VIISAGE TECHNOLOGY INC
Form 10-Q
August 13, 2003
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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 Quarter Ended June 29, 2003.**

**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** | **04-3320515** |

| | |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **30 Porter Road, Littleton, MA** | **01460** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**(978) 952-2200**

**Registrant s telephone number, including area code**

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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. þ 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 þ No

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

| Class | Outstanding at August 11, 2003 |
|---|---|
| **Common stock, $.001 par value** | **20,360,840** |

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**VIISAGE TECHNOLOGY, INC.**

**FORM 10 Q FOR THE QUARTER ENDED JUNE 29, 2003**

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**PART 1 FINANCIAL INFORMATION**

**ITEM 1 FINANCIAL STATEMENTS**

**VIISAGE TECHNOLOGY, INC.**

**Consolidated Balance Sheets**

**(in thousands)**

| | June 29, 2003 (Unaudited) | *December 31, 2002 |
|---|---|---|
| **Assets** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 1,173 | $ 2,212 |
| Restricted cash | | 1,241 |
| Accounts receivable | 6,805 | 7,360 |
| Costs and estimated earnings in excess of billings | 24,406 | 23,372 |
| Other current assets | 591 | 339 |
| Total current assets | 32,975 | 34,524 |
| Property and equipment, net | 15,454 | 16,629 |
| Intangible assets, net | 3,018 | 3,147 |
| Restricted cash | 5,120 | 6,163 |
| Other assets | 1,887 | 726 |
| | $ 58,454 | $ 61,189 |
| **Liabilities and Shareholders Equity** | | |
| Current Liabilities: | | |
| Accounts payable and accrued expenses | $ 7,371 | $ 7,017 |
| Current portion of project financing | 6,174 | 5,263 |
| Total current liabilities | 13,545 | 12,280 |
| Project financing | 8,839 | 9,845 |
| Total liabilities | 22,384 | 22,125 |
| Shareholders equity | 36,070 | 39,064 |
| | $ 58,454 | $ 61,189 |

* Derived from audited financial statements.

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

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**VIISAGE TECHNOLOGY, INC.**

**Consolidated Statements of Operations**

**(in thousands, except per share data)**

**(Unaudited)**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 29, 2003 | June 30, 2002 | June 29, 2003 | June 30, 2002 |
| Revenues | $ 10,184 | $ 9,038 | $ 18,775 | $ 15,437 |
| Cost of revenues | 8,193 | 7,468 | 14,787 | 12,553 |
| Gross margin | 1,991 | 1,570 | 3,988 | 2,884 |
| Operating Expenses: | | | | |
| Sales and marketing | 1,138 | 1,700 | 2,549 | 2,562 |
| Research and development | 937 | 1,315 | 1,882 | 1,821 |
| General and administrative | 1,033 | 1,136 | 2,126 | 1,734 |
| Total operating expenses | 3,108 | 4,151 | 6,557 | 6,117 |
| Operating loss | (1,117) | (2,581) | (2,569) | (3,233) |
| Interest expense | 231 | 224 | 450 | 429 |
| Loss before income taxes | (1,348) | (2,805) | (3,019) | (3,662) |
| Provision for income taxes | | | 63 | |
| Net loss | (1,348) | (2,805) | (3,082) | (3,662) |
| Net loss per basic and diluted shares | $ (0.07) | $ (0.14) | $ (0.15) | $ (0.18) |
| Weighted average basic and diluted shares | 20,351 | 19,960 | 20,305 | 19,891 |

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

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**VIISAGE TECHNOLOGY, INC.**

**Consolidated Statements of Cash Flows**

**(in thousands)**

**(Unaudited)**

| | Six Months Ended | |
|---|---|---|
| | **June 29, 2003** | **June 30, 2002** |
| **Cash Flows from Operating Activities:** | | |
| Net loss | $ (3,082) | $ (3,662) |
| Adjustments to reconcile net loss to net cash provided by (used for) operating activities, net of effects of acquisitions: | | |
| Depreciation and amortization | 4,056 | 2,855 |
| Directors fees paid in common stock | 120 | 170 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 555 | (1,006) |
| Costs and estimated earnings in excess of billings | (1,034) | (2,393) |
| Other current assets | (371) | (564) |
| Accounts payable and accrued expenses | 354 | 1,309 |
| Net cash provided by (used for) operating activities | 598 | (3,291) |
| **Cash Flows from Investing Activities:** | | |
| Decrease in restricted cash | 2,284 | |
| Additions to property and equipment | (2,039) | (913) |
| Cash paid for an acquisition | | (2,747) |
| Cash paid for acquisition expenses | (758) | |
| Increase in other assets | (533) | (208) |
| Net cash used for investing activities | (1,046) | (3,868) |
| **Cash Flows from Financing Activities:** | | |
| Net proceeds from long-term borrowing | 2,018 | |
| Principal payments on project financing | (2,697) | (2,148) |
| Net proceeds from issuance of common stock | 88 | 603 |
| Net cash used for financing activities | (591) | (1,545) |
| Net decrease in cash and cash equivalents | (1,039) | (8,704) |
| Cash and cash equivalents, beginning of period | 2,212 | 20,662 |
| Cash and cash equivalents, end of period | $ 1,173 | $ 11,958 |
| **Supplemental Cash Flow Information:** | | |
| Cash paid during the period for interest | $ 471 | $ 431 |
| **Non Cash Activities:** | | |
| Equipment purchased under capital leases | $ 584 | $ |

| | | |
|---|---|---|
| Directors fees paid in common stock | $ 120 | $ 170 |
| Services paid in common stock | $ | $ 320 |
| Net assets acquired from Lau Technologies | $ | $ 1,384 |

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

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**VIISAGE TECHNOLOGY, INC.**

**Notes To Financial Statements**

## 1. DESCRIPTION OF BUSINESS

We are the leading provider of advanced technology solutions for identity verification. We focus on identification solutions that improve personal convenience and security, deter fraud, and reduce identification program costs. We combine our systems integration and software design capabilities with our proprietary software and hardware products and other industry standard products to create complete customized solutions. These turnkey solutions integrate image and data capture, create relational databases, incorporate multiple biometrics and improve our customers ability to move and manage information. Applications can include driver s licenses, voter registration, national ID s, law enforcement, social services, access control and PC network and internet access security. Our primary customers have been government agencies with particular penetration in Departments of Motor Vehicles.

