Cogent, Inc.
Form S-1
May 16, 2005
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As filed with the Securities and Exchange Commission on May 16, 2005

Registration No. 333-

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

COGENT, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**7373**	**95-4305768**
(State or other jurisdiction of incorporation or organization)	**(Primary standard industrial classification code number)**	**(I.R.S. Employer Identification Number)**

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Ming Hsieh

President and Chief Executive Officer

Cogent, Inc.

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Approximate date of commencement of proposed sale to the public:

As soon as practicable after this Registration Statement is declared effective.

If any of the securities being registered on this Form are being offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, as amended (the Securities Act), check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box. ¨

CALCULATION OF REGISTRATION FEE

Title of Each Class of	Amount to	Proposed Maximum	Proposed Maximum	Amount of

Securities to be Registered	be Registered(1)	Offering Price Per Share(2)	Aggregate Offering Price(2)	Registration Fee
Common Stock, $0.001 par value	12,650,000	$ 21.47	$ 271,595,500	$ 31,967

(1) Includes 1,650,000 shares that the underwriters have the option to purchase to cover over-allotments, if any.
(2) Estimated solely for the purposes of determining the registration fee pursuant to Rule 457(c) promulgated under the Securities Act, and based on the average of the high and low prices of the common stock reported on the Nasdaq National Market on May 10, 2005.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act or until the Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and we are not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

PROSPECTUS (Subject to Completion)

Issued May 16, 2005

11,000,000 Shares

COMMON STOCK

Cogent, Inc. is offering 4,000,000 shares of its common stock, and the selling stockholders are offering 7,000,000 shares. Cogent will not receive any of the proceeds from the shares of common stock sold by the selling stockholders.

Our common stock is quoted on the Nasdaq National Market under the symbol COGT. The last reported sale price of our common stock on May 13, 2005 was $22.61 per share.

Investing in our common stock involves risks. See Risk Factors beginning on page 7.

PRICE $ A SHARE

	Price to Public	Underwriting Discounts and Commissions	Proceeds to Cogent	Proceeds to Selling Stockholders
Per Share	$	$	$	$
Total	$	$	$	$

A selling stockholder has granted the underwriters the right to purchase up to an additional 1,650,000 shares of common stock to cover over-allotments.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares to purchasers on , 2005.

MORGAN STANLEY JPMORGAN

BEAR, STEARNS & CO. INC. SG COWEN & CO.

NEEDHAM & COMPANY, LLC

, 2005

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You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus. We are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or any sale of our common stock.

For investors outside the United States: Neither we nor any of the underwriters have done anything that would permit this offering or possession or distribution of this prospectus in any jurisdiction where action for that purpose is required, other than in the United States. You are required to inform yourselves about and to observe any restrictions relating to this offering and the distribution of this prospectus.

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PROSPECTUS SUMMARY

You should read the following summary together with the entire prospectus, including the more detailed information in our consolidated financial statements and related notes appearing elsewhere in this prospectus. You should carefully consider, among other things, the matters discussed in Risk Factors.

Overview

We are a leading provider of Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometric solutions to governments, law enforcement agencies and other organizations worldwide. Our solutions are used primarily in border control, law enforcement and civil applications, and increasingly in commercial applications. Our solutions enable our customers to capture fingerprint images electronically, encode fingerprints into searchable files and accurately compare a set of fingerprints to a database containing potentially millions of fingerprints in seconds. For over fifteen years, we have researched, designed, developed and marketed fingerprint biometrics technologies that incorporate advanced concepts in fluid dynamics, neural networks, image enhancement, data mining and massively parallel processing. Our proprietary software algorithms, together with optimized hardware, enable our customers to cost-effectively achieve what we believe to be industry-leading accuracy rates and performance. We support the latest standards in fingerprint biometrics and have based our systems on cost-effective industry-standard hardware and software platforms. We are focused on enabling our customers to expand the capabilities of their systems as their biometrics needs evolve.

We market our solutions directly to end customers and indirectly as a subcontractor with other vendors to U.S. and international government organizations such as the U.S. Department of Homeland Security, or DHS, the National Electoral Council in the Republic of Venezuela, or CNE, the U.S. Department of Justice, Federal Bureau of Investigations, or FBI, the Federal Bureau of Prisons, the European Commission, the Chilean National Police, the Italian National Police, the U.K. police, and the Singapore National Police, state and local law enforcement and government agencies, such as the Los Angeles County Sheriff s Department and the Los Angeles Police Department, the State of Connecticut and the Ohio Bureau of Criminal Investigation and Identification, and other organizations such as the National Association of Securities Dealers and Hewlett-Packard. To date, we have served as the primary supplier of AFIS solutions for the United States Visitor and Immigrant Status Indicator Technology, or US-VISIT, program, an extensive effort by the DHS requiring the fingerprinting of visitors that enter and exit the United States through air, sea and land ports.

Our Industry

Effectively authenticating and identifying individuals is critical to the safety and integrity of transactions, communications, travel and life in today s society. Authentication is the act of confirming that an individual is who he claims to be, while identification is the act of determining the identity of an unknown person. Security breaches and frauds resulting from failures to authenticate and identify individuals can cause significant economic harm and loss of life, as demonstrated by the recent increase in the number and severity of terrorist attacks worldwide. In response to the resultant demand for more effective security, governments, businesses and other organizations are seeking to improve upon traditional authentication and identification methodologies, such as signatures, photos or physical access cards. These traditional authentication methodologies can be easily compromised and are also cumbersome and inefficient for both users and administrators.

The inadequacies of these traditional methodologies have contributed to the increased focus in recent years on the development of biometrics as an alternative. Biometrics is the automated use of unique physiological characteristics of individuals, such as fingerprints, palm prints, faces or irises, to authenticate or verify an individual s identity. Biometrics can be more accurate, convenient and cost-effective than traditional methodologies due to its reliance on unchanging, unique characteristics that cannot be lost, stolen, forged, shared or forgotten. Of the various types of biometrics, fingerprints have been, and we believe will continue to be, the most widely used biometric because they are relatively simple to capture, are oftentimes left at crime scenes, are relatively non-intrusive and are supported by a standardized classification format. In addition, databases of hundreds of millions of fingerprints are already in use by law enforcement agencies, government agencies and other organizations worldwide.

The market for AFIS, which has traditionally been focused on large-scale biometrics systems for law enforcement and government applications, and the market for other fingerprint biometric solutions, which are emerging applications primarily for the commercial sector, are both expected to increase significantly. We are one of only four major suppliers of fully integrated AFIS solutions that address this market. According to International Biometric Group, or IBG, an independent market research firm, the biometrics market is expected to grow from $719 million in 2003, with AFIS representing 43% of the market and other fingerprint biometrics solutions representing 28% of the market, to $4.6 billion in 2008, with AFIS and other fingerprint biometrics solutions representing an aggregate of 56% of the market. We believe there are a number of factors driving this growth, including:

- Recent legislation has been passed in the United States and in many foreign jurisdictions, such as the European Union, mandating the implementation of fingerprint systems at points of entry and exit, including borders, seaports and airports;

- Government mandates that require real-time identification and authentication in high traffic areas such as airports and border crossings will require AFIS solutions that produce increasingly fast response times when searching large fingerprint databases;

- Recent terrorist attacks and security breaches have resulted in people becoming increasingly willing to submit to fingerprinting and other protective measures designed to enhance security;

- There are approximately 15,000 state and local law enforcement agencies in the United States, many of which use an AFIS. It is anticipated that many of these agencies will upgrade their existing AFIS due to the emergence of a new, higher resolution fingerprint standard;

- Many countries have begun implementing passports, national identification cards and voting machines that use fingerprint information to improve security and streamline citizen-to-government interactions. For example, in 2004 the government of Venezuela held a national referendum and mayoral elections using voting machines that utilized fingerprint information to authenticate the identities of voters and to prevent duplicate voter registration;

- Increased government spending on the infrastructure for fingerprint biometrics and the improving price-to-performance characteristics of biometrics technology are expediting the adoption of other fingerprint biometrics solutions primarily by the commercial sector; and

- Increasing amounts of personal and financial information stored on and transmitted through cell phones and smart handheld devices have led to increased concern over the security of such information.

