible assets acquired in connection with these acquisitions will be amortized over their estimated useful lives.

**The acquisitions of ZN, TDT and Imaging Automation could result in future impairment charges which could adversely affect our results of operations.**

As a result of our acquisitions of ZN, TDT and Imaging Automation, goodwill and other intangible assets have been created. The values we may record for goodwill and other intangible assets will represent fair values calculated by independent third-party appraisers. Such valuations require us to provide significant estimates and assumptions, which are derived from information obtained from the management of the acquired businesses and our business plans for the acquired businesses or intellectual property. If estimates and assumptions used to initially value goodwill and intangible assets prove to be inaccurate, ongoing reviews of the carrying values of such goodwill and intangible assets may indicate impairments which will require us to record an impairment charge in the period in which we identify the impairments.

**If we do not achieve the expected benefits of our acquisitions of ZN, TDT and Imaging Automation, the price of our common stock could decline.**

We expect that the acquisition of ZN will enhance our leadership in face recognition technology through the combination of our technologies with those of ZN. Although the results of the initial tests of our combined technologies have been positive, the combination of such technologies

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might not meet the demands of the marketplace. If our technologies fail to meet such demand, customer acceptance of our face recognition solutions could decline, which would have an adverse effect on our results of operations and financial condition. In addition, we expect that the acquisition of ZN will enable us to market our systems and products on a global scale. Our face recognition customers are primarily located in the United States, and ZN's customers are primarily located in Europe. We might not be able to market successfully our products and services to ZN's customers or ZN's products and services to our customers. We expect that the acquisition of TDT will enhance

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our position in the market for secure credentials, particularly the U.S. government. We expect that the acquisition of Imaging Automation will provide us with a market leadership position in identity document authentication and will complement our core competencies in secure credentials and biometrics. We expect that this addition to our product portfolio will extend our reach into our current markets and provide a critical component to our comprehensive offering for new markets in need of identity solutions. However, there can be no assurance that our current customers or customers in new markets will be receptive to these additional offerings. If our product offerings and services fail to meet the demands of this marketplace, our results of operations and financial condition could be adversely affected. There is also a risk that we will not achieve the anticipated benefits of the acquisitions as rapidly as, or to the extent, anticipated by financial or industry analysts, or that such analysts will not perceive the same benefits to the acquisitions as we do. If these risks materialize, our stock price could be adversely affected.

### **The success of our strategic plan to grow sales and develop relationships in Europe may be limited by risks related to conducting business in European markets.**

Although ZN has experience marketing and distributing its products and developing strategic relationships in Europe, part of our strategy will be to increase sales and build additional relationships in European markets. Risks inherent in marketing, selling and developing relationships in European markets include those associated with;

economic conditions in European markets, including fluctuations in the relative values of the U.S. dollar and the Euro;

taxes and fees imposed by European governments that may increase the cost of products and services; and

laws and regulations imposed by individual countries and by the European Union.

In addition, European intellectual property laws are different than U.S. intellectual property laws and we will have to ensure that our intellectual property is adequately protected in foreign jurisdictions and that ZN's intellectual property is adequately protected in the United States. If we do not adequately protect our intellectual property rights, competitors could use our proprietary technologies in non-protected jurisdictions and put us at a competitive disadvantage.

### **Our business may be impacted by changes in the local marketplace of our foreign operations and fluctuations in currency exchange rates.**

As a result of our acquisitions of ZN, TDT and Imaging Automation, we expect that we will have increased exposure to foreign currency fluctuations. Net revenue and related expenses generated from our international location in Germany are denominated in euros. The results of operations and certain of our inter-company balances associated with this international location are exposed to foreign exchange rate fluctuations. As of April 3, 2005 and December 31, 2004, the cumulative loss from foreign currency translation adjustments was \$312,000 and \$322,000, respectively. In addition to our German operation, we will have increased transactions with Japanese vendors supplying hardware and consumables for the delivery of the TDT contracts. These transactions will increase our exposure to foreign currency fluctuations with the yen. To the extent the U.S. dollar weakens against these foreign currencies, the translation of these foreign currencies denominated transactions results in increased net revenue, operating expenses and net income. Similarly, our net revenue, operating expenses and net income will decrease when the U.S. dollar strengthens against these foreign currencies. For the quarter ended April 3, 2005, we had unrealized gains related to transactions with Japanese vendors of approximately \$98,000.