Our patented face-recognition technology is focused on three major product application areas.

***Face*EXPLORER**, our technology for image retrieval and analysis, is recognized for its leadership technology performance in real-time and large-database applications. ***FaceEXPLORER*** is deployed in the world s largest face-recognition application with a database of more than 14.5 million enrolled images and is growing by 15,000 new images per day.

***Face*PASS** for physical access control and keyless entry; and

***Face*FINDER** for surveillance and identification.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The accompanying financial data as of June 29, 2003 and December 31, 2002, and for the three and six month periods ended June 29, 2003 and June 30, 2002, 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, 2002 balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. 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, 2002.

The financial statements as of and for the three and six months ended June 30, 2002 include the assets and liabilities of Biometrica Systems, Inc. ( Biometrica ) as of June 30, 2002 and the results of its operations and its cash flows from March 18, 2002 (date of acquisition) to June 30, 2002.

All inter-company accounts and transactions have been eliminated in consolidation.

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 June 29, 2003 and for the three and six month periods ended June 29, 2003 and June 30, 2002, have been made. The results of operations for the three and six month periods ended June 29, 2003 are not necessarily indicative of the operating results for the full year.

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**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, 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**

We account for our stock-based compensation plans using the intrinsic value method, in accordance with the provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and comply with the disclosure provisions of 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 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, *Accountingfor Stock-Based Compensation Transition and Disclosure*, the effect on net loss and loss per share if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 29, 2003 | June 30, 2002 | June 29, 2003 | June 30, 2002 |
| Net loss as reported | $ (1,348) | $ (2,805) | $ (3,082) | $ (3,662) |
| Add: stock based employee compensation expense included in reported net loss, net of tax | | | | |
| Deduct: total stock based employee compensation expense determined under the fair value based method for all awards, net of tax | (1,061) | (672) | (1,663) | (1,677) |
| Pro forma net loss | $ (2,409) | $ (3,477) | $ (4,745) | $ (5,339) |
| Loss per share: | | | | |
| Basic as reported | $ (0.07) | $ (0.14) | $ (0.15) | $ (0.18) |
| Basic pro forma | (0.12) | (0.17) | (0.23) | (0.27) |
| Diluted as reported | (0.07) | (0.14) | (0.15) | (0.18) |
| Diluted pro forma | (0.12) | (0.17) | (0.23) | (0.27) |

The fair value of the Company s stock-based option awards to employees was estimated assuming no expected dividends and the following weighted-average assumptions:

| | June 29, 2003 | June 30, 2002 |
|---|---|---|

| | | |
|---|---|---|
| Risk free interest rate | 4.0 5.0% | 3.7 5.0% |
| Expected dividend yield | | |
| Expected lives | 3-10 years | 3-10 years |
| Expected volatility | 80 % | 80 % |

**Computation of Net 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 3,534,000 shares of common stock equivalents consisting of certain outstanding options and stock warrants were not reflected in the June 29, 2003 dilutive net loss per share calculation. The impact of approximately 2,643,000 shares of common stock consisting of certain outstanding options and stock warrants were not reflected in the June 30, 2002 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.

**Recent Accounting Pronouncements**

In November 2002, the EITF reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 will be effective for periods beginning after June 15, 2003. The adoption of EITF 00-21 is not expected to have a material impact on our financial position and results of operations.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and hedging relations designated after June 30, 2003, except for those provisions of SFAS No. 149 which relate to SFAS No. 133 implementation issues that have been effective for fiscal quarters that began prior to June 15, 2003. For those issues, the provisions that are currently in effect should continue to be applied in accordance with their respective effective dates. In addition, certain provisions of SFAS No. 149, which relate to forward purchases or sales of when-issued securities or other securities that do not yet exist, should be applied to both existing contracts and new contracts entered into after June 30, 2003. The adoption of SFAS No. 149 is not expected to have a material effect on our financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within the scope of SFAS No. 150 as a liability. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective beginning September 1, 2003. The adoption of SFAS No. 150 is not expected to have a material effect on our financial statements.

**3. INCOME TAXES**

No provision for federal income taxes has been made for the three and six month periods ended June 29, 2003 and June 30, 2002 due to the net loss in both periods. The provision for state income taxes for the six month period ended June 29, 2003 was approximately $63,000. There was no provision for state income taxes for the three month period ended June 29, 2003 and for the three and six month periods ended June 30, 2002.

**4. RELATED PARTY TRANSACTIONS AND SHAREHOLDERS EQUITY**

Currently, Lau Technologies, or Lau, owns approximately 30% of the Company s common stock. Readers are referred to the Notes to Financial Statements section of the Company s 2002 Annual Report on Form 10-K for further discussion.

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In May 2003 we entered into a loan agreement with Lau Technologies which provided for four term notes aggregating $7.3 million but not to exceed an outstanding principal balance of $7.0 million at any point in time. Two of these term notes, in the amounts of approximately $1.6 million and $287,000, replaced existing system finance lease obligations we had with a commercial leasing organization. These finance lease obligations were paid in full with the proceeds of the two new term notes. The remaining two new term notes, totaling $3.0 million and $2.5 million, are additional financing related to two new state contracts. All four new term notes bear interest at a rate of 8.5%. We will draw funding on these notes as needed to meet our obligations for equipment purchases on the related state contracts. As of June 29, 2003 we had approximately $3.7 million outstanding under this loan agreement, leaving approximately $3.3 million available for future needs.