To satisfy the evolving needs of the market for AFIS and other fingerprint biometric solutions, vendors must deliver systems that achieve both an increasingly high level of accuracy and performance in a cost-effective and scalable manner.

Our Solution

We are a leading provider of fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. Key elements of our solution include:

- *End-to-End Solution and Services Capability.* Our fully integrated AFIS solution, comprised of our proprietary fingerprint biometrics software, together with optimized hardware and professional and custom development services, provides a total biometrics solution to our customers.

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High Accuracy Rates. We employ technology based on over fifteen years of research and development in fluid dynamics, neural networks and image processing principles to achieve what we believe to be industry-leading accuracy rates, while still maintaining rapid response times when searching large fingerprint databases.

High Performance. By utilizing our advanced search algorithms together with optimized hardware, we achieve high performance levels that enable our customers to deploy our systems in high traffic areas where real-time authentication or identification is critical, while still maintaining high accuracy rates.

Significant Cost Savings and Linear Scalability and Flexibility. We believe we provide a significantly lower total cost of ownership than competing solutions because our systems are compatible with earlier versions, interoperable with a wide variety of industry-standard software and hardware platforms and can scale linearly in performance to meet our customers evolving needs.

Our Strategy

Our objective is to become the leading provider of biometric solutions for governments, law enforcement agencies and other organizations worldwide. Key elements of our strategy to achieve this objective include:

- increase sales to government organizations in the United States;
- expand our international presence;
- increase the size and scope of our customer engagements;
- pursue opportunities in the developing markets for other fingerprint biometrics solutions;
- continue to innovate and develop leading biometrics technology capabilities; and
- pursue strategic alliances and acquisitions.

Corporate Information

We were incorporated in California in April 1990 and reincorporated in Delaware in May 2004. The address of our principal executive office is 209 Fair Oaks Avenue, South Pasadena, California 91030, and our telephone number is (626) 799-8090. Our web site address is www.cogentsystems.com. The information on, or accessible through, our website is not part of this prospectus.

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THE OFFERING

Common stock offered by us	4,000,000 shares
Common stock offered by the selling stockholders	7,000,000 shares
Common stock to be outstanding after this offering	90,565,957 shares
Use of proceeds	We intend to use the net proceeds that we receive from this offering for working capital and general corporate purposes, including research and development and potential acquisitions of products, technologies or companies. See Use of Proceeds. We will not receive any of the proceeds from the sale of the shares of our common stock by the selling stockholders.
Nasdaq National Market symbol	COGT

The number of shares of our common stock to be outstanding immediately after the offering is based on 85,603,457 shares outstanding as of May 10, 2005. The number of shares of our common stock that will be outstanding immediately after this offering also includes 962,500 shares of common stock issuable upon exercise of options outstanding at May 10, 2005. These options will be exercised by three selling stockholders, and the shares purchased through these exercises will be sold in this offering. The common stock outstanding immediately after this offering excludes 7,079,793 shares of common stock issuable as of May 10, 2005 upon the exercise of stock options issued under our stock option plans at a weighted average exercise price of $1.25 per share, less 962,500 shares of common stock subject to options which, as noted above, will be exercised by three selling stockholders in this offering.

Except as otherwise indicated, all information contained in this prospectus assumes:

- no exercise of stock options after May 10, 2005; and
- no exercise by the underwriters of their right to purchase up to an additional 1,650,000 shares from a selling stockholder to cover over-allotments.

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SUMMARY CONSOLIDATED FINANCIAL DATA

The following tables provide our summary consolidated financial information. The summary consolidated statement of operations data for each of the three years in the period ended December 31, 2004, have been derived from our audited consolidated financial statements included elsewhere in this prospectus. The summary consolidated statement of operations data for the three month periods ended March 31, 2004 and 2005 and the summary consolidated balance sheet data as of March 31, 2005, have been derived from our unaudited consolidated financial statements included elsewhere in this prospectus. You should read this information together with our consolidated financial statements and related notes and the information under Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus.

	Year Ended December 31,			Three Months Ended March 31,	
	2002	2003	2004	2004(1)	2005
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Total revenues	$ 16,357	$ 32,179	$ 87,688	$ 15,398	$ 35,841
Gross profit	11,388	21,942	57,861	12,300	20,719
Operating expenses:					
Research and development	4,551	5,687	6,890	1,660	1,913
Selling and marketing	2,135	2,752	3,826	807	1,526
General and administrative	2,152	1,986	3,976	818	1,727
Amortization of deferred stock-based compensation	10	1,142	9,759	4,223	1,623
Total operating expenses	8,848	11,567	24,451	7,508	6,789
Operating income	2,540	10,375	33,410	4,792	13,930
Income tax provision (benefit)	35	577	(6,428)	311	5,537
Net income	$ 2,279	$ 9,189	$ 42,581	$ 4,517	$ 10,065
Net income per share:					
Basic	$ 0.04	$ 0.15	$ 0.65	$ 0.08	$ 0.12
Diluted	$ 0.04	$ 0.14	$ 0.56	$ 0.07	$ 0.11
Weighted average number of shares used in per share calculations:					
Basic	60,000	60,000	65,617	60,000	82,008
Diluted	63,723	67,853	75,817	68,576	91,845
Pro forma net income data:(2)					
Income before income taxes and after equity in losses of investee and impairment of equity investment, as reported	$ 2,314	$ 9,766	$ 36,153	$ 4,828	
Pro forma provision for income taxes	636	4,123	14,837	2,752	
Pro forma net income	$ 1,678	$ 5,643	$ 21,316	$ 2,076	
Pro forma net income per share:					
Basic	$ 0.03	$ 0.09	$ 0.32	$ 0.03	
Diluted	$ 0.03	$ 0.08	$ 0.28	$ 0.03	

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The as adjusted column of the consolidated balance sheet data reflects (i) the sale of 4,000,000 shares of common stock offered by us at an assumed public offering price of $22.61 per share, after deducting estimated underwriting discounts and commissions and estimated offering costs payable by us, and (ii) the proceeds from the exercise of options to purchase 962,500 shares of common stock by three selling stockholders in this offering.

	As of March 31, 2005	
	Actual	As Adjusted
	(in thousands)	
Consolidated Balance Sheet Data:		
Cash, cash equivalents and investments in marketable securities, current and long term	$ 219,977	$ 306,272
Total debt		
Working capital	168,787	255,082
Total assets	294,330	380,625
Deferred revenue	48,498	48,498
Total stockholders equity	239,662	325,957

(1) Subsequent to the issuance of our consolidated financial statements for the three months ended March 31, 2004, an error was discovered in the calculation of amortization of deferred stock-based compensation that extended back into 2003, as previously disclosed in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004. As a result, our results of operations for the three months ended March 31, 2004 were restated from the amounts previously reported in the registration statement on Form S-1 for our initial public offering. The effects of the error in 2003 were not significant and were recognized in the three months ended March 31, 2004. See Note 15 to our consolidated financial statements.