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### **If our systems and products do not perform as promised, we could experience increased costs, lower margins, liquidated damage payment obligations and harm to our reputation.**

We will be required to provide complex systems that will be required to operate on an as needed basis. Although we will deploy back-up systems, the failure of our products to perform as promised could result in increased costs, lower margins, liquidated damage payment obligations and harm to our reputation. This could result in contract terminations and have a material adverse effect on our business and financial results.

### **Misappropriation of our intellectual property could harm our reputation, affect our competitive position and cost us money.**

We believe that our intellectual property, including our methodologies, will be critical to our success and competitive position. If we are unable to protect this intellectual property against unauthorized use by third parties, our reputation among existing and potential customers could be damaged and our competitive position adversely affected. Our strategies to deter misappropriation could be undermined if:

the proprietary nature or protection of our methodologies is not recognized in the United States or foreign countries;

third parties misappropriate our proprietary methodologies and such misappropriation is not detected; and

competitors create applications similar to ours but which do not technically infringe on our legally protected rights.

If these risks materialize, we could be required to spend significant amounts to defend our rights and divert critical managerial resources. In addition, our proprietary methodologies may decline in value or our rights to them may become unenforceable.

### **If we fail to adequately manage our resources, it could have a severe negative impact on our financial results or stock price.**

We could be subject to fluctuations in technology spending by existing and potential customers. Accordingly, we will have to actively manage expenses in a rapidly changing economic environment. This could require reducing costs during economic downturns and selectively growing in periods of economic expansion. If we do not properly manage our resources in response to these conditions, our results of operations could be negatively impacted.

### **Future acquisitions of companies or technologies may result in disruptions to our business.**

Beyond the acquisitions of ZN, TDT and Imaging Automation, our growth strategy could include additional acquisitions of companies or technologies that complement ours. Future acquisitions could involve risks inherent in acquisitions, such as:

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challenges associated with integrating acquired technologies and the business and operations of acquired companies;

exposure to unknown liabilities;

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diversion of managerial resources from day-to-day operations;

possible loss of key employees, customers and suppliers;

higher than expected transaction costs; and

additional dilution to our existing stockholders if we use our common stock as consideration.

If we fail to manage these challenges adequately, our results of operations and stock price could be adversely affected.

**The loss of key personnel could adversely affect our ability to remain competitive.**

We believe that the continued service of our executive officers will be important to our future growth and competitiveness. We have entered into employment agreements with Bernard C. Bailey, our Chief Executive Officer, William K. Aulet, our Chief Financial Officer, Iftikhar Ahmad, our Senior Vice President, Worldwide Services, Mohamed Lazzouni, our Chief Technology Officer, and James P. Ebzery, our Senior Vice President, Customer Solutions. These agreements are intended to provide the executives with incentives to remain employed by us. However, we cannot assure you that they will remain employed by us. In addition, we believe that the continued employment of key members of our technical and sales staff is important to us. Most of our employees are entitled to voluntarily terminate their relationship with us, typically without any, or with only minimal, advance notice. The process of finding additional trained personnel to carry out our strategy could be lengthy, costly and disruptive. We might not be able to retain the services of all of our key employees or a sufficient number of them to execute our plans. In addition, we might not be able to continue to attract new employees as required.

**Our quarterly results could be volatile and may cause our stock price to fluctuate.**

We have experienced fluctuations in quarterly operating results and we expect those fluctuations to continue. We expect that our quarterly results will continue to be affected by, among other things, factors such as:

the size and timing of contract awards;

the timing of our contract performance;

variations in the mix of our products and services; and

contract losses and changes in management estimates inherent in accounting for contracts.

**Certain of our stockholders have significant relationships with us, which could result in us taking actions that are not supported by unaffiliated stockholders.**

Lau Technologies, or Lau, and Mr. Buddy Beck, the former sole stockholder of TDT who is now a director and Vice Chairman of our Board of Directors, beneficially own approximately 11.4% and 11.9%, respectively, of our outstanding common stock. As a result, both Lau and Mr. Beck have a strong influence on matters requiring approval by our stockholders, including the election of directors and most corporate actions, including mergers and acquisitions. In addition, we have significant relationships with each of Lau and Mr. Beck, including:

we acquired significant intellectual property, contracts and distribution channels through a transaction with Lau in January 2002 under which we agreed to pay Lau a 3.1% royalty on our face recognition revenues through June 30, 2014, up to a maximum of \$27.5 million;



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in connection with the above transaction with Lau, we entered into consulting agreements with Joanna Lau, the President of Lau, and her spouse Denis K. Berube, the Chief Operating Officer of Lau who also serves as the Chairman of our Board of Directors, under which we will pay each of Ms. Lau and Mr. Berube \$125,000 per year for ten years;

the Chairman of our Board of Directors and his spouse own a majority of Lau's voting stock;

in connection with the acquisition of TDT in February 2004, Mr. Beck was elected a member of our Board of Directors and appointed Vice Chairman; and

in connection with the acquisition of TDT, we entered into a consulting agreement with Mr. Beck under which we will pay Mr. Beck \$300,000 per year for two years, provided that Mr. Beck devotes his full business time to developing business opportunities for us.

### **Future sales of our common stock by Lau or Mr. Buddy Beck could depress the market price of our common stock.**

As of June 27, 2005, there were 48,090,780 shares of our common stock outstanding. Lau and Mr. Buddy Beck own approximately 11.4% and 11.9%, respectively, of our common stock. If either of these stockholders sell a significant number of shares of our common stock in the open market, our stock price could decline.

## **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Since our January 2004 acquisition of ZN, our international operating results from transactions by our German operations have been denominated in euros. For the quarter ended April 3, 2005, the cumulative loss from foreign currency translation adjustments was \$312,000. Hardware and consumables purchases related to contracts associated with the TDT acquisition are denominated in Japanese yen. We mitigate exchange rate volatility by utilizing foreign currency forward contracts. Prior to 2005, we did not hedge foreign currencies using derivative instruments. Subsequent to year end, we entered into derivatives contracts as cash flow hedges to mitigate exchange risk associated with our Japanese yen purchases. For the quarter ended April 3, 2005, we had unrealized gains related to transactions with Japanese vendors of approximately \$98,000. Our international operations and transactions are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign currency exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

## **ITEM 4 CONTROLS AND PROCEDURES**

(a) *Evaluation of disclosure controls and procedures.* We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act, 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 management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and

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procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

In connection with the preparation of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including the CEO and CFO, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of April 3, 2005. In performing this evaluation, management reviewed our internal controls over financial reporting, noting that there were two that had significant deficiencies that constituted material weaknesses in our control processes. The first of these is with regard to insufficient personnel resources and technical accounting expertise within the accounting function to effect timely financial close process and to effectively evaluate and resolve non-routine and/or complex accounting transactions. The second is with regard to inadequate or ineffective control processes around information technology systems, including inadequate security, inadequate restricted access to systems, inadequate segregation of duties within systems, lack of appropriate system documentation, ineffective change management processes and insufficient disaster recovery plans. Based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were not effective as of April 3, 2005.

(b) *Changes in internal controls.* As described below, management has identified and begun implementing the steps they believe necessary to address the material weaknesses described above.

With respect to the lack of accounting resources, the Company:

Hired an experienced Accounting Manager with 17 years experience in three public companies who started in January 2005;

Hired an Assistant Controller who is a Certified Public Accountant with eight years of experience who started at the beginning of April 2005; and

Hired an experienced Business Systems Administrator with eight years of experience working on the same financial management and accounting system currently being implemented company-wide who started at the beginning of March 2005.

With respect to the Company's information technology, or IT, systems, the Company:

Identified gaps in IT policies and procedures as noted above in November 2004;

Developed a detailed plan to remediate identified deficiencies which was completed in November 2004;

Completed policy and procedure documentation of all key processes in December 2004;

Implemented all identified general IT controls in the first quarter of 2005, other than those related to change control and access control of the newly-implemented financial application system and related spreadsheets;

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Plans to complete implementation of all identified general IT controls in 2005; and

Hired a full-time IT manager with seven years experience who started at the beginning of March 2005.

There were no changes to any reported financial results that have been released by the Company in this or any other filing as a result of these identified deficiencies. The impact of the above conditions was relevant to the fiscal year ended December 31, 2004 and the quarter ended April 3, 2005 only and did not affect the results of

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these periods or any prior periods. Management believes that the steps taken to date, along with certain other remediation plans it is currently undertaking, will address the material weaknesses that affected the Company's internal controls over financial reporting in fiscal year 2004 and the first quarter of fiscal 2005. Management will continue with its on-going evaluation and will improve the Company's internal controls over financial reporting as necessary to assure their effectiveness. Notwithstanding, the effectiveness of the Company's system of internal control over financial reporting is subject to certain limitations, including the exercise of management's judgment in evaluating the same. As a result, there can be no assurance that the Company's internal controls over financial reporting will prevent all errors.

Other than the changes described above, there were no changes in our internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**VIISAGE TECHNOLOGY, INC.**

**PART II - OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

In March and April 2005, eight putative class action lawsuits were filed in the United States District Court for the District of Massachusetts against us, Bernard C. Bailey, William K. Aulet and Denis K. Berube and other members of our Board of Directors. A motion has been filed by the so-called Turnberry Group to consolidate these lawsuits into one action under the case name: *Darquea v. Viisage Technology, Inc. et al.*, Civil Action No. 05-10438-MLW. This motion also seeks to have the Turnberry Group designated as lead plaintiff and its counsel designated as lead counsel. The suits allege violations of the federal securities laws by us and certain of our officers and directors arising out of purported misrepresentations in the guidance that we provided on our anticipated financial results for fiscal 2004 following the release of our 2004 second and third quarter results, which allegedly artificially inflated the price of our stock during the period May 3, 2004 through March 2, 2005. We are not able to estimate the amount of the loss allegedly suffered by members of the putative class or the amount of legal costs and internal efforts associated with defending ourselves and our officers and directors. We believe that the allegations and claims made in these lawsuits are wholly without merit and intend to defend the actions vigorously. If we are unsuccessful in defending ourselves in this litigation, these lawsuits could adversely affect our business, financial condition, results of operations and cash flows as a result of the damages that we would be required to pay. It is possible that our insurance policies either may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. In April 2005, two purported shareholder derivative actions also were filed against our directors, naming us as a nominal defendant. The suits claim that these directors breached their fiduciary duties to our shareholders and to the Company generally in connection with the same set of circumstances alleged in the class action lawsuits. The complaints are derivative in nature and do not seek relief from the Company. One of these actions has been filed in Massachusetts Superior Court and the other has been filed in the United States District Court for the District of Massachusetts. We have filed a motion to dismiss the state court action. Our response to the federal court action is not yet due. We believe that the allegations and claims made in these lawsuits are likewise wholly without merit and intend to defend the actions vigorously.

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia's Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers' license program. In July 2003, the court had issued a preliminary injunction prohibiting DMVS from continuing to work with us to install the State's new drivers' license system. In July 2004, we reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay us \$2.0 million in cash and the State agreed to purchase certain equipment from us for \$500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers' license system, but disallowed the \$2.0 million cash payment described above. Without this payment, we believe either that the settlement agreement with DMVS is not effective and that our contract with DMVS remains in place, or that our initial claim for an \$8.2 million settlement payment is revived. The State has paid us the \$500,000 for the equipment and we appealed the disallowance of the \$2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted in a 4-3 decision not to hear our appeal based on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge's ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, we have identified \$2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately \$2.2 million to their estimated fair value of approximately \$200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a \$2.0 million charge in the fourth quarter of 2004. In addition, we have removed the contract from our backlog, and we

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will lose up to \$19.7 million in revenue that we expected to recognize over the next five and one-half years, unless the contract remains in place or we are able to win the new contract for the digital drivers license system and the revenues from such new contract are substantially similar to the prior contract. There are approximately \$2.9 million of system assets remaining on our balance sheet from the Georgia contract. These consist of approximately \$1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately \$150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately \$1.6 million of assets constituting our central production facility in Georgia. We have evaluated these assets for impairment and, based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these assets in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

In May 2005, Viisage, Toppan Printing Co., Ltd. and Fargo Electronics, Inc. agreed to a settlement of the lawsuit Fargo had filed against Toppan and TDT in July 2004 in the U.S. District Court for the Eastern District of Virginia. The lawsuit alleged that a reverse image printer manufactured by Toppan and distributed by TDT infringed four U.S. patents owned by Fargo. The settlement agreement required Toppan to pay a settlement amount to Fargo and granted Fargo distribution rights worldwide outside Japan for the Toppan CP-400 card printer. Additionally, we and Fargo entered into a strategic distribution agreement that allows us to purchase the full line of Fargo printers, become Fargo's exclusive distributor of the Toppan CP-400 card printer to the U.S. federal government and U.S. state drivers license markets, and distribute the Toppan CP-400 printer worldwide outside Japan. As part of this arrangement, we have committed to purchase \$1.0 million of products from Fargo over the next two years and will pay to Fargo a commission on future sales of the Toppan CP-400 printer and consumables for the Department of Defense Common Access Card program.

## **ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

## **ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

For the quarter ended April 3, 2005, we were not in compliance with the covenant under our Loan and Security Agreement with Citizens Bank of Massachusetts that requires us to make timely required filings with the Securities and Exchange Commission as a result of our failure to timely file this Form 10-Q and our Form 10-K for the year ended December 31, 2004. Once we have made these filings, we will be in compliance with all of the covenants under the Loan and Security Agreement. If we do not remain in compliance with the applicable covenants, Citizens could refuse to lend funds to us and could require repayment of any amounts outstanding at the time that we are not in compliance with such covenants. Currently, there are no borrowings outstanding under the Loan and Security Agreement other than a commitment of \$2.3 million in letters of credit issued by Citizens to certain of our customers.

## **ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

## **ITEM 5 OTHER INFORMATION**

None.

**ITEM 6 EXHIBITS**

The exhibits listed in the Exhibits Index immediately preceding such exhibits are filed as part of this report.

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**VIISAGE TECHNOLOGY, INC.**

**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.

Date: June 30, 2005

By: */s/* BERNARD C. BAILEY  
**Bernard C. Bailey**  
**President and Chief Executive Officer**  
**(Principal Executive Officer)**

Date: June 30, 2005

By: */s/* WILLIAM K. AULET  
**William K. Aulet**  
**Senior Vice President and Chief Financial Officer**  
**(Principal Financial Officer)**



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| <b>Exhibit<br/>No.</b> | <b>Note</b> | <b>Description</b>   |
|------------------------|-------------|--|
| 31.1                   | (a)         | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2                   | (a)         | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1                   | (a)         | Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2                   | (a)         | Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

| <b>Note</b> | <b>Description</b> |
|-------------|--------------------|
| (a)         | Filed herewith.    |