**5. BUSINESS SEGMENTS**

We follow 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 separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

During fiscal 2002, our direct investment in facial recognition technology increased due to three acquisitions of facial recognition businesses, which significantly enhanced our portfolio of facial recognition technologies, customers and distribution channels. Due to the impact of the acquisitions on assets and revenues we determined that it would be appropriate to begin reporting our financial results in two segments and, accordingly, we now report two operating segments: secure identification and facial recognition.

**Secure Identification Products and Solutions (SIPS)**

Our secure identification business designs and implements digital identification systems and solutions. Our systems can produce identification cards that are virtually tamper proof, and utilize facial recognition and other biometrics with or without cards for the real-time identification (one-to-many) and verification (one-to-one) of individuals. Applications can include driver s licenses, voter registration, national identification cards, law enforcement and social services. Our primary customers have been government agencies with particular penetration in Departments of Motor Vehicles.

**Facial Recognition Segment (FRS)**

We offer several facial recognition software systems that can be utilized in virtually any solution requiring identification or verification of an individual. The human face is a unique and prominent feature that can be easily captured by a digital camera and verified visually in most cases by an individual with little special training. We are concentrating on four principal areas: real-time large database applications; physical keyless entry and access control; screening applications; and surveillance applications. We have several on-going facial recognition identification projects, including projects with the Pinellas County Sheriff s Office, the Illinois Secretary of State, Illinois State Police, the state of Connecticut Department of Information Technology, the state of Mississippi Department of Information Technology Services and a number of other installations, including more than 110 surveillance applications in casinos.

The following table provides financial information by segment for the three and six month periods ended June 29, 2003 and June 30, 2002, which is used by the chief operating decision maker in assessing segment performance. We allocate direct costs and administrative expenses to each business segment based on management s analysis of each segment s resource needs. Revenues are reported within the segments by customer contracts. Within the secure identification segment there is a component of the contract that utilizes our facial recognition technology. The following table identifies the value of facial recognition revenue that is included in the secure identification segment.

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| | Three Months Ended 06/29/03 | | | Three Months Ended 06/30/02 | | |
|---|---|---|---|---|---|---|
| | SIPS | FRS | Total | SIPS | FRS | Total |
| Credential revenue | $ 8,739 | $ | $ 8,739 | $ 7,112 | $ | $ 7,112 |
| Facial recognition revenue | 97 | 1,348 | 1,445 | 459 | 1,467 | 1,926 |
| Total segment revenue | $ 8,836 | $ 1,348 | $ 10,184 | $ 7,571 | $ 1,467 | $ 9,038 |
| Segment profit (loss) before taxes | $ 64 | $ (1,412) | $ (1,348) | $ 167 | $ (2,972) | $ (2,805) |
| Depreciation and amortization | $ 1,909 | $ 179 | $ 2,088 | $ 1,163 | $ 134 | $ 1,297 |
| Interest expense | $ 231 | $ | $ 231 | $ 224 | $ | $ 224 |
| Total Assets | $ 52,065 | $ 6,389 | $ 58,454 | $ 59,151 | $ 6,533 | $ 65,684 |
| Expenditures for long lived assets | $ 1,967 | $ 1,334 | $ 3,301 | $ 166 | $ 697 | $ 863 |

| | Six Months Ended 06/29/03 | | | Six Months Ended 06/30/02 | | |
|---|---|---|---|---|---|---|
| | SIPS | FRS | Total | SIPS | FRS | Total |
| Credential revenue | $ 15,645 | $ | $ 15,645 | $ 12,827 | $ | $ 12,827 |
| Facial recognition revenue | 428 | 2,702 | 3,130 | 620 | 1,990 | 2,610 |
| Total segment revenue | $ 16,073 | $ 2,702 | $ 18,775 | $ 13,447 | $ 1,990 | $ 15,437 |
| Segment profit (loss) before taxes | $ 95 | $ (3,114) | $ (3,019) | $ 583 | $ (4,245) | $ (3,662) |
| Depreciation and amortization | $ 3,723 | $ 333 | $ 4,056 | $ 2,717 | $ 138 | $ 2,855 |
| Interest expense | $ 450 | $ | $ 450 | $ 429 | $ | $ 429 |
| Total Assets | $ 52,065 | $ 6,389 | $ 58,454 | $ 59,151 | $ 6,533 | $ 65,684 |
| Expenditures for long lived assets | $ 1,967 | $ 1,363 | $ 3,330 | $ 248 | $ 3,620 | $ 3,868 |

For the six months ended June 29, 2003 approximately $18.6 million, or 98.8%, of our direct revenue was derived within the United States. The remaining 1.2% of revenue was primarily derived in Canada and the United Arab Emirates. For the three months ended June 29, 2003 approximately $10.0 million or 97.8% of our direct revenue was derived in the United States. The remaining 2.2% of revenue was primarily derived in Canada and the United Arab Emirates. For the three and six month periods ended June 30, 2002, virtually all of our direct revenue was derived in the United States.

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. Secure identification segment customers who accounted for more than 10% of our total revenues are as follows:

For the three and six month periods ended June 29, 2003, two customers accounted for an aggregate of 42% and 41% respectively.

For the three and six month periods ended June 30, 2002, two customers accounted for an aggregate of 35% and 29% respectively.

No single facial recognition customer accounted for over 10% of our total revenue in either three or six month period.

**6. ACQUISITIONS**

On March 28, 2003, we entered into a securities purchase agreement with ZN Vision Technologies AG, a German provider of facial recognition and computer vision technologies, and all of the shareholders of ZN. Pursuant to the securities purchase agreement, the ZN shareholders agreed to sell, and we agreed to purchase, all of the capital stock of

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ZN. As consideration for the shares of ZN, we will pay approximately $13,000 in cash and issue an aggregate of 6,360,000 shares of our common stock, of which 5,221,454 shares will be issued directly to the ZN shareholders and 1,138,546 shares will be reserved for issuance under ZN s option plan, which we will assume upon the closing of the acquisition. The acquisition is expected to be completed in the third quarter of 2003 and is subject to approval by our stockholders.

**7. SUBSEQUENT EVENTS**

On July 31, 2003 the superior court for Fulton County, Georgia issued a preliminary injunction stopping Georgia s Department of Motor Vehicle Safety from continuing to work with us to install a new drivers license system for the state of Georgia. This injunction is the result of a law suit filed in March 2003 by one of our competitors, Digimarc Corporation. The suit claims that the Department of Motor Vehicle Safety did not comply with its own bid process when selecting a vendor for the digital drivers license program. The merits of Digimarc Corporation s claims against the Department of Motor Vehicle Safety are to be addressed in further court proceedings. The Department of Motor Vehicle Safety has confirmed that our contract with them remains in place.

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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 the Company s 2002 Annual Report on Form 10-K and in this Form 10-Q.

**OVERVIEW**

We are the leading provider of advanced technology solutions for identity verification. We began operations in 1996, providing integrated solutions to capture facial images, demographic information and other biometric identifiers, produce identification cards and create relational databases containing this information. Since our inception, we have also been acquiring and developing proprietary facial recognition technologies for a variety of applications. Applications can include driver s licenses, voter registration, national identification cards, law enforcement, social services, access control and PC network and Internet access security. Our primary customers have been government agencies with particular penetration in Departments of Motor Vehicles. We have captured approximately 32% of the domestic driver s license market. Our products annually produce more than 28 million identification documents at more than 1,800 locations in 16 states. We have also provided services under subcontracts for projects in Jamaica, the Philippines and for the U.S. Immigration and Naturalization Service. Originally developed at MIT, face-recognition technology is widely recognized as the most convenient, non-intrusive and cost-effective biometric available. In 2002, we completed three acquisitions through which we enhanced our portfolio of facial recognition technologies and acquired customers and distribution channels. Our patented face-recognition technology is focused on three major product application areas:

- FaceEXPLORER, our technology for image retrieval and analysis, is recognized for its leadership technology performance in real-time and large-database applications. FaceEXPLORER is deployed in the world s largest face-recognition application with a database of more than 14.5 million enrolled images and is growing by 15,000 new images per day.

- FacePASS for physical access control and keyless entry; and

- FaceFINDER for surveillance and identification.

**SEGMENTS**

Our business involves two related segments: secure identification products and solutions and facial recognition. Substantially all of our revenues have been derived within the United States of America.

*Secure Identification Products and Solutions Segment*

Our secure identification segment accounted for approximately 86.8% and 83.8% of our revenues in the three-month periods ended June 29, 2003 and June 30, 2002, respectively. For the six month periods ended June 29, 2003 and June 30, 2002 our secure identification segment accounted for approximately 85.6% and 87.1% of revenues, respectively. Secure identification involves the design and implementation of integrated software and hardware solutions that produce identification cards utilizing facial recognition and other biometrics.

We provide systems and services principally under contracts that typically have five to seven year terms and several optional annual renewals after the initial contract term. Contracts generally provide for a fixed price for the system

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and/or for each identification card produced. Contract prices vary depending on, among other things, design and integration complexities, the nature and number of workstations and sites, the projected number of cards to be produced, the size of the database, the level of post-installation support and the competitive environment.

*Facial Recognition Segment*

Our facial recognition segment accounted for approximately 13.2% and 16.2% of our revenues in the three-month periods ended June 29, 2003 and June 30, 2002, respectively. For the six month periods ended June 29, 2003 and June 30, 2002 our facial recognition segment accounted for approximately 14.4% and 12.9% of revenues, respectively. Approximately 12.4% and 15.4% of our facial recognition revenues in the three and six month periods ended June 29, 2003 were derived from casino surveillance applications, the remaining 87.6% and 84.6% were derived from applications designed to deter criminal and terrorist activities.

**POTENTIAL ACQUISITION**

On March 28, 2003, we entered into a securities purchase agreement with ZN Vision Technologies AG, a German provider of facial recognition and computer vision technologies, and all of the shareholders of ZN. Pursuant to the securities purchase agreement, the ZN shareholders agreed to sell, and we agreed to purchase, all of the capital stock of ZN. As consideration for the shares of ZN, we will pay approximately $13,000 in cash and issue an aggregate of 6,360,000 shares of our common stock, of which 5,221,454 shares will be issued directly to the ZN shareholders and 1,138,546 shares will be reserved for issuance under ZN s option plan, which we will assume upon the closing of the acquisition. We anticipate completion of the acquisition in the third quarter of 2003, subject to approval by our stockholders.

**CRITICAL ACCOUNTING POLICIES**

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

*Contract Revenue and Cost Recognition*

Our most significant contracts are our driver s license contracts, which are within our secure identification segment. These contracts typically provide that the state department of transportation, or similar agency, will pay us a fixed price for each system we install and for each identification card produced under the system. Prices under these contracts vary depending on, among other things:

design and integration complexities;

the nature and number of workstations and sites installed;

the projected number of cards to be produced;

the size of the database;

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

the competitive environment.

We recognize revenue under these contracts using the percentage-of-completion method. We use the percentage-of-completion method 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.