(2) We were an S Corporation prior to September 22, 2004, and thus were exempt from paying federal income taxes and paid certain state income taxes at a reduced rate. We terminated our S Corporation status effective September 22, 2004. Pro forma net income data is unaudited and reflects the income tax expense that would have been recordable had we not been exempt from paying income taxes due to our S Corporation election. Pro forma net income data for the years ended December 31, 2002 and 2003 have been corrected from the data presented in our Annual Report on Form 10-K for the year ended December 31, 2004 to properly reflect the inclusion of equity in losses of investee and impairment of equity investment. See Note 14 to our consolidated financial statements.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors, as well as the other information in this prospectus, before deciding whether to invest in shares of our common stock. If any of the following risks actually materializes, our business, financial condition and results of operations would suffer. In this case, the trading price of our common stock would likely decline, and you might lose all or part of your investment in our common stock.

Risks Related To Our Business

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

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

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

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

In 2004 and for the three months ended March 31, 2005, we derived 71% and 70%, respectively, of our revenues from a limited number of customers.

In each fiscal period we have derived, and we believe that in each future fiscal period we will continue to derive, a significant portion of our revenues from a limited number of customers. We had three customers that collectively accounted for 71% of revenues in 2004, including the DHS and the CNE, which accounted for 25% and 38% of revenues, respectively. In the three months ended March 31, 2005, the DHS and the CNE collectively accounted for 70% of revenues for that period, or 26% and 44%, respectively. The success of our business is substantially dependent on the continuation of our relationships with, and additional sales to, these significant customers. In addition, our business is dependent upon entering into relationships with additional significant customers. To the extent that any significant customer reduces or delays its purchases from us or terminates its relationship with us, our revenues would decline significantly and our financial condition and results of operations would suffer substantially. None of our customers are obligated to purchase additional solutions from us. As a result, the amount of revenue that we derive from a specific customer may vary from period to period, and a significant customer in one period may not be a significant customer in any subsequent period.

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In 2004 and for the three months ended March 31, 2005, we derived 44% and 42%, respectively, of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

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

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

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

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

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

- the cost, performance and reliability of our solutions and the products and services offered by our competitors;
- customers perceptions regarding the benefits of biometrics solutions;
- the development and growth of demand for biometrics solutions in markets outside of government and law enforcement;
- public perceptions regarding the intrusiveness of these solutions and the manner in which organizations use the biometric information collected;
- public perceptions regarding the confidentiality of private information;

- proposed or enacted legislation related to privacy of information;

- customers satisfaction with biometrics solutions; and

- marketing efforts and publicity regarding biometrics solutions.

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

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

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

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

- the lack or reduction of government funding and the political, budgetary and purchasing constraints of our government agency customers;
- the size and timing of our receipt of customer orders;
- significant fluctuation in demand for our solutions;
- price reductions or adjustments, new competitors, or the introduction of enhanced solutions from new or existing competitors;
- cancellations, delays or contract amendments by government agency customers;
- protests of federal, state or local government contract awards by competitors;
- unforeseen legal expenses, including litigation and/or administrative protest costs;
- expenses related to acquisitions or mergers;
- potential effects of providing services as a prime contractor that may not carry gross margins as high as those of our core solutions;
- impairment charges arising out of our assessments of goodwill and intangibles; and
- other one-time financial charges.

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

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

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

- companies that are AFIS component providers, such as Cross Match Technologies and Identix;

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

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

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

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

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated and our reputation may be harmed and the trading price of our stock could be negatively affected. We have in the past discovered, and may in the future discover, areas in our internal controls that are materially weak or that need improvement. For example, in connection with the audit of our financial statements for the three years ended December 31, 2003, in May 2004, our independent registered public accounting firm, or independent auditors, reported to our audit committee several matters that were reportable conditions and material weaknesses in our internal controls as defined in standards established by the American Institute of Certified Public Accountants. In addition, in connection with the preparation of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, we discovered a deficiency in our internal controls used in calculating amortization of deferred stock compensation. In connection with the preparation of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, we discovered that the pro forma net income data for fiscal years 2002 and 2003 presented in our Annual Report on Form 10-K for the year ended December 31, 2004 contained an error as described in Note 14 to our financial statements. In general, reportable conditions are significant deficiencies in our internal controls that could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. A material weakness is a reportable condition in which our internal controls do not reduce to a low level the risk that undetected misstatements caused by error or fraud may occur in amounts that are material to our audited financial statements.

In 2004, we devoted significant resources to remediate and improve our internal controls. We believe that these efforts have remedied the concerns that gave rise to the reportable conditions and material weaknesses, and we did not identify any reportable conditions or material weaknesses in the preparation of our financial statements for the year ended December 31, 2004. However, our auditors did not audit our internal control over financial reporting, and we cannot be certain that our internal control over financial reporting will be adequate in the future. Any deficiencies in our internal control over financial reporting in the future could cause us to fail to accurately report our financial results on a timely basis and could adversely affect the results of our required annual management evaluation reports and auditor attestation reports regarding the effectiveness of our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002, which will be required beginning with our Annual Report on Form 10-K for our current fiscal year ending December 31, 2005.

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

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

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Among the most significant regulations affecting our business are:

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

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

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

- the Foreign Corrupt Practices Act; and

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

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

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

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

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

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

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

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

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

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

Deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the projects and deploy appropriate resources, including our own project managers and third party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in reputational damage or claims for monetary damages against us, which could be substantial. In addition, we sometimes guarantee customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit from a particular project. Moreover, 79% of our revenues in 2004 and 58% of our revenues in the three months ended March 31, 2005 were derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing solutions in order to address the changing and sophisticated needs of the marketplace. Frequently, technical development programs in the biometrics industry require assessments to be made of the future direction of technology, which is inherently difficult to predict. Delays in introducing new products and enhancements, the failure to choose correctly among technical alternatives or the failure to offer innovative products or enhancements at competitive prices may cause customers to forego purchases of our solutions and purchase our competitors solutions. We may not have adequate resources available to us or may not adequately keep pace with appropriate requirements in order to effectively compete in the marketplace.

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

Our success depends largely upon the continued services of our executive officers and other key personnel, particularly Ming Hsieh, our founder, President, Chairman and Chief Executive Officer. The relationships that our key managers have cultivated with our customers make us particularly dependent upon their continued employment with us. We are also substantially dependent on the continued services of our existing engineering

and project management personnel because of the highly technical nature of our solutions. We do not have employment agreements with any of our executive officers or key personnel obligating them to provide us with continued services and therefore, they could terminate their employment with us at any time without penalty. We do not maintain key person life insurance policies on any of our employees. The loss of one or more members of our management team could seriously harm our business.

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

Historically, our business and products have been focused on the government and law enforcement markets. In 2004 and for the three months ended March 31, 2005, sales to customers in these markets accounted for 99% of our revenues. A key component of our strategy is to develop and grow our sales of other fingerprint biometrics solutions. The market for these solutions is at an early stage of development compared to the market for law enforcement and other government sector biometrics products. We cannot assure you that other fingerprint biometrics products and solutions will gain wide market acceptance, that this market will develop and grow as we expect, that we will successfully develop products for this market or that we will have the same success in this market as we have had in the government and law enforcement markets. In addition, we cannot assure you that our strategy of expanding our business to cover biometric solutions and products based on biometrics other than fingerprints will be successful.

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

We record an item as backlog when we receive a contract, purchase order or other notification indicating the specific products and/or services to be purchased, the purchase price, specifications and other customary terms and conditions. Our backlog includes deferred revenue reflected on our consolidated balance sheet. There can be no assurance that any of the contracts comprising our backlog presented in this prospectus will result in actual revenue in any particular periods or that the actual revenue from such contracts will equal our backlog estimates. Furthermore, there can be no assurance that any contract included in our estimated backlog that actually generates revenue will be profitable. These estimates are based on our experience under such contracts and similar contracts and may not be accurate. As of December 31, 2004 and 2003, our total backlog was approximately $127 million and $47 million, respectively.

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

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

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

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

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

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

We may be required to expend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any such litigation, whether or not it is ultimately resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

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

As the size of our market increases, the likelihood of an intellectual property claim against us increases. Our technologies may not be able to withstand third-party claims against their use. Any intellectual property claims,

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with or without merit, could be time-consuming and expensive to litigate or settle, and could divert management attention away from the execution of our business plan. In addition, we may be required to indemnify our customers for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also prevent us from offering our solutions to others.

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

Ming Hsieh, our Chief Executive Officer, currently controls approximately 69.7% of our outstanding common stock, and upon consummation of this offering he will continue to hold approximately 59.0% of our outstanding common stock (assuming no exercise by the underwriters of their right to purchase up to an additional 1,650,000 shares from Mr. Hsieh to cover over-allotments). As a result, he is able to exercise control over matters requiring stockholder approval, such as the election of directors and the approval of significant corporate transactions. These types of transactions include transactions involving an actual or potential change of control of our company or other transactions that the non-controlling stockholders may deem to be in their best interests and in which such stockholders could receive a premium for their shares. We are currently, and following this offering will continue to be, a controlled company under the Nasdaq corporate governance rules, and therefore we are entitled to exemptions from certain of the Nasdaq corporate governance rules. These requirements are generally intended to increase the likelihood that boards will make decisions in the best interests of stockholders. Specifically, we are not required to have a majority of our directors be independent or to have compensation, nominating and corporate governance committees comprised solely of independent directors. We do not intend to avail ourselves of the controlled company exemptions, but our intentions may change and in such event, if our stockholders interests differed from those of Mr. Hsieh, our stockholders would not be afforded the protections of these Nasdaq corporate governance requirements.

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

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

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

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

In 2004 and for the three months ended March 31, 2005, revenues outside of the Americas accounted for approximately 15% and 11%, respectively, of our total revenues. We also currently have international operations,

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including offices in Austria, China and Taiwan. Our international revenues and operations are subject to a number of material risks, including, but not limited to:

- difficulties in building and managing foreign operations;
- regulatory uncertainties in foreign countries;
- difficulties in enforcing agreements and collecting receivables through foreign legal systems and other relevant legal issues;
- longer payment cycles;
- foreign and U.S. taxation issues;
- potential weaknesses in foreign economies;
- fluctuations in the value of foreign currencies;
- general economic and political conditions in the markets in which we operate; and
- unexpected domestic and international regulatory, economic or political changes.

Our sales, including sales to customers outside the United States, are primarily denominated in U.S. dollars, and therefore downward fluctuations in the value of foreign currencies relative to the U.S. dollar may make our solutions more expensive than local solutions in international locations. This would make our solutions less price competitive than local solutions, which could harm our business. We do not currently engage in currency hedging activities to limit the risks of currency fluctuations. Therefore, fluctuations in the value of foreign currencies could harm our profitability.

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

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

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

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

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

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

- difficulties in integrating operations, technologies, accounting and personnel;

- difficulties in supporting and transitioning customers of our acquired companies;

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- diversion of financial and management resources from existing operations;
- risks of entering new markets;
- potential loss of key employees; and
- inability to generate sufficient revenues to offset acquisition costs.

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

Risks related to this offering

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

Our certificate of incorporation, as amended, and our bylaws, as amended, contain provisions that could delay or prevent a change of control of our company that our stockholders might consider favorable. In addition, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may discourage, delay or prevent certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our charter documents may make it more difficult for stockholders or potential acquirers to initiate actions that are opposed by the then-current board of directors, including delaying or impeding a merger, tender offer, or proxy contest or other change of control transaction involving our company. Any delay or prevention of a change of control transaction could cause stockholders to lose a substantial premium over the then current market price of their shares. Our board of directors has the authority, without further action by our stockholders, to issue up to 5,000,000 shares of preferred stock in one or more series. The ability to issue preferred stock could delay or impede a change in control.

The trading price of our common stock is volatile.

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

- variations in our financial results;
- announcements of technological innovations, new solutions, strategic alliances or significant agreements by us or by our competitors;

- recruitment or departure of key personnel;

- changes in the estimates of our financial results or changes in the recommendations of any securities analysts that elect to follow our common stock; and

- market conditions in our industry, the industries of our customers and the economy as a whole.

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

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If securities analysts do not publish research or reports about our business or if they downgrade their evaluations of our stock, the price of our stock could decline.

The trading market for our common stock relies in part on the research and reports that industry or financial analysts publish about us or our business. We do not control these analysts. Furthermore, if one or more of the analysts covering us downgrade their evaluation of our stock, the price of our stock could decline. If one or more of these analysts cease coverage of our company, we could lose visibility in the market for our stock, which in turn could cause our stock price to decline.

Our ability to raise capital in the future may be limited, and our failure to raise capital when needed could prevent us from executing our growth strategy.

We believe that our existing cash and cash equivalents together with the net proceeds from this offering will be sufficient to meet our anticipated cash needs for at least the next 12 months. The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

- market acceptance of our solutions;
- the need to adapt to changing technologies and technical requirements;
- the existence of opportunities for expansion; and
- access to and availability of sufficient management, technical and marketing personnel.

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. We have not made arrangements to obtain additional financing, and there is no assurance that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

Our management will have broad discretion over the use of the proceeds to us from this offering and might not apply the proceeds of this offering in ways that increase the value of your investment.

Our management will have broad discretion over the use of the net proceeds we receive from this offering, and you will be relying on the judgment of our management regarding the application of these proceeds. They might not apply the net proceeds we receive from this offering in ways that increase the value of your investment. We anticipate we will use the net proceeds that we receive from this offering for working capital and general corporate purposes, including research and development and potential acquisitions of products, technologies or companies. We have not allocated these net proceeds for any specific purposes. Our management might not be able to yield a significant return, if any, on any investment of these net proceeds. We will not receive any of the proceeds from the sale of the shares of our common stock by the selling stockholders.

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

Ming Hsieh, who was our sole stockholder prior to the sale of the shares in our initial public offering, continues to hold a substantial majority of the shares of our common stock. Sales by Mr. Hsieh of a substantial number of shares, or the expectation that such sales may occur, could significantly reduce the market price of our common stock. The selling stockholders participating in this offering, along with certain directors and executive officers of ours, will enter into contractual lock-up agreements with respect to sales, offers to sell, and other transfers or transactions relating to our common stock, beginning as of the date of this prospectus. The term of the lock-up agreement for selling stockholders and certain of our directors and executive officers, other than Mr. Hsieh, will expire 90 days after the date of this prospectus. Mr. Hsieh s lock-up agreement term will extend to

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the end of calendar year 2005, provided that Mr. Hsieh will be permitted to make sales of up to 1,000,000 shares pursuant to a trading plan designed to comply with SEC Rule 10b5-1 that provides for sales of no more than 250,000 shares per month. No sales under such plan will be made during the 90 day period following the date of this prospectus. Morgan Stanley & Co. Incorporated and J.P. Morgan Securities Inc. may, in their sole discretion, permit these stockholders, officers, directors and employees to sell shares prior to the expiration of the lock-up agreements.

In addition, the lock-up agreements that were executed in connection with our initial public offering expired on March 22, 2005. Other than shares subject to the lock-ups executed in connection with this offering, all of our outstanding shares are eligible for sale in the public market, subject to volume limitations under Rule 144 under the Securities Act of 1933, as amended, or the Securities Act. Also, shares subject to outstanding options and rights under our 2000 Stock Option Plan and 2004 Equity Incentive Plan are eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements and Rules 144 and 701 under the Securities Act. If these additional shares are sold, or if it is perceived that they will be sold in the public market, the trading price of our common stock could decline.

We may incur increased costs as a result of laws and regulations applicable to public companies.

The laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules of the Securities and Exchange Commission and by the Nasdaq Stock Market, could result in increased costs to us. The rules could make it more difficult or more costly for us to obtain certain types of insurance, including directors and officers liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. We are presently evaluating and monitoring developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements that involve risks and uncertainties. The forward-looking statements are contained principally in the sections entitled Prospectus Summary, Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business. These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. Forward-looking statements include, but are not limited to, statements about:

- marketing and commercialization of our AFIS solutions;
- our estimates for future revenues, expenses and profitability;
- our ability to attract customers and enter into customer contracts;
- our estimates regarding our capital requirements and our needs for additional financing;
- plans for future products and services and for enhancements of our existing AFIS solutions;
- our plans to pursue strategic alliances and acquisitions; and
- sources of revenues and anticipated revenues and the continued viability and duration of existing customer agreements.

In some cases, you can identify forward-looking statements by terms such as may, might, will, should, could, would, expect, believe, estimate, predict, potential, or the negative of these terms, and similar expressions intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. We discuss many of these risks in this prospectus in greater detail under the heading Risk Factors. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this prospectus.

This prospectus contains statistical data that we obtained from industry publications and other industry sources, including reports generated by International Biometric Group and other third parties. These industry publications generally indicate that they have obtained their information from sources believed to be reliable, but the sources do not guarantee the accuracy and completeness of their information. We have not independently verified their data. You should read this prospectus and the documents that we reference in this prospectus and have filed as exhibits to the registration statement, of which this prospectus is a part, completely and with the understanding that our actual future results may be materially different from what we expect. We qualify all of our forward-looking statements by these cautionary statements.

TRADEMARKS

We have common law trademark rights in or registered trademarks for Cogent Systems, BioGate, Live-ID and PMA. Each trademark, trade name or service mark of another company appearing in this prospectus belongs to its holder, and does not belong to us.

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USE OF PROCEEDS

We expect that the net proceeds we will receive from the sale of the shares of common stock we are offering will be approximately $86.3 million, based on an assumed public offering price of $22.61 per share, after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us. We will not receive any proceeds from the sale of the shares to be sold by the selling stockholders.

We anticipate that we will use the net proceeds we receive from this offering for working capital and general corporate purposes, including research and development and potential acquisitions of products, technologies or companies. We have no current agreements or commitments with respect to any such acquisition. In addition, the actual use of the proceeds may vary significantly and will depend on a number of factors, including our future revenue and cash generated by operations and the other factors described in Risk Factors. Accordingly, our management will have broad discretion in applying the net proceeds of this offering. Pending these uses, we intend to invest the net proceeds in high quality, investment grade instruments, which include corporate, financial institution, federal agency or U.S. government obligations.

PRICE RANGE OF COMMON STOCK

Our common stock has been traded on the Nasdaq National Market under the symbol COGT since September 24, 2004. Prior to that time, there was no public market for our common stock. The following table sets forth the range of high and low sales prices of our common stock, as reported on the Nasdaq National Market.

	Common Stock Price	
	High ($)	Low ($)
Fiscal Year 2004		
Third Quarter 2004 (from September 24, 2004)	19.03	15.50
Fourth Quarter 2004	38.25	17.61
Fiscal Year 2005		
First Quarter 2005	34.48	23.04
Second Quarter 2005 (through May 13, 2005)	25.35	21.09

As of May 13, 2005, there were 14 holders of record of our common stock. On May 13, 2005, the last sale price reported on the Nasdaq National Market for our common stock was $22.61 per share.

DIVIDEND POLICY

As an S Corporation prior to September 22, 2004, we historically paid dividends to our stockholders. We declared a final dividend of $65.5 million to Ming Hsieh, our sole stockholder prior to our initial public offering, which was paid after completion of our initial public offering. We anticipate that any future earnings will be retained to finance continuing development of our business. Accordingly, we do not anticipate paying dividends on our common stock in the foreseeable future.

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 certain state income tax purposes, since 1992 we have paid dividends to our stockholders. We terminated our S Corporation status effective September 22, 2004, and since this date we have been treated for federal and state income tax purposes as a corporation under Subchapter C of the Code and, as a result, are now subject to state and federal income taxes.

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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. For information concerning the tax matters agreement, see Certain Relationships and Related Party Transactions Tax Matters Agreement.

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CAPITALIZATION

The following table sets forth our unaudited cash and cash equivalents, investments in marketable securities and capitalization as of March 31, 2005 (i) on an actual basis, and (ii) on an as adjusted basis to reflect the issuance and sale of 4,000,000 shares of common stock in this offering, offered by us at an assumed public offering price of $22.61 per share, after deducting the estimated underwriting discounts and commissions and estimated expenses payable by us, and the proceeds from the exercise of options to purchase 962,500 shares of common stock by three selling stockholders in this offering. This table should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this prospectus.

	As of March 31, 2005	
	Actual	As Adjusted
	(in thousands, except share data)	
Cash, cash equivalents and investments in marketable securities, current and long term	$ 219,977	$ 306,272
Total debt	$	$
Stockholders equity:		
Preferred stock, $.001 par value: 5,000,000 shares authorized, no shares issued or outstanding, actual and as adjusted		
Common stock, $.001 par value: 250,000,000 shares authorized, actual and as adjusted; 83,280,540 shares issued and outstanding, actual; and 88,243,040 shares issued and outstanding, as adjusted	$ 120	$ 120
Additional paid-in capital	258,180	344,475
Deferred stock-based compensation	(8,058)	(8,058)
Retained earnings (deficit)	(9,930)	(9,930)
Accumulated other comprehensive loss	(650)	(650)
Total stockholders equity	239,662	325,957
Total capitalization	$ 239,662	$ 325,957

The number of shares shown as issued and outstanding in the table above excludes 9,406,585 shares of common stock issuable as of March 31, 2005, upon the exercise of stock options issued under our stock option plans at a weighted average exercise price of $1.05 per share, less 962,500 shares of common stock subject to options that will be exercised by three selling stockholders in this offering.

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SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus. The selected consolidated balance sheet data as of December 31, 2003 and 2004 and the selected consolidated statement of operations data for each of the three years in the period ended December 31, 2004, have been derived from our audited consolidated financial statements, which are included elsewhere in this prospectus. The selected consolidated balance sheet data as of December 31, 2001 and 2002 and selected consolidated statement of operations data for the year ended December 31, 2001 have been derived from our audited consolidated financial statements not included in this prospectus. The selected consolidated balance sheet data as of December 31, 2000 and the selected consolidated statements of operations data for the year then ended have been derived from unaudited consolidated financial statements not included in this prospectus. The selected consolidated statements of operations data for the three month periods ended March 31, 2004 and 2005 and the selected consolidated balance sheet data as of March 31, 2005, have been derived from our unaudited consolidated financial statements included elsewhere in this prospectus. The unaudited consolidated financial statements include, in the opinion of management, all adjustments that management considers necessary for the fair presentation of the financial information set forth in those statements. Historical results are not necessarily indicative of the results to be expected in the future, and the results for the three months ended March 31, 2005, should not be considered indicative of results expected for the full fiscal year. The pro forma net income data below is unaudited.

	Year Ended December 31,					Three Months Ended March 31,	
	2000	2001	2002	2003	2004	2004(1)	2005
	(in thousands, except per share data)						
Statements of Operations Data:							
Revenues:							
Product revenues	*	$ 8,716	$ 10,450	$ 24,911	$ 74,698	$ 12,694	$ 31,780
Maintenance and services revenues	*	4,352	5,907	7,268	12,990	2,704	4,061
Total revenues	$ 14,120	13,068	16,357	32,179	87,688	15,398	35,841
Cost of revenues:							
Cost of product revenues(2)	*	3,520	3,841	7,881	25,551	2,365	13,838
Cost of maintenance and services revenues(2)	*	1,015	1,128	2,051	3,607	619	1,089
Amortization of deferred stock-based compensation	*			305	669	114	195
Total cost of revenues	4,815	4,535	4,969	10,237	29,827	3,098	15,122
Gross profit	9,305	8,533	11,388	21,942	57,861	12,300	20,719
Operating expenses:							
Research and development(2)	3,194	4,270	4,551	5,687	6,890	1,660	1,913
Selling and marketing(2)	4,991	1,886	2,135	2,752	3,826	807	1,526
General and administrative(2)	*	2,904	2,152	1,986	3,976	818	1,727
Amortization of deferred stock-based compensation	*	13	10	1,142	9,759	4,223	1,623
Total operating expenses	8,185	9,073	8,848	11,567	24,451	7,508	6,789
Operating income (loss)	1,120	(540)	2,540	10,375	33,410	4,792	13,930

Other income (expenses):							
Interest income	138	189	69	120	1,144	36	1,388
Other, net(3)	7,117	15	19	(48)	1,599		284
Total other income	7,255	204	88	72	2,743	36	1,672
Income (loss) before income taxes and equity in losses of investee and impairment of equity investment	8,375	(336)	2,628	10,447	36,153	4,828	15,602
Income tax provision (benefit)	18	(32)	35	577	(6,428)	311	5,537
Equity in losses of investee		(107)	(314)	(246)			
Impairment of equity investment				(435)			
Net income (loss)	$ 8,357	$ (411)	$ 2,279	$ 9,189	$ 42,581	$ 4,517	$ 10,065

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	Year Ended December 31,					Three Months Ended March 31,	
	2000	2001	2002	2003	2004	2004(1)	2005
	(in thousands, except per share data)						
Net income (loss) per share(4):							
Basic	$ 0.14	$ (0.01)	$ 0.04	$ 0.15	$ 0.65	$ 0.08	$ 0.12
Diluted	$ 0.14	$ (0.01)	$ 0.04	$ 0.14	$ 0.56	$ 0.07	$ 0.11
Weighted average number of shares used in per share calculations:							
Basic	60,000	60,000	60,000	60,000	65,617	60,000	82,008
Diluted	60,000	60,000	63,723	67,853	75,817	68,576	91,845
Pro forma net income data(5):							
Income before income taxes and after equity in losses of investee and impairment of equity investment, as reported			$ 2,314	$ 9,766	$ 36,153	$ 4,828	
Pro forma provision for income taxes			636	4,123	14,837	2,752	
Pro forma net income			$ 1,678	$ 5,643	$ 21,316	$ 2,076	
Pro forma net income per share:							
Basic			$ 0.03	$ 0.09	$ 0.32	$ 0.03	
Diluted			$ 0.03	$ 0.08	$ 0.28	$ 0.03	

	As of December 31,					As of March 31, 2005
	2000	2001	2002	2003	2004	
	(in thousands)					
Balance Sheet Data:						
Cash and cash equivalents	$ 2,074	$ 1,111	$ 1,522	$ 17,457	$ 27,004	$ 23,511
Investments in marketable securities, current and long term					195,719	196,466
Working capital	8,080	4,602	9,606	20,228	187,546	168,787
Total debt						
Total assets	16,229	14,732	22,223	37,655	300,894	294,330
Deferred revenue	940	1,129	6,162	15,264	68,429	48,498
Total stockholders equity	14,743	11,980	12,367	19,716	222,064	239,662

* During the year ended December 31, 2000, we did not separately record product revenues and maintenance and services revenues or the related costs of product revenues and costs of maintenance and services revenues. In addition, during that period we recorded our selling and marketing and general and administrative expenses as a single expense category which we have presented as selling and marketing expenses in this table.

(1) Subsequent to the issuance of our consolidated financial statements for the three months ended March 31, 2004, an error was discovered in the calculation of amortization of deferred stock-based compensation that extended back into 2003, as previously disclosed in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004. As a result, our results of operations for the three months ended March 31, 2004 were restated from the amounts previously reported in the registration statement on Form S-1 for our initial public offering. The effects of the error in 2003 were not significant and were recognized in the three months ended March 31, 2004. See Note 15 to our consolidated financial statements.

(2) Excludes amortization of stock-based compensation expense as follows:

	Year Ended December 31,					Three Months Ended March 31,	
	2000	2001	2002	2003	2004	2004(1)	2005

				(in thousands)			
Cost of product revenues	$ *	$ *	$ *	$ 100	$ 172	$ 32	$ 66
Cost of maintenance and services revenues	*	*	*	205	497	82	129
Research and development	*	*	*	663	1,413	318	529
Selling and marketing	*	13	10	421	1,558	371	430
General and administrative	*	*	*	58	6,788	3,534	664
	$ 0	$ 13	$ 10	$ 1,447	$ 10,428	$ 4,337	$ 1,818

(3) Other, net of $7.1 million for the year ended December 31, 2000 relates primarily to the proceeds we received from the settlement of a lawsuit in June 2000.

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(4) See Note 1 to our consolidated financial statements for an explanation of the determination of the number of shares used to compute basic and diluted per share amounts.

(5) Prior to the termination of our S Corporation status, we were exempt from paying federal income taxes and have paid certain state income taxes at a reduced rate because of our S Corporation status. Our S Corporation status terminated effective September 22, 2004. Pro forma net income (loss) data reflects the income tax expense (credit) that would have been recorded had we not been exempt from paying taxes under the S Corporation election. Pro forma net income data for the years ended December 31, 2002 and 2003 have been corrected from the data presented in our Annual Report on Form 10-K for the year ended December 31, 2004 to properly reflect the inclusion of equity losses of investee and impairment of equity investment. See Note 14 to our consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with the financial statements and related notes that are included elsewhere in this prospectus. This discussion may contain forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under Risk Factors or in other parts of this prospectus.

The accompanying management s discussion and analysis of financial condition and results of operations gives effect to the restatement of our March 31, 2004 condensed consolidated financial statements. See Note 15 to our consolidated financial statements.

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 2004 as the market for our AFIS and other fingerprint biometric solutions expanded primarily due to increased demand for our AFIS solutions 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 2004. 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. For larger AFIS deployments, the maintenance period is frequently longer than 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

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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 purchase orders. Any delay or other change in the rollout of US-VISIT or any failure to obtain new orders from the CNE would 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. 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, payments to contract manufacturers that perform assembly functions and payments to subcontractors. 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

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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.

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 three months ended March 31, 2005, we recorded $17.9 million and $0 in deferred stock-based compensation within stockholders equity, respectively. These options 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 year ended December 31, 2004 and the three months ended March 31, 2005, we recognized expense for amortization of deferred stock compensation of $10.4 million and $1.8 million, respectively. As of March 31, 2005, we had an aggregate of $8.1 million of deferred stock-based compensation remaining to be amortized. This deferred compensation balance will be amortized as follows: $4.1 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. The amount of stock based compensation which we recognize will increase beginning in the fiscal quarter ending March 31, 2006 as a result of the implementation of Statement of Financial Accounting Standards (SFAS) 123 (Revised 2004) Share Based Payment (SFAS 123R). See Recent Accounting Pronouncements.

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 have been treated for federal and state income tax purposes as a C Corporation under Subchapter C of the Code and, as a result, are 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.

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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. For information concerning the tax matters agreement, see Certain Relationships and Related Party Transactions Tax Matters Agreement.

All pro forma income taxes and pro forma net income (loss) 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 Policies

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 Certain 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.

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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 software license 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.

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

Revenue Recognition Criteria

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

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 December 31, 2004, our net deferred tax assets were approximately $14.3 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 beginning in the first quarter of 2005, and for the remainder of 2005, is expected to be impacted as a result of the disqualifying disposition of incentive stock options. We expect our effective tax rate to fluctuate from quarter to quarter primarily as a result of disqualifying dispositions that may occur after the first quarter of 2005 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 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 three months ended March 31, 2005, the Company recorded a tax benefit from stock option transactions which totaled approximately $5.5 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, or 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 Cost 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.

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:

	Year Ended December 31,			Three Months ended March 31,	
	2002	**2003**	**2004**	**2004(1)**	**2005**
Consolidated Statements of Operations Data:					
Revenues:					
Product revenues	63.9%	77.4%	85.2%	82.4%	88.7%
Maintenance and services revenues	36.1	22.6	14.8	17.6	11.3
Total revenues	100.0	100.0	100.0	100.0	100.0
Cost of revenues:					
Cost of product revenues	23.5	24.5	29.1	15.4	38.6
Cost of maintenance and services revenue	6.9	6.4	4.1	4.0	3.0
Amortization of deferred stock-based compensation	0.0	0.9	0.8	0.7	0.6
Total cost of revenues	30.4	31.8	34.0	20.1	42.2
Gross profit	69.6	68.2	66.0	79.9	57.8
Operating expenses:					
Research and development	27.8	17.7	7.9	10.8	5.3
Selling and marketing	13.1	8.6	4.4	5.3	4.3
General and administrative	13.2	6.2	4.5	5.3	4.8
Amortization of deferred stock-based compensation	0.1	3.5	11.1	27.4	4.5
Total operating expenses	54.2	36.0	27.9	48.8	18.9
Income from operations	15.4	32.2	38.1	31.1	38.9
Income before income taxes and equity in losses of investee and impairment of equity investment	16.1	32.5	41.2	31.3	43.5
Income tax provision (benefit)	0.2	1.8	(7.3)	2.0	15.4

Net income	13.9%	28.6%	48.6%	29.3%	28.1%
Pro forma net income data (unaudited):					
Pro forma provision for net income taxes	3.9%	12.8%	16.9%	17.9%	
Pro forma net income	10.3%	17.5%	24.3%	13.5%	

(1) Subsequent to the issuance of our consolidated financial statements for the three months ended March 31, 2004, an error was discovered in the calculation of amortization of deferred stock-based compensation that extended back into 2003, as previously disclosed in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004. As a result, our results of operations for the three months ended March 31, 2004 were restated from the amounts previously reported in the registration statement on Form S-1 for our initial public offering. The effects of the error in 2003 were not significant and were recognized in the three months ended March 31, 2004. See Note 15 to our consolidated financial statements.

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Comparison of the Three Months Ended March 31, 2005 and 2004

Revenues. Revenues were $35.8 million for three months ended March 31, 2005 compared to $15.4 million for the three months ended March 31, 2004. This substantial increase in revenues resulted from a number of factors which are driving the growth in the market for AFIS solutions. These factors include recent legislation passed in the United States and in many foreign jurisdictions mandating the implementation of fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics, recent terrorist attacks and increased demand in the civil sector, particularly for voting applications. Product revenues were $31.8 million for the three months ended March 31, 2005 compared to $12.7 million for the three months ended March 31, 2004. The $19.1 million increase in product revenues resulted primarily from AFIS solutions delivered to the CNE, an AFIS solution sold to a customer in Algeria as well as sales to a number of other domestic and international customers. During the three months ended March 31, 2005, we recognized revenue of approximately $15.8 million for AFIS solutions delivered to the CNE. In the third quarter of 2004, we entered into a contract with the CNE for the deployment and sale of an automated fingerprint identification and voter authentication/matching system for use in the Venezuelan national and regional elections. Revenue recorded relating to this contract totaled $11.8 million in the first quarter of fiscal 2005. Deferred revenue of $15.8 million related to this contract will be recognized ratably over the remaining portion of the one year maintenance period. In the fourth quarter of 2004, we entered into a second contract with the CNE for the deployment and sale of a new automated fingerprint identification and voter authentication/matching system for use in the Venezuelan regional elections. Revenue recorded on this contract totaled $4.0 million in first quarter of fiscal 2005. Deferred revenue of $9.6 million related to this contract will be recognized ratably over the remaining portion of the one year maintenance period. In 2004, we also entered into a contract with a value of approximately $10 million for the development and implementation of an automated palm and fingerprint identification system for a customer in Algeria. During the three months ended March 31, 2005, we recorded revenue of approximately $1.9 million related to this contract, which is being accounted for using the percentage of completion method. Maintenance and services revenues increased by 50.2% to $4.1 million for the three months ended March 31, 2005 from $2.7 million for the three months ended March 31, 2004. The $1.4 million increase was due to an increase in maintenance revenues and engineering services associated with higher product sales and increased support provided to the DHS, as well as to the generally increasing size of the installed base of customers who purchase maintenance. Maintenance and services revenues as a percentage of total revenues declined from period to period due to the increase in product revenues in the three months ended March 31, 2005 in comparison to the three months ended March 31, 2004.

Gross Profit. Gross profit as a percentage of revenues was 57.8% for the three months ended March 31, 2005 compared to 79.9% for the three months ended March 31, 2004. Amortization of deferred stock-based compensation included in cost of revenues increased to $195,000 for the three months ended March 31, 2005 from $114,000 for the three months ended March 31, 2004, which accounted for approximately one percentage point of revenues for both of these respective periods. Product gross margins were 56.2% for the three months ended March 31, 2005 compared to 81.1% for the three months ended March 31, 2004. The portion of deferred stock-based compensation included in cost of revenues related to product cost of revenues was $66,000 and $32,000 for the three months ended March 31, 2005 and 2004, respectively, which reduced product gross margins by less than one percentage point for these respective periods. The decrease in product gross margins was primarily due to lower gross margins associated with our significant AFIS installations, particularly the CNE contracts, resulting from the resale of third party hardware, which was partially offset by the allocation of fixed overhead costs over a higher revenue base. Costs of product revenues increased to $13.8 million for the three months ended March 31, 2005 from $2.4 million for the three months ended March 31, 2004. Maintenance and services gross margins were 70.0% for the three months ended March 31, 2005 compared to 74.1% for the three months ended March 31, 2004. The portion of deferred stock-based compensation included in cost of revenues related to maintenance and services cost of revenues was $129,000 and $82,000 for the three months ended March 31, 2005 and 2004, respectively, which reduced maintenance and service margins by three percentage points for both of these respective periods. Costs of maintenance and service revenues increased to $1.1 million for the three months ended March 31, 2005 from $619,000 for the three months ended March 31, 2004.

Research and Development. Research and development expenses increased to $1.9 million, or 5% of revenues, for the three months ended March 31, 2005 compared to $1.7 million, or 11% of revenues for the three months ended March 31, 2004. The increase was primarily due to an increase in outside development fees of approximately $288,000 for the three months ended March 31, 2005 compared to March 31, 2004.

Selling and Marketing. Selling and marketing expenses increased to $1.5 million, or 4% of revenues, for the three months ended March 31, 2005 compared to $807,000, or 5% of revenues, for the three months ended March 31, 2004. The increase in absolute dollars was primarily due to an increase in consulting and professional service fees to support increased business development and proposal activities.

General and Administrative. General and administrative expenses increased to $1.7 million, or 5% of revenues, for the three months ended March 31, 2005 compared to $818,000, or 5% of revenues, for the three months ended March 31, 2004. The increase in absolute dollars was attributable to increased outside legal and accounting fees of approximately $354,000, increased compensation expenses of approximately $221,000, which resulted from an increase in headcount in finance and accounting personnel and an increase in board fees, directors and officers insurance costs and investor relations expenses of approximately $226,000.

Interest Income. We earned interest income of $1.4 million during the three months ended March 31, 2005 compared to $36,000 during the three months ended March 31, 2004. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds raised of approximately $228.6 million from our initial public offering in the third quarter of fiscal 2004.

Other, net. During the three months ended March 31, 2005 we recorded other income of $284,000 primarily related to receipt of a payment related to royalty obligations under a settlement agreement.

Income Tax Provision. We recognized an income tax provision of $5.5 million, with an effective tax rate of 35.5%, during the three months ended March 31, 2005 as a result of the net income incurred in the period. Our effective tax rate of 35.5% for the three months ended March 31, 2005 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may occur after the first quarter of 2005 related to incentive stock options currently outstanding and held by company personnel. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place. During the three months ended March 31, 2004, we recorded an income tax provision of $311,000 due to the net income incurred in the period and based on our tax rate as an S Corporation.

Comparison of Years Ended December 31, 2004 and 2003

Revenues. Revenues were $87.7 million for the year ended December 31, 2004 compared to $32.2 million for the year ended December 31, 2003. This substantial increase in revenues resulted from a number of factors which have been driving the growth in the market for AFIS solutions. These factors include recent legislation passed in the United States and in many foreign jurisdictions mandating the implementation of fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics, recent terrorist attacks and increased demand in the civil sector, particularly for voting applications. Product revenues were $74.7 million for the year ended December 31, 2004 compared to $24.9 million for the year ended December 31, 2003. The $49.8 million increase in product revenues resulted primarily from AFIS solutions delivered to the CNE, solutions sold to the DHS for the US-VISIT program, an AFIS solution sold to a customer in Algeria as well as sales of our products to a number of other domestic and international customers. During the year ended December 31, 2004, we recognized revenue of approximately $33 million for AFIS solutions delivered to the CNE. In the third quarter of 2004, we entered into a contract with the CNE for the deployment and sale of an automated fingerprint identification and voter authentication/matching system for use in the Venezuelan national and regional elections. Revenue recorded relating to this contract totaled $26.4 million in fiscal 2004. Deferred revenue of $27.6 million related to this contract will be recognized ratably over the remaining portion of

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the one year maintenance period. In the fourth quarter of 2004, we entered into a contract with the CNE for the deployment and sale of a new automated fingerprint identification and voter authentication/matching system for use in the Venezuelan regional elections. Revenue recorded on this contract totaled $6.5 million in fiscal 2004. Deferred revenue of $13.7 million related to this contract will be recognized ratably over the remaining portion of the one year maintenance period. Product sales to the DHS for the US-VISIT program in the year ended December 31, 2004 totaled $19.7 million compared to $15.8 million during the year ended December 31, 2003. In 2004, we also entered into a contract with a value of approximately $10 million for the development and implementation of an automated palm and fingerprint identification system for a customer in Algeria. During the year ended December 31, 2004, we recorded revenue of approximately $6.5 million related to this contract which is being accounted for using the percentage of completion method. Maintenance and services revenues increased by 78.7% to $13.0 million for the year ended December 31, 2004 from $7.3 million for the year ended December 31, 2003. The $5.7 million increase was due to an increase in maintenance revenues and engineering services associated with higher product sales and increased support provided to the DHS. Maintenance and services revenues as a percentage of total revenues declined from period to period due to the increase in product revenues in the year ended December 31, 2004.

Gross Profit. Gross profit as a percentage of revenues was 66.0% for the year ended December 31, 2004 compared to 68.2% for the year ended December 31, 2003. Amortization of deferred stock-based compensation included in cost of revenues increased to $669,000 for the year ended December 31, 2004 from $305,000 for the year ended December 31, 2003, which accounted for approximately one percentage point of revenues for these respective periods. Product gross margins were 65.6% for the year ended December 31, 2004 compared to 68.0% for the year ended December 31, 2003. The portion of deferred stock-based compensation included in cost of revenues related to product cost of revenues was $172,000 and $100,000 for the years ended December 31, 2004 and 2003, respectively, which reduced product gross margins by less than one percentage point for these respective periods. The decrease in product gross margins was primarily due to lower gross margins associated with our significant AFIS installations, particularly the CNE contract, resulting from the resale of third party hardware, which was partially offset by the allocation of fixed overhead costs over a higher revenue base. Costs of product revenues increased to $25.6 million for the year ended December 31, 2004 from $7.9 million for the year ended December 31, 2003. Maintenance and services gross margins were 68.4% for the year ended December 31, 2004 compared to 69.0% for the year ended December 31, 2003. The portion of deferred stock-based compensation included in cost of revenues related to maintenance and services cost of revenues was $497,000 and $205,000 for the years ended December 31, 2004 and 2003, respectively, which reduced maintenance and service margins by approximately four and three percentage points for these respective periods. Costs of maintenance and service revenues increased to $3.6 million for the year ended December 31, 2004 from $2.1 million for the year ended December 31, 2003.

Research and Development. