Cogent, Inc.
Form 10-Q
November 14, 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 SEPTEMBER 30, 2005

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

Commission file number 000-50947

COGENT, INC.

(Exact name of registrant as specified in its charter)

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

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

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2)

Yes ¨ No x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of November 1, 2005 there were 92,925,077 shares of the registrant s common stock outstanding.

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COGENT, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

COGENT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands, except share data)

(unaudited)

	December 31, 2004	September 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,004	$ 19,610
Investments in marketable securities	167,202	284,951
Billed accounts receivable, net of allowance for doubtful accounts of $229 at December 31, 2004 and $462 at September 30, 2005	14,761	32,368
Unbilled accounts receivable	1,308	1,565
Inventory and contract related costs	35,854	21,189
Prepaid expenses and other current assets	741	6,544
Deferred income taxes	10,744	28,372
Total current assets	257,614	394,599
Investments in marketable securities	28,517	62,944
Inventory and contract related costs	2,126	1,582
Property and equipment, net	8,478	7,273
Restricted cash	561	495
Deferred income taxes	3,568	26,094
Intangible and other assets	30	2,189
Total assets	$ 300,894	$ 495,176
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,790	$ 3,439
Accrued expenses	1,480	7,527
Income taxes payable	6,131	568
Deferred revenues	59,667	46,313
Total current liabilities	70,068	57,847
Deferred revenues	8,762	5,540

Commitments and contingencies (note 14)		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2004 and September 30, 2005, respectively		
Common stock, $0.001 par value; 245,000,000 shares authorized; 80,788,040 and 92,734,800 shares issued and outstanding at December 31, 2004 and September 30, 2005, respectively	120	120
Additional paid-in capital	251,871	412,974
Deferred stock-based compensation	(9,831)	(5,125)
Retained (deficit) earnings	(19,995)	24,622
Accumulated other comprehensive loss	(101)	(802)
Total stockholders equity	222,064	431,789
Total liabilities and stockholders equity	$ 300,894	$ 495,176

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2004	**2005**	**2004**	**2005**
Revenues:				
Product revenues	$ 19,933	$ 32,966	$ 46,248	$ 100,303
Maintenance and services revenues	3,515	5,479	9,660	13,337
Total revenues	23,448	38,445	55,908	113,640
Cost of revenues:				
Cost of product revenues (1)	7,577	8,027	13,094	36,458
Cost of maintenance and services revenues (1)	1,012	1,058	2,538	3,400
Amortization of deferred stock-based compensation	230	155	500	542
Total cost of revenues	8,819	9,240	16,132	40,400
Gross profit	14,629	29,205	39,776	73,240
Operating expenses:				
Research and development (1)	1,998	1,694	5,157	5,390
Selling and marketing (1)	840	1,415	2,444	4,525
General and administrative (1)	986	1,959	2,730	5,426
Amortization of deferred stock-based compensation	2,044	1,177	8,262	4,255
Total operating expenses	5,868	6,245	18,593	19,596
Operating income	8,761	22,960	21,183	53,644
Other income:				
Interest income	106	2,574	196	5,532
Other, net		341	362	737
Total other income	106	2,915	558	6,269
Income before income taxes	8,867	25,875	21,741	59,913
Income tax (benefit) provision	(11,578)	5,771	(10,930)	15,296
Net income	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Basic net income per share	$ 0.33	$ 0.22	$ 0.54	$ 0.51

Diluted net income per share	$ 0.29	$ 0.21	$ 0.47	$ 0.48
Shares used in computing basic net income per share	61,493	92,399	60,501	86,868
Shares used in computing diluted net income per share	70,987	96,079	69,545	93,377
Pro forma net income data (see Note 9)				
Income before income taxes, as reported	$ 8,867		$ 21,741	
Pro forma provision for income taxes	4,234		10,110	
Pro forma net income	$ 4,633		$ 11,631	
Pro forma net income per share				
Basic	$ 0.08		$ 0.19	
Diluted	$ 0.07		$ 0.17	

(1) Excludes amortization of deferred stock-based compensation as follows:

Cost of product revenues	$ 67	$ 50	$ 144	$ 187
Cost of maintenance and services revenues	163	105	356	355
Research and development expenses	519	324	1,331	1,337
Selling and marketing expenses	458	359	1,125	1,182
General and administrative expenses	1,067	494	5,806	1,736
	$ 2,274	$ 1,332	$ 8,762	$ 4,797

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended, September 30,	
	2004	**2005**
Cash Flows from operating activities:		
Net income	$ 32,671	$ 44,617
Adjustments to reconcile net income to net cash provided by operating activities:		
Tax benefit from stock option transactions		60,096
Depreciation and amortization	774	1,365
Allowance for doubtful accounts	52	233
Amortization of deferred stock-based compensation	8,762	4,626
Amortization of bond premium on available for sale securities		(356)
Deferred income taxes	(13,650)	(40,154)
Changes in assets and liabilities:		
Billed accounts receivable	(7,711)	(17,851)
Unbilled accounts receivable	(1,250)	(257)
Inventory and contract related costs	(28,275)	15,527
Prepaid expenses and other current assets	39	(5,799)
Other assets		(468)
Accounts payable	1,870	653
Accrued expenses	3,470	6,036
Income taxes payable	1,068	(5,562)
Deferred revenues	46,453	(16,576)
Net cash provided by operating activities	44,273	46,130
Cash Flows from investing activities:		
Deposit for purchase of building		(1,000)
Proceeds from sale of available-for-sale securities		687,182
Purchase of available-for-sale securities		(839,609)
Restricted cash	(1,400)	
Purchase of Intangible Assets		(750)
Purchase of property and equipment	(4,897)	(413)
Net cash used in investing activities	(6,297)	(154,590)
Cash Flows from financing activities:		
Distributions to stockholders	(77,826)	
Proceeds from the issuance of common stock, net of issuance costs incurred	228,932	96,769
Issuance of shares under ESPP Plan		801
Proceeds from the exercise of stock options	42	3,517
Net cash provided by financing activities	151,148	101,087

Effect of exchange rate changes on cash	(28)	(21)
Net increase in cash and cash equivalents	189,096	(7,394)
Cash and cash equivalents, beginning of period	17,457	27,004
Cash and cash equivalents, end of period	$ 206,553	$ 19,610
Supplemental disclosures of cash flow information:		
Cash received (paid) during the period for:		
Interest income	$ 196	$ 3,868
Income taxes	$ (1,651)	$ (6,465)
Non-cash financing activities:		
Declared but unpaid dividend to stockholder	$ 1,800	$
Deferred stock-based compensation, net	17,828	
Capitalized deferred stock-based compensation (Inventory & contract related costs)	$	$ 65
Conversion of property and equipment to inventories	$	$ 317

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. General

Company Background

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

Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2005 and the condensed consolidated statements of operations for the three and nine months ended September 30, 2004 and 2005 and condensed consolidated statements of cash flows for the nine months ended September 30, 2004 and 2005 are unaudited. These statements should be read in conjunction with the audited consolidated financial statements and related notes, together with management s discussion and analysis of financial position and results of operations, contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 22, 2005.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or (GAAP). In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2004 and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of September 30, 2005, its results of operations for the three and nine months ended September 30, 2004 and 2005 and its cash flows for the nine months ended September 30, 2004 and 2005. The condensed consolidated balance sheet as of December 31, 2004 has been derived from the December 31, 2004 audited financial statements. The interim financial information contained in this quarterly report is not necessarily indicative of the results to be expected for any other interim period or for the entire year.

In the accompanying condensed consolidated statement of cash flows for the nine months ended September 30, 2005, the Company changed the classification of changes in restricted cash balances in the statement of cash flows to present such changes as an investing activity. The Company previously presented such changes as an operating activity. In the accompanying condensed consolidated statements of cash flows for the nine months ended September 30, 2004, the Company reclassified changes in restricted cash balances to be consistent with its 2005 presentation which resulted in a $1,400,000 decrease to investing cash flows and a corresponding increase to operating cash flows from the amounts previously reported.

Concentration

The Company derives a significant portion of its revenues from a limited number of customers. For the three months ended September 30, 2004 and 2005, the Company had one and two customers that collectively accounted for 64% and 72% of revenues for those periods, respectively. For the nine months ended September 30, 2004 and 2005, the Company had two customers that collectively accounted for 59% and 76% of revenues for those periods, respectively.

Note 2. Recent Accounting Pronouncements

In July 2004, the Emerging Issues Task Force (EITF) published its consensus on Issue No. 03-01, The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments. EITF Issue No. 03-01 addresses the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities certain debt and equity securities within the scope of SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting. However, implementation guidance related to this consensus was requested. In

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November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 115-1 and 124-1 which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005. The Company continues to assess the potential impact that the adoption of this FSP could have on its financial statements.

In December 2004, the FASB issued SFAS 123 (Revised 2004)-Share Based Payment (SFAS 123R). SFAS 123R requires that the Company record stock option expense in its financial statements based on a fair value methodology. In March 2005 the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107. SAB 107 expresses views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules. In April 2005, the SEC adopted a rule that delayed the compliance dates for adoption of SFAS 123R. The SEC s rule allows companies to implement SFAS 123R at the beginning of the next fiscal year after September 15, 2005, which is January 1, 2006 for the Company. The Company is evaluating the impact of the new standard and the method and timing of adoption. Although the Company has not completed its analysis, it is anticipated that the expense related to stock options will increase under the new pronouncement, however, it cannot be quantified at this time.

In November 2004, the FASB issued SFAS No. 151 Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe SFAS No. 151 will have a significant impact on the Company s consolidated results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 replaces Accounting Principles Board (APB) Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Company is required to adopt SFAS No. 154 for accounting changes and error corrections at the beginning of the next fiscal year after December 15, 2005, which is January 1, 2006 for the Company. The Company s results of operations and financial condition will only be impacted by SFAS No. 154 if it implements changes in accounting principles that are addressed by the standard or corrects accounting errors in future periods.

Note 3. Stock-Based Compensation

The Company has two stock option plans, the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, which authorize the issuance of stock options, restricted stock and other stock-based incentives to employees. The Company accounts for these plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under APB Opinion No. 25, compensation for employee common stock option grants is calculated as the difference, if any, on the date of grant, between the fair value of the Company s common stock and the exercise price of the option. Stock-based compensation related to employee option grants is recorded on the grant date as deferred stock-based compensation, which is classified as a separate component of stockholders equity, and is amortized to expense based on the multiple option model, which results in more compensation expense being attributed to an option s initial vesting periods when compared to the straight-line method. The Company accounts for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

In accordance with SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the following pro forma net income and earnings per share information is presented as if the Company accounted for stock-based compensation awarded under the stock incentive plans using the fair value method. Under the fair value method, the estimated fair value of stock incentive awards is charged against income using the multiple option model over the vesting period.

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
	(in thousands, except per share data)			
Net income as reported	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Add: Total stock-based employee compensation expense included in reported net income net of related tax effects	1,891	1,267	6,945	4,545
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards net of the related tax effects	(2,151)	(1,643)	(7,761)	(5,207)
Pro forma net income	$ 20,185	$ 19,728	$ 31,855	$ 43,955
Net Income per share				
Basic as reported	$ 0.33	$ 0.22	$ 0.54	$ 0.51
Basic pro forma	$ 0.33	$ 0.21	$ 0.53	$ 0.51
Diluted as reported	$ 0.29	$ 0.21	$ 0.47	$ 0.48
Diluted pro forma	$ 0.28	$ 0.21	$ 0.46	$ 0.47

The Company used the Black-Scholes option-pricing model with the following weighted-average assumptions in determining the pro forma compensation costs:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Risk-free interest rate	2.92%	4.05%	2.56%	3.90%
Dividend yield	0.00%	0.00%	0.00%	0.00%
Expected life (years)	3.0	4.0	3.05	4.0
Volatility	88%	82%	94%	83%

The weighted-average estimated fair value of options granted was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Weighted average fair value	$ 5.52	$ 16.56	$ 7.19	$ 15.77

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Note 4. Fair Value of Investments in Marketable Securities

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

	As of December 31, 2004	As of September 30, 2005
	(in thousands)	
Type of Security:		
Short-term instruments	$ 24,368	$ 109,229
Corporate debt securities with maturities of less than one year	58,962	82,698
Municipal securities with maturities of less than one year	75,460	61,718
U.S. government securities with maturities of less than one year	8,412	31,306
Total short-term investments	167,202	284,951
Corporate debt securities with maturities between one and three years	15,015	33,882
Municipal securities with maturities between one and three years	12,011	2,001
U.S. government securities with maturities between one and three years	1,491	27,061
Total long-term investments	28,517	62,944
	$ 195,719	$ 347,895

These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of stockholders equity. At December 31, 2004 and September 30, 2005, the gross unrealized loss on available-for-sale securities totaled $142,000 and $1,225,000, respectively. The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses are reported in other income and expense. Realized losses were approximately $13,000 for the three and nine months ended September 30, 2005, respectively. The Company s short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper.

Note 5. Inventory and Contract Related Costs

Inventory and contract related costs consist of the following:

As of December 31, 2004	As of September 30, 2005
(in thousands)	

Materials and components	$ 1,398	$ 1,089
Inventories and costs related to long-term contracts	1,257	174
Deferred costs of revenues	35,325	21,508
	$ 37,980	$ 22,771

Materials and components are stated at the lower of cost or market determined using the first-in, first-out method. Inventoried costs relating to long-term contracts are stated at actual production costs incurred to date reduced by amounts identified with revenue recognized on progress completed. Deferred costs of revenue relate to contracts for which revenue has been deferred, and such costs are stated at actual production costs incurred to date, which primarily include materials, labor and subcontract costs which are directly related to the contract. Deferred costs of revenue are amortized to cost of revenues at the time revenue is recognized. The long-term component of inventory and contract related costs of $2,126,000 and $1,582,000 at December 31, 2004 and September 30, 2005, respectively, consists of deferred costs relating to contracts where revenue recognition is deferred beyond one year (see Note 10).

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Note 6. Net Income Per Share

The Company calculates net income per share in accordance with SFAS No. 128, Earnings Per Share . Under SFAS No. 128, basic net income per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share reflects the effects of potentially dilutive securities, which consist of stock options. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
	(in thousands, except per share data)			
Numerator:				
Net income available to common stockholders	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Denominator:				
Denominator for basic net income per share weighted average shares	61,493	92,399	60,501	86,868
Dilutive potential common stock				
Stock options	9,494	3,680	9,044	6,509
Denominator for diluted net income per share adjusted weighted average shares	70,987	96,079	69,545	93,377
Basic net income per share	$ 0.33	$ 0.22	$ 0.54	$ 0.51
Diluted net income per share	$ 0.29	$ 0.21	$ 0.47	$ 0.48

During the three and nine months ended September 30, 2005, options to purchase 14,000 and 85,000 shares of common stock were outstanding as of September 30, 2005 but were not included in the computation of diluted earnings per share because the options exercise price was greater than the average market price of the common shares for each of these respective periods.

Note 7. Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005

	(In thousands)		(In thousands)	
Net income	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Other comprehensive income (loss):				
Change in unrealized loss, net of tax		(128)		(608)
Change in foreign currency translation adjustment	1	7	(40)	(94)
Total comprehensive income	$ 20,446	$ 19,983	$ 32,631	$ 43,915

Note 8. Income Taxes

Prior to the Company s initial public offering, the Company elected to be treated as an S Corporation for U.S. federal income tax purposes. Under this election, the Company s stockholders, rather than the Company, were subject to federal income taxes on their respective share of the Company s taxable income. The Company elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at the corporate level of 1.5%. The Company was also subject to state income taxes in various other states in which it does business.

Effective September 22, 2004, the Company terminated its S Corporation status. As a result of the termination of the Company s S Corporation status, the Company is subject to federal and certain state income taxes at the corporate level at statutory rates.

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During the three and nine months ended September 30, 2005, the Company experienced disqualifying dispositions of incentive stock options. Disqualifying dispositions result in a tax deduction on the Company s corporate tax return equal to the intrinsic value of the option at exercise. To the extent the Company recorded stock-based compensation expense related to disqualifying dispositions of incentive stock options, the Company recorded the benefit from the disqualifying disposition of incentive stock options as a reduction to the Company s provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the financial statements is credited to additional paid-in capital.

During the nine months ended September 30, 2005, a total of 7,868,208 stock options were exercised resulting in net proceeds to the Company of $3,517,000. As a result of the disqualifying dispositions of incentive stock options during the three and nine months ended September 30, 2005, the Company recorded tax benefits from stock option transactions which totaled approximately $10.9 million and $60.1 million, respectively, as a credit to additional paid-in capital. Additionally, as a result of the tax benefits from stock option transactions, the Company recorded a $39.7 million increase in the deferred tax asset balance as of September 30, 2005. The Company s effective tax rates for the three and nine months ended September 30, 2005 were less than the statutory rate primarily as a result of the tax benefit resulting from the disqualifying dispositions and research and development tax credits.

Note 9. Pro Forma Net Income and Pro Forma Net Income Per Share

Pro forma net income reflects the income tax expense that would have been reported by the Company had it been subject to income taxes at the corporate level during the three and nine months ended September 30, 2004.

Pro forma net income per share is computed by dividing the pro forma net income available to common stockholders for the period by the weighted average number of shares of common shares and potentially dilutive common shares outstanding during the period.

Note 10. Deferred Revenues and Deferred Costs

In the third quarter of 2004, the Company entered into contracts with a total value of approximately $54 million with the National Electoral Council (CNE) of Venezuela. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contracts also provided for the short-term lease of equipment to be used by the CNE in connection with the October 15, 2004 Venezuela national election. The estimated value of the lease component of approximately $7.0 million, which was based upon an independent valuation, was recognized as revenue in the third quarter of fiscal 2004. Because vendor-specific objective evidence (VSOE) of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component was amortized over the life of the contracts. During the three and nine months ended September 30, 2004, the Company recognized approximately $15.0 million of revenue related to these contracts. During the three and nine months ended September 30, 2005, the Company recognized approximately $3.9 million and $27.6 million of revenue, respectively, representing the ratable recognition of the total remaining value of the contracts over the one-year maintenance period. As of September 30, 2005, all revenue and costs associated with these contracts have been recognized.

In the fourth quarter of 2004, the Company entered into a contract with a total value of approximately $20.2 million with the CNE. The contract required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the October 31, 2004 Venezuela regional elections. The estimated value of the lease component of approximately $3.7 million, which was based upon an independent valuation, was recognized as revenue in the fourth quarter of fiscal 2004. Because VSOE of the maintenance element of this contract does not

exist, all revenue in excess of the fair value of the lease component is being amortized over the life of the contract. During the three and nine months ended September 30, 2005, the Company recognized approximately $4.2 million and $12.3 million, respectively, of revenue representing the ratable recognition of the total remaining value of the contract over the one-year maintenance period. The remaining $1.4 million of the contract value is included in deferred revenue at September 30, 2005. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In the second quarter of 2005, the Company entered into contracts with a total value of approximately $31.8 million with the CNE. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the August 7, 2005 Venezuela local elections. The estimated value of the lease

component of approximately $3.0 million, which was based upon an independent valuation and relative fair value analysis of the contract components, was recognized as revenue in the third quarter of fiscal 2005. Because VSOE of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component will be amortized over the life of the contract once all software deliverables have been accepted by the customer. As of September 30, 2005, the Company has not completed all software deliverables required under the contract with CNE; therefore, no revenue in excess of the fair value of the lease component was recognized during the three and nine months ended September 30, 2005. As of September 30, 2005, deferred revenue related to this contract totaled $25.9 million. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately $15 million with a domestic customer to provide a customized AFIS solution for which VSOE of the maintenance element did not exist. Revenue from this contract is being recognized ratably over the contractual maintenance period of five years, commencing upon the acceptance of the AFIS solution by the customer in October 2003. During the three and nine months ended September 30, 2004, the Company recognized $707,000 and $2.1 million of revenue related to this contract, respectively. During the three and nine months ended September 30, 2005, the Company recognized $707,000 and $2.1 million of revenue related to this contract, respectively. As of December 31, 2004 and September 30, 2005, deferred revenue related to this contract totaled approximately $9.3 million and $7.6 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately $10 million with a domestic customer to provide a customized AFIS solution. This contract includes provisions that could require a refund of the entire contract value in the event of non-performance by the Company during the contract term. As a result of the refund provision, in accordance with of Statement of Position (SOP) 97-2, Software Revenue Recognition, the Company is deferring recognition of revenue from the contract until the expiration of the refund provision, which is expected to expire in the quarter ending December 31, 2005. As of December 31, 2004 and September 30, 2005, deferred revenue related to this contract totaled approximately $6.5 million and $6.8 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues upon the expiration of the refund provisions.

Note 11. Employee Stock Purchase Plan

In May 2004, the Company s board of directors and stockholders adopted the 2004 Employee Stock Purchase Plan (the Purchase Plan) which became effective immediately upon the closing of the Company s initial public offering. The Purchase Plan was intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. A total of two million shares of common stock were initially authorized and reserved for sale under the Purchase Plan. The Purchase Plan permitted eligible employees to purchase shares of common stock at a fifteen percent (15%) discount through payroll deductions during sequential six month offering periods. Unless the Board established a higher price, the price at which shares were purchased under the Purchase Plan for such six month offering period was equal to 85% of the lesser of the fair market value of the common stock on the first day of such offering period or the purchase date, which was the last day of the offering period.

Pursuant to a resolution by the Company s Board of Directors, the purchase plan was terminated on April 30, 2005.

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Note 12. Segment Information

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

	Three Months Ended September 30, 2004				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 17,721	$ 49	$ 3	$ 2,160	$ 19,933
Maintenance and services revenues	2,898	333	284		3,515
Total	$ 20,619	$ 382	$ 287	$ 2,160	$ 23,448

	Three Months Ended September 30, 2005				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 31,278	$ 846	$ 842	$	$ 32,966
Maintenance and services revenues	4,702	401	175	201	5,479
Total	$ 35,980	$ 1,247	$ 1,017	$ 201	$ 38,445

	Nine Months Ended September 30, 2004				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 38,258	$ 3,851	$ 443	$ 3,696	$ 46,248
Maintenance and services revenues	8,195	840	625		9,660
Total	$ 46,453	$ 4,691	$ 1,068	$ 3,696	$ 55,908

	Nine Months Ended September 30, 2005				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 94,806	$ 927	$ 2,670	$ 1,900	$ 100,303
Maintenance and services revenues	10,980	1,496	449	412	13,337
Total	$ 105,786	$ 2,423	$ 3,119	$ 2,312	$ 113,640

At December 31, 2004 and September 30, 2005, the Company s property and equipment, net of accumulated depreciation and amortization in the United States was approximately $5,505,000 and $5,282,000, respectively. At December 31, 2004 and September 30, 2005, the Company s property and equipment, net of accumulated depreciation and amortization in foreign countries was approximately $2,974,000 and $1,991,000, respectively. At September 30, 2005, the Company s intangible assets in the United States, net of accumulated amortization, were approximately $688,000.

Note 13. Public Offering

In June 2005, the Company completed an underwritten public offering of 12,650,000 shares of common stock (of which 4,000,000 shares were primary shares sold by the Company and 8,650,000 shares were secondary shares sold by selling stockholders), including the underwriters exercise of an over-allotment option to purchase up to 1,650,000 shares from a selling stockholder, at a price to the public of $25.50 per share. The Company raised a total of $102,000,000 in gross proceeds in the public offering. After deducting the underwriting discount of $4,335,000 and offering expenses of $896,000, net proceeds to the Company were $96,769,000.

Note 14. Commitments and Contingencies

The Company periodically evaluates all pending or threatened contingencies and any commitments, if any, which are reasonably likely to have a material adverse effect on its operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies. If information available prior to the issuance of the Company s financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred

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at the date of the Company s financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

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

Note 15. Subsequent Event

On September 29, 2005, the Company agreed to purchase a facility for $26.0 million in cash. The purchase of the property provides for the expansion of the Company s workforce in Pasadena, California. The purchase was closed on October 7, 2005 at which time the total purchase price less a $1.0 million deposit was paid. As of September 30, 2005, the $1.0 million property deposit is reflected on the balance sheet as intangible and other assets.

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

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

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

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, under the caption Risk Factors, and the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2004, previously filed with the Securities and Exchange Commission.

Overview

We are a leading provider of advanced Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. We were incorporated and commenced operations in 1990. We have been researching, designing, developing and marketing AFIS and other fingerprint biometrics solutions since inception. During most of our operating history, we have achieved positive income and cash flows from operations. We experienced a significant increase in our revenues and net income since the fourth quarter of 2003 as the market for our AFIS and other fingerprint biometric solutions expanded primarily due to increased demand by the Department of Homeland Security, or DHS, as well as the National Electoral Council of Venezuela, or CNE. There can be no assurance that our revenues or net income will continue to grow at the same rates as in the past or at the rate we expect or that we will achieve similar results in future periods.

Sources of Revenue

Revenues. We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator, or PMA, servers and other AFIS equipment, including work stations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. To a lesser extent, we generate product revenues from sales of our proprietary biometrics application specific integrated circuit, or ASIC, and biometrics products that incorporate our ASIC. Revenues from sales of our ASIC and products that incorporate our ASIC have historically been immaterial and accounted for less than 1% of our total revenue in both 2004 and the nine months ended September 30, 2005. We generate maintenance revenues from maintenance contracts that are typically included with the sale of our AFIS solutions. Maintenance contracts for technical support and software updates generally cover a period of one year, and after contract expiration, our customers have the right to purchase maintenance contract renewals, which generally cover a period of one year. Revenues from maintenance contracts are deferred and amortized on a straight-line basis over the life of the maintenance obligation. We generate services revenues from engineering services and AFIS system operation services that are not an element of an arrangement for the sale of products. These services are typically performed under fixed-price and time-and-material agreements.

We market our solutions primarily to U.S. and foreign government agencies and law enforcement agencies. In a typical contract with a government agency for an initial AFIS deployment, we agree to design the AFIS, supply and install equipment and software and integrate the AFIS within the agency s existing network infrastructure. These initial deployment contracts frequently require significant modification or customization of our solution as part of our integration services. These contracts provide for billings up to a fixed price total contract value upon completion of agreed milestones or deliveries, with each milestone or delivery typically having a value specified in the contract. These customers usually impose specific performance and acceptance criteria that must be satisfied prior to invoicing for each milestone or delivery. When customers purchase AFIS solutions that do not require significant modification or customization of our software,

whether as an initial deployment or as an expansion of an existing AFIS, we typically agree to deliver the products and perform limited installation services subject to customer-specific acceptance criteria. Certain of our customers, including the DHS, submit purchase orders under blanket purchase order agreements. Blanket purchase order agreements set out the basic terms and conditions of our arrangement with the customer and simplify the procedures for ordering our products to avoid administrative processes that would otherwise apply, particularly with the federal government. The billing of these contracts is generally tied to delivery and acceptance of specific AFIS equipment, usually our PMA servers or live-scans. Most of our contracts for AFIS solutions also include an ongoing maintenance obligation that we honor over a term specified in the deployment contract or the blanket purchase order agreement. The nature of our business and our customer base is such that we negotiate a set of unique terms for each contract that are based upon the purchaser s standard form of documentation.

Our growth in revenues since the fourth quarter of 2003 is due principally to increased demand by the DHS and the CNE for our AFIS solutions. The DHS uses our solutions in connection with the implementation of the United States Visitor and Immigrant Status Indicator Technology, or US-VISIT, program, and the CNE uses our solutions for national and regional elections. We anticipate that both of these customers will account for a significant portion of our revenues for the foreseeable future. We do not have any long-term contracts with the DHS or the CNE for the sale of our products, and our future sales to the DHS and the CNE will depend upon the receipt of new orders. Any delay or other change in the rollout of US-VISIT or any failure to obtain new orders from the CNE could cause our revenues to fall short of our expectations.

We also expect to experience increased demand from a number of other governments as they deploy AFIS solutions in elections and, at points of entry and exit, including borders, seaports and airports, and in connection with national identification programs. Notwithstanding our expectations regarding demand for these solutions, the quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations. Government contracts for security solutions in elections and at points of entry and exit are typically awarded in open competitive bidding processes. Therefore, our future level of sales of AFIS solutions for deployments in elections and at points of entry and exit may vary substantially, and will depend on our ability to successfully compete for this business.

Cost of Revenues and Operating Expenses

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

Research and Development. Research and development expenses consist primarily of salaries and related expenses for engineering personnel, fees paid to consultants and outside service providers, depreciation of development and test equipment, prototyping expenses related to the design, development, testing and enhancements of our products, and the cost of computer support services. We expense all research and development costs as incurred. Under our customer contracts, we typically obtain the rights to use any improvements to our technology developed on a particular customer deployment on other customer deployments. As a result, we have historically been able to moderate our research and development expenses by leveraging the improvements developed by our personnel working on customer engagements. Research and development expenses do not include amortization of deferred stock-based compensation allocable to personnel performing services related to research and development.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses do not include amortization of deferred stock-based compensation allocable to personnel performing services related to sales and marketing.

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General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses do not include amortization of deferred stock-based compensation allocable to personnel performing general and administrative services.

Amortization of Deferred Stock-Based Compensation. In connection with the grant of stock options during the year ended December 31, 2004, and the nine months ended September 30, 2005, we recorded $17.9 million and $0 in deferred stock-based compensation within stockholders equity, respectively. Options issued during the year ended December 31, 2004 were considered compensatory because the deemed fair value of the underlying common stock for financial reporting purposes was greater than the exercise prices determined by the board of directors on the date of grant. The determination of the fair value prior to our initial public offering of the underlying shares of common stock involves subjective judgment and the consideration of a variety of factors, including our historical and anticipated operating results and the earnings and revenue multiples implicit in the trading prices of securities of comparable companies. Because there was no public market for our common stock prior to our initial public offering, the amount of the compensatory charge is not based on an objective measure such as the trading price of our common stock. For the nine months ended September 30, 2004 and 2005, we recognized expense for amortization of deferred stock compensation of $8.8 million and $4.8 million, respectively. As of September 30, 2005, we had an aggregate of $5.1 million of deferred stock-based compensation remaining to be amortized. This deferred compensation balance will be amortized as follows: $1.1 million in the remainder of 2005; $2.9 million in 2006; $1.0 million in 2007; and $61,000 in 2008. We are amortizing the deferred compensation on an accelerated basis over the vesting period of the related options, which is generally four years. The amount of stock-based compensation amortization actually recognized in future periods could decrease if options for which accrued but unvested deferred compensation has been recorded are forfeited.

Prior S Corporation Status

In 1992, we elected to be treated for federal and certain state income tax purposes as an S Corporation under Subchapter S of the Internal Revenue Code of 1986, as amended, or the Code, and comparable state laws. As a result, our earnings since such initial election and through September 21, 2004, were included in the taxable income of our stockholders for federal and certain state income tax purposes, and we were subject only to reduced amounts of state income tax on such earnings. By reason of our treatment as an S Corporation for federal and state income tax purposes, since 1992 we have paid dividends to our stockholders. We terminated our S Corporation status effective September 22, 2004, and beginning on that date we were and are treated for federal and state income tax purposes as a C Corporation under Subchapter C of the Code and, as a result, are now subject to state and federal income taxes.

We declared as a dividend to Ming Hsieh, our sole stockholder prior to our initial public offering, the undistributed balance of our federal tax-exempt earnings and taxable earnings included or includable in the taxable income of our stockholders as a result of our S Corporation status through December 31, 2003. We also declared as a dividend to Mr. Hsieh in the same manner and at the same time our estimate of such amounts for the period beginning on January 1, 2004 and ending on the day before we terminated our S Corporation election (September 22, 2004). The total final dividend was $65.5 million.

We have entered into a tax matters agreement with Mr. Hsieh pursuant to which we have agreed, among other things, to indemnify Mr. Hsieh and Mr. Hsieh has agreed to indemnify us against certain income tax consequences which may occur if a taxing authority increases our income for tax periods prior to or after the termination of our S election, as applicable, but only to the extent of the actual tax benefit, if any, to the indemnifying party attributable to the circumstances resulting in additional tax to the indemnified party. Mr. Hsieh has further agreed to indemnify us for any tax liability resulting from our failure to qualify as an S Corporation at the initial election or at any time prior to the our termination of our S Corporation status.

All pro forma income taxes and pro forma net income data reflect adjustments for federal and state income taxes as if we had been taxed as a C Corporation rather than an S Corporation.

Application of Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to percentage-of-completion, bad debts, inventories,

investments, income taxes, commitments, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

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

Revenue Recognition. Because our proprietary software is essential to the functionality of our AFIS solutions and other biometrics products, we apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. For arrangements that require significant production, modification, or customization of software, we apply the provisions of Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. To the extent an element within our software arrangements falls within a level of accounting literature that is higher than SOP 97-2, we record revenue on such element in accordance with the relevant authoritative literature. For arrangements that contain the lease of equipment, we account for the lease element in accordance with SFAS No. 13 Accounting for Leases and account for the remaining elements in the arrangement in accordance with SOP 97-2. The application of the appropriate accounting principle to our revenue is dependent upon the specific transaction and whether the sale includes systems, software and services or a combination of these items. As our business evolves, the mix of products and services sold will impact the timing of when revenue and related costs are recognized. Additionally, revenue recognition involves judgments, including estimates of costs to complete contracts accounted for using the percentage of completion method of accounting and assessments of the likelihood of nonpayment. We analyze various factors, including a review of specific transactions, the credit-worthiness of our customers, our historical experience and market and economic conditions. Changes in judgments on these factors could materially impact the timing and amount of revenue and costs recognized.

Product Revenues

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

- Revenues associated with AFIS solutions that do not require significant modification, or customization of our software, exclusive of amounts allocated to maintenance for which we have vendor-specific objective evidence of fair value, or VSOE, is recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided

all other criteria for revenue recognition have been met. For example, we recognize revenue in this manner from sales of our PMA servers to the DHS under our blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

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

Revenue associated with the sale of our ASIC applications and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable. We recognize revenue in this manner upon shipment of our BioGate and MobileIdent products. The amount of these revenues has historically not been significant.

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

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

Maintenance Revenues

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

Services Revenues

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

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

Revenue Recognition Criteria

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

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

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

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

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

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Deferred Revenues

Our deferred revenue balance results primarily from payments received from customers in advance of recognition of the related revenue and, to a lesser extent, from invoicing of customers prior to recognition of the related revenue. For example, certain customers, such as the CNE, make upfront payments resulting in cash collected prior to our recognition of revenue. These payments can be significant. We record this upfront payment as deferred revenue and reduce the deferred revenue balance as revenue is recognized. As a result, our deferred revenue balance fluctuates from quarter to quarter because it is a function of the timing of (i) the receipt of cash payments from those customers who pay in advance of revenue recognition, (ii) invoicing of customers in advance of revenue recognition and (iii) amortization of deferred revenues into revenues. Deferred revenues also consist of payments received in advance from our customers for maintenance agreements, under which revenues are recognized ratably over the term of the maintenance period. However, the fluctuation in the deferred revenue balance from quarter to quarter is generally not significantly affected by the deferred maintenance revenue. Because the mix of customers who pay or are invoiced in advance of revenue recognition changes from period to period, fluctuations in our deferred revenue balance are not a reliable indicator of total revenue to be recognized in any future period. Our cash flow from operations is also affected each quarter as a result of fluctuations in the deferred revenue balance.

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

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

Accounting for Taxes. In preparing our consolidated financial statements, we estimate our income tax liability in each of the jurisdictions in which we operate by estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. As of September 30, 2005, our net deferred tax assets were approximately $54.5 million. Management judgment is required in assessing the realizability of our deferred tax assets. In performing this assessment, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from our estimates or we adjust our estimates in future periods, we may need to make or adjust valuation allowances with respect to our deferred tax assets, which could materially impact our financial position and results of operations. Our income tax provision is based on calculations and assumptions that may be subject to examination by the Internal Revenue Service and other tax authorities. Should the actual results differ from our estimates, we would have to adjust the income tax provision in the period in which the facts that give rise to the revision become known. Tax law and rate changes are reflected in the income tax provision in the period in which such changes are enacted.

Our effective tax rate for the first nine months of 2005, and for the remainder of 2005, has been and is expected to continue to be impacted as a result of the disqualifying disposition of incentive stock options and research and development tax credits. We expect our effective tax rate to fluctuate from quarter to quarter primarily as a result of disqualifying dispositions that may continue to occur related to incentive stock options

currently outstanding. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place thus impacting the effective tax rate on a quarterly basis. The benefit resulting from disqualifying dispositions results in a tax deduction on our corporate tax return with no expense recorded in our consolidated financial statements. To the extent we have previously recorded stock-based compensation expense related to incentive stock options in our consolidated financial

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statements, we record the benefit from the disqualifying disposition of incentive stock options as a reduction to our provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the consolidated financial statements is credited to additional paid-in capital. As a result of the disqualifying dispositions of incentive stock options during the nine months ended September 30, 2005, the Company recorded a tax benefit from stock option transactions which totaled approximately $60.1 million as a credit to additional paid-in capital.

Accounting for Stock-Based Compensation. We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations, and comply with the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. Under APB Opinion No. 25, compensation cost, if any, is recognized over the respective vesting period based on the difference between the deemed fair value of our common stock and the exercise price on the date of grant. The determination of the volatility, expected term and other assumptions used to determine the fair value of stock options granted under SFAS 123 for footnote disclosure purposes involves subjective judgment and the consideration of a variety of factors, including our historical stock price, option exercise activity to date and the review of assumptions used by comparable companies. We have recorded compensation charges for issuances of stock awards where the exercise price was less than the deemed fair value of the underlying stock for financial accounting purposes. See Costs of Revenues and Operating Expenses Amortization of Deferred Stock-Based Compensation.

We account for stock options issued to non-employees, in which goods or services are the consideration received for the equity instruments issued, in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. See Recent Accounting Pronouncements.

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Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Consolidated Statements of Operations Data:				
Revenues:				
Product revenues	85.0%	85.7%	82.7%	88.3%
Maintenance and services revenues	15.0	14.3	17.3	11.7
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				