Using the percentage-of-completion method, we recognize a percentage of the revenue we expect to receive under the contract based on the percentage of labor costs we incur and cards we produce. Although these contracts typically have a term of 5 years or longer and include possible renewal terms, we incur a significant amount of labor costs under these contracts within the first 12 months of the contract. Accordingly, we recognize the revenue associated with the costs of the roll out phase of these contracts within the first 12 months of the contract.

Generally, we bill under these contracts when contract milestones, such as installation, are met and as cards are produced. We recognize losses, if any, under these contracts in the period in which they become determinable.

Revenue related to software licenses is recognized in accordance with Statement of Position No. 97-2 *Software Revenue Recognition*. 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.

Revenue related to software licenses is generally recognized upon shipment. 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.

We record costs and estimated earnings in excess of billings under these contracts as current assets. We record billings in excess of costs and estimated earnings and accrued contract costs as current liabilities.

*Estimates of Revenues under Secure Identification Contracts*

We account for revenue from our driver s license contracts using the percentage-of-completion method. Revenues under these contracts are based on completion of installation and the number of cards produced. We estimate the amount of time it will take to install the systems and the number of cards that will be produced. In arriving at these estimates, we undertake a quarterly review of historical trends as to the volume of cards produced. In addition, we consider factors that could impact the volume of production, such as:

- legislative changes to the life of identification credentials; and
- state government funding levels.

We also take into consideration the fact that, although it has never occurred, any one of our contracts could be terminated for reasons such as lack of performance. If our estimates as to labor costs, consumable inventory levels, maintenance costs or the volume of cards that will be produced are materially incorrect, it could have a material adverse effect on our financial results.

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Management has discussed the use and impact of these critical accounting policies and estimates with the audit committee of our Board of Directors.

**RESULTS OF OPERATIONS**

Revenues from our secure identification segment are derived principally from multi-year contracts for systems implementation, card production and related services. Revenues from our facial recognition segment are derived principally from sales to law enforcement agencies, the federal government, and the gaming industry. Revenues for the second quarter of 2003 increased 12.7% from approximately $9.0 million in the second quarter of 2002 to approximately $10.2 million in the second quarter of 2003. Revenues for the first six months of 2003 increased 21.6% from approximately $15.4 million for the first six months of 2002 to approximately $18.8 million for the first six months of 2003. The increase in revenues of approximately $3.3 million for the first six months of 2003 derives from increases of approximately $2.6 million, or 19.5%, in the secure identification segment and $712,000, or 35.8 %, in the facial recognition segment. These increases primarily reflect our performance on new contracts awarded and contract extensions received in the fourth quarter of 2002.

Gross margins increased to 19.6% in the second quarter of 2003 from 17.4% in the second quarter of 2002. Gross margins increased to 21.2% for the first six months of 2003 compared to 18.7% for the same period in 2002. The overall increase in gross margin between these three and six month periods is attributable to the margin improvement in our facial recognition segment, which increased to 51.6% in the second quarter of 2003 from -11.4% in the second quarter of 2002. Our overall margin increase for the first six months of 2003 is also due to the large increase in facial recognition revenues, and their corresponding higher margins, between the two periods. For the quarter ended June 29, 2003 margins in the secure identification segment decreased to 14.7% from 22.9% for the same period in 2002. For the six months ended June 29, 2003 margins in the secure identification segment decreased to 16.6% from 21.5% for the same period in 2002. Although prices remain fixed for products and services on a contract-by-contract basis, fluctuations in gross margin can be attributable to the revenue mix from quarter to quarter. The decrease in the three and six month periods was due to the impact of recently won competitive awards within our secure identification products and solutions segment at margins that are lower than our existing contract portfolio.

Sales and marketing expenses decreased approximately $562,000, from $1.7 million in the second quarter of 2002 to $1.1 million in the second quarter of 2003. For the fiscal year to date, sales and marketing expenses were substantially unchanged at approximately $2.6 million for the first six months of 2002 and for the first six months of 2003. As a percentage of revenue sales and marketing decreased from 18.8% in the second quarter of 2002 to 11.2% in the second quarter of 2003 and from 16.6% for the first six months of 2002 to 13.6% for the first six months of 2003. The decrease in the second quarter is primarily due to a decrease in the level of request for proposals from state governments within the secure identification products and solutions market as a result of delays due to state budgetary constraints. As the volume of proposal activity increases or decreases we reallocate resources and expenses from other functions with similar skill sets versus increasing or decreasing our sales and marketing headcount and expenses. This allows us to more responsibly respond to fluctuations in the marketplace.

Research and development expenses decreased approximately $378,000, from $1.3 million in the second quarter of 2002 to $937,000 in the second quarter of 2003. For the fiscal year to date, research and development expenses increased approximately $60,000, from $1.8 million for the first six months of 2002 to $1.9 million for the first six months of 2003. As a percentage of revenue research and development decreased from 14.5% in the second quarter of 2002 to 9.2% in the second quarter of 2003 and from 11.8% for the first six months of 2002 to 10.0% for the first six months of 2003. The increase in research and development expenses for the first six months of 2003 is due principally to our continued investment in facial recognition technologies and new product development. This included enhancing existing products with the intellectual property that was acquired through our recent acquisitions.

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General and administrative expenses decreased approximately $103,000, from $1.1 million in the second quarter of 2002 to $1.0 million in the second quarter of 2003. For the fiscal year to date, general and administrative expenses increased approximately $392,000, from $1.7 million for the first six months of 2002 to $2.1 million for the first six months of 2003. As a percentage of revenue general and administrative expenses decreased from 12.6% in the second quarter of 2002 to 10.1% in the second quarter of 2003 and increased from 11.2% for the first six months of 2002 to 11.3% for the first six months of 2003. The increase is due to the logistical support required to grow our facial recognition business through acquisitions while continuing to meet the financing requirements created by our expanding operations. The increase includes $320,000 for our newly created strategic development department, and $150,000 of expenses related to pursuing new financing opportunities netted with our continued efforts to reduce and control costs.

For the six months ended June 29, 2003, we have realized a net savings of approximately $600,000 as a result of the workforce reduction that was completed in the fourth quarter of 2002. The anticipated savings of approximately $1.1 million for the six month period ended June 29, 2003 was offset with headcount additions and additional expenses associated with employee terminations in 2003.

Interest expense, net of approximately $19,000 of interest income, increased approximately $7,000 in the second quarter of 2003 from the second quarter of 2002. Interest expense, net of approximately $48,000 of interest income, increased approximately $21,000 for the first six months of 2003 from the first six months of 2002. This represents a decrease to 2.3% from 2.5% of revenue for the quarter to quarter period and 2.4% from 2.8% for the first six months of each fiscal year. The increase in interest expense reflects the additional debt financing required to fund performance on contracts awarded in the fourth quarter of 2002.

No provision for federal income taxes has been made for the three and six month periods ended June 29, 2003 and June 30, 2002 due to the net loss in both periods. The provision for state income taxes for the six month period ended June 29, 2003 was approximately $63,000. There was no provision for state income taxes for the three month period ended June 29, 2003 and for the three and six month periods ended June 30, 2002.

**LIQUIDITY AND CAPITAL RESOURCES**

Cash and cash equivalents were approximately $1.2 million at June 29, 2003, which consisted entirely of cash. This amount excludes approximately $5.1 million which is restricted under our term loan agreements and project financing. Cash and cash equivalents at December 31, 2002 were approximately $2.2 million, which consisted entirely of cash. This number excludes approximately $7.4 million which was restricted under our term loan agreements and project financing.

In the six month periods ended June 30, 2003 cash provided by operating activities was approximately $598,000, which stems from our net loss of approximately $3.1 million, offset by non cash charges for depreciation and amortization of approximately $4.1 million, and cash provided by the net decrease in operating assets of approximately $376,000.

Accounts receivable decreased approximately 7.5% from approximately $7.4 million at December 31, 2002 to approximately $6.8 million at June 29, 2003 due to the timing of billings and more efficient collections.

Costs and estimated earnings in excess of billings increased approximately 4.4% from $23.4 million at December 31, 2002 to $24.4 million at June 29, 2003, and reflect the unbilled accumulation of costs on contracts in progress.

Accounts payable and accrued expenses increased approximately 5.0% from $7.0 million at December 31, 2002 to $7.4 million at June 29, 2003 due to the timing of payables.

In May 2003 we entered into a loan agreement with Lau Technologies which provided for four term notes aggregating $7.3 million but not to exceed an outstanding principal balance of $7.0 million at any point in time. Two of these term notes, in the amounts of approximately $1.6 million and $287,000, replace existing system finance lease obligations we

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had with a commercial leasing organization. These finance lease obligations were paid in full with the proceeds of the two new term notes. The remaining two new term notes, totaling $3.0 million and $2.5 million, are additional financing related to two new state contracts. All four new term notes bear interest at a rate of 8.5%. We will draw funding on these notes as needed to meet our obligations for equipment purchases on the related state contracts. As of June 29, 2003 we had approximately $3.7 million outstanding under this loan agreement, leaving approximately $3.3 million available for future needs.

In May 2003, we entered into a new loan agreement with Commerce Bank and Trust Company that superceded the original loan agreement for our existing term loans. The following table lists the approximate term note information for the bank and Lau Technologies as of June 29, 2003 (in thousands):

| Lender | Original Loan Amount | Principal Balance | Monthly Payment Provisions | Date of Loan | Due Date Of Loan | Interest Rate |
|---|---|---|---|---|---|---|
| 1 | $ 4,000 | $ 2,659 | $ 84 | 02/07/2001 | 06/20/2006 | 8.00% |
| 1 | 3,200 | 2,167 | 72 | 09/11/2001 | 03/11/2006 | 6.25% |
| 1 | 1,800 | 1,641 | 34 | 12/12/2002 | 12/31/2007 | 5.25% |
| 1 | 1,500 | 1,379 | 27 | 12/12/2002 | 04/24/2008 | 5.25% |
| 1 | 1,200 | 1,083 | 24 | 12/12/2002 | 06/24/2007 | 5.25% |
| 2 | 3,000 | 1,534 | 53 | 05/30/2003 | 06/30/2009 | 8.50% |
| 2 | 2,500 | 433 | 51 | 05/30/2003 | 05/30/2008 | 8.50% |
| 2 | 1,562 | 1,506 | 64 | 05/30/2003 | 08/30/2005 | 8.50% |
| 2 | 287 | 246 | 42 | 05/30/2003 | 12/30/2003 | 8.50% |
| Total | $ 19,049 | $ 12,648 | $ 451 | | | |

1. Commerce Bank & Trust Company
2. Lau Technologies

In accordance with the new loan agreements all of our term notes are collateralized by certain of our assets and the related contract assets. We are required to maintain various financial covenants, including profitability by quarter (as defined), tangible net worth, debt to net worth ratio, debt service coverage and limits on capital expenditures. Additionally, in accordance with the new agreement, we must maintain $5.1 million of cash on deposit with the lenders. This amount is recorded as restricted cash in long term assets.

In April 2003 we entered into 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 June 29, 2003 we have utilized $584,000 under these arrangements. The interest rates are between 6% and 8% and are fixed. The terms of these leases range from 12 months to 60 months.

We also have one capital lease arrangement where we are also required to maintain the same financial ratios and minimum levels of tangible capital funds, as stated above. Pursuant to this arrangement, the lessor purchases certain of our digital identification systems and leases them back to us for deployment with identified and contracted customers approved by the lessor. The lessor retains title to systems and has an assignment of our rights under the related customer contracts, including rights to use the software and technology underlying the related systems.

Under these arrangements, the lessor bears the credit risk associated with payments by our customers, but we bear performance and appropriation risk and are generally required to repurchase a system in the event of a termination by a customer for any reason except credit default. At June 29, 2003 we had approximately $1.9 million outstanding under this lease-financing arrangement.

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For the quarter ended June 29, 2003, we were in violation of the net income covenant on one of our capital leases. We received a waiver of this covenant and we are currently in negotiations with the lender to amend this covenant. We believe that we will be in compliance with the amended debt covenant and will remain in compliance with all other debt covenants. However, this expectation is dependent on achieving our business plan. If we do not remain in compliance with such covenants, the banks and the lessors could require immediate repayment of outstanding amounts.

Our current business plan indicates that we will require additional financing to meet our 2003 plan and to fund our ongoing operations. We have satisfied a substantial portion of these needs through the $7 million loan agreement with Lau Technologies described above. We intend to meet the balance of these needs by obtaining additional bank debt, equipment lease financing and/or equity financing. We are in discussions with a number of sources to secure this financing. There can be no assurances that we will secure such financing or that such financing will be available on favorable terms. If we are unable to secure such financing, we may not be able to fund our operations or expand our business to meet our plans.

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

The installation of our digital identification systems requires significant capital expenditures. In addition, the further development of our biometric and other advanced technologies is expected to require additional capital. Although we completed a $25 million private placement of our common stock at the end of 2001 and have been successful in the past in obtaining project financing, we will have ongoing capital needs as we expand our business. If we are unable to obtain additional funds in a timely manner or on acceptable terms, we may not be able to fund our operations or expand our business to meet our plans. If we are unable to obtain capital when we need it, we may have to restructure our business or delay or abandon our development and expansion plans. That could have a material adverse effect on our business and financial condition.

**Our leverage creates financial and operating risk that could limit the growth of our business.**

We have a significant amount of indebtedness. As of June 29, 2003, we had approximately $15.0 million in short and long-term debt and lease financing. Our leverage could have important consequences to us including:

- limiting our ability to obtain necessary financing for future working capital;
- limiting our ability to finance the acquisition of equipment needed to meet customer requirements;

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- limiting our ability to finance the development of new technologies;
- requiring that we use a substantial portion of our cash flow from operations for debt service and not other operating purposes; and
- requiring us to comply with financial and operating covenants, which could cause an event of default under our debt instruments.

Further, our ability to make principal and interest payments under long-term indebtedness and bank loans will be dependent upon our future performance, which is subject to financial, economic and other factors affecting us, some of which are beyond our control.

**Our business depends on large public sector contracts, which can involve delays.**

Our business depends on a limited number of large public sector contracts. These contracts result from purchasing decisions made by public sector agencies that are often subject to political influence, onerous procurement procedures, budget changes and award protests. These factors can cause delays, which make our quarterly results difficult to predict. This can also make our ability to meet analysts expectations equally uncertain and adversely affect the price of our common stock.

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

We have experienced fluctuations in our quarterly operating results and expect those fluctuations to continue. Our quarterly results are 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 to accounting for contracts.

**The loss of any significant customer could cause our revenue to decline.**

For the three months ended June 29, 2003, two customers each accounted for over 10% of our revenues and an aggregate of approximately 42% of revenues. The loss of any significant customer could cause our revenue to decline and thus have an adverse material effect on our business and financial condition.

**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. At June 29, 2003, we had an accumulated deficit of approximately $27.5 million. We intend to continue to invest in the development of our biometrics technologies and thus we cannot predict when or if we will ever achieve overall profitability.

**The market for our common stock has been volatile.**

The market for stock of many security-related businesses, including ours, has been highly volatile, especially since the terrorist attacks of September 11, 2001. It is likely that the market price of our common stock will fluctuate widely in the future. Factors affecting the trading price of our common stock are likely to include:

Responses to quarter-to-quarter variations in our results of operations;

The announcement of new contracts, products or product enhancements by us or our competitors;

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Technological innovation by our competitors or us;

General market conditions or market conditions specific to particular industries; and

Changes in earnings estimates by analysts.

**Our reliance on sole and single-source suppliers could cause delays or increases in cost of revenues.**

We rely on outside vendors to manufacture or develop components, software and consumables, which are used for our systems and services. Some of these items are obtained from a single supplier or a limited group of suppliers. Our inability to obtain adequate deliveries or alternative sources of supply could cause delays or increases in cost of revenues.

**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.**

We license 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. There is 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, we believe that as our sales increase, and given the large-scale deployment required by 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 would have a material adverse effect on our business, operating results and financial condition.

**If we lose any key personnel, or fail to attract and retain additional personnel, we may be unable to continue expanding our business and product line.**

The loss of the services of one or more of our key personnel could have a material adverse effect on our business, operating results and financial condition. We cannot guarantee that we will be able to retain our key personnel. Our future success also depends on our continuing ability to attract, assimilate and retain highly qualified sales, technical and managerial personnel. Competition for these individuals is intense, and there can be no assurance that we can attract, assimilate or retain necessary personnel in the future.

**If our target customers do not accept our biometric technologies, our growth may be restricted.**

Our growth plan assumes, in part, that biometric technologies will gain widespread market acceptance. Although we have had success with several recent biometric projects, the widespread market acceptance of biometric technologies remains uncertain.

**If we fail to keep pace with changing technologies, we may not win new customers.**

Rapidly changing customer requirements and evolving industry standards characterize our market. If we cannot keep pace with these changes, our business could suffer. To achieve our goals, we need to develop cost-effective business solutions and methodologies to keep pace with continuing changes in industry standards and customer preferences.

**System failures could seriously damage our business.**

We depend on our ability to provide customers with complex systems, which can operate on an as needed basis. Although we deploy back up systems, system failures could result in increased costs, lower margins, liquidated damage

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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.

**We are controlled by a single stockholder, which could result in it taking actions, which other stockholders do not approve.**

Lau Technologies, or Lau, beneficially owns approximately 30% of our outstanding common stock. As a result, Lau has a strong influence on matters requiring approval by our stockholders, including the election of all of the directors and most corporate actions. We have certain contractual relations with Lau that could give rise to conflicts of interest.

**Competition from new entrants and bigger, more established competitors with greater financial resources could diminish our business opportunities and limit our growth.**

The business areas in which we compete are intensely competitive and subject to rapid technological change. We expect competition to continue. In particular, the events of September 11, 2001 have heightened interest in the use of biometric technologies and competition in this field is expected to intensify. There is no assurance that companies with greater financial resources and name recognition will not enter our business sectors. Our competitors may be able to respond more quickly to technological developments and changes in customers needs.

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

We believe our intellectual property, including our proprietary methodologies, is important to our success and competitive position. If we are unable to protect our intellectual property against others unauthorized use, our reputation among existing and potential customers could be damaged and our competitive position adversely affected.

**Our strategies to deter misappropriation could be undermined in light of the following risks:**

- Non-recognition of the proprietary nature of or inadequate protection of our methodologies in the United States or foreign countries;
- Undetected misappropriation of our proprietary methodologies; and
- Development of similar software or applications by our competitors.

The materialization of any of these risks could require us to spend significant amounts to defend our rights and could divert our managerial resources. In addition, our proprietary methodologies may decline in value or our rights to them may be unenforceable.

**Others could claim that we infringe on their intellectual property rights, which may result in substantial costs, diversion of resources and management attention, and harm to our reputation.**

Although we believe that our products and services do not infringe the intellectual property rights of others, we cannot give any assurances that we can successfully defend an infringement claim. A successful infringement claim against us could materially and adversely affect us in the following ways:

- We may be liable for damages and litigation costs, including attorneys fees;
- We may be enjoined from further use of the intellectual property;
- We may have to license the intellectual property, incurring licensing fees;
- We may have to develop a non-infringing alternative, which could be costly and delay projects; and

We may have to indemnify clients with respect to losses incurred as a result of our infringement of the intellectual property.

Regardless of the outcome, an infringement claim could result in substantial costs, diversion of resources and management attention, termination of customer contracts and harm to our reputation.

**You may be subject to dilution.**

We have outstanding stock purchase warrants and stock options that could result in dilution for our common stockholders, depending upon the market price of the Company s common stock from time to time. We may issue additional stock, warrants and options as part of an acquisition or financing transaction.

**You should not expect dividends from us.**

We are prohibited under our borrowing arrangements from paying any cash dividends. We do not expect to declare or pay any cash dividends in the near future.

## ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have no material exposure to market risk that could affect our future results of operations and financial condition.

## ITEM 4 CONTROLS AND PROCEDURES

We carried out an evaluation, as of June 30, 2003, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us (including our consolidated subsidiaries) required to be included in our periodic SEC filings. There have been no significant changes in our internal controls or in other factors, which could significantly affect internal controls subsequent to the date we carried out the evaluation.

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**VIISAGE TECHNOLOGY, INC.**

## PART II OTHER INFORMATION

### ITEM 1 LEGAL PROCEEDINGS

None.

### ITEM 2 CHANGES IN SECURITIES AND USE OF PROCEEDS

*Restrictions Upon the Payment of Dividends*

We are prohibited under our borrowing arrangements from paying any cash dividends.

### ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None.

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

1) The decision to fix the number of directors at eight and the number of Class I directors at three was ratified. The vote was 13,050,823 for, 360,939 against, and 48,827 abstained.

2) Denis K. Berube and Charles E. Levine were elected as Class I directors to serve three year terms. The vote was 13,270,528 and 13,361,757 respectively for, and 184,061 and 92,832 respectively withheld.

3) The decision to amend the Viisage 1996 Management Stock Option Plan, increasing the number of shares available for issuance from 3,807,100 to 4,807,100, was ratified. The vote was 12,352,689 for, 1,066,856 against, and 35,044 abstained.

4) The selection of BDO Seidman, LLP as independent public accountants for the Company for the year ending December 31, 2003, was ratified. The vote was 13,357,817 for, 48,631 against, and 48,141 abstained.

**ITEM 5 OTHER INFORMATION**

None.

**ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits

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

(b) Reports on Form 8-K

Current Report on Form 8-K filed March 31, 2003.

Current Report on Form 8-K filed June 4, 2003.

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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.

**VIISAGE TECHNOLOGY, INC.**

Date: August 13, 2003

By: /s/ BERNARD C. BAILEY

**Bernard C. Bailey**

**President and Chief Executive Officer**

**(Principal Executive Officer)**

/s/ WILLIAM AULET

**William Aulet**

**Chief Financial Officer**

**(Principal Financial Officer)**

## EXHIBIT INDEX

| Exhibit No. | Description |
| --- | --- |
| 2.02* | Securities Purchase Agreement dated as of March 28, 2003 by and among Viisage Technology, Inc., ZN Vision Technologies AG and the Sellers named therein. |
| 10.05** | Second Amended and Restated 1996 Management Stock Option Plan. |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | 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 | 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 |

* Incorporated by reference to Annex A to the preliminary proxy statement on Form 14A filed by the registrant with the Securities and Exchange Commission on July 3, 2003

** Incorporated by reference to Appendix B to the definitive proxy statement on Form 14A filed by the registrant with the Securities and Exchange Commission on April 14, 2004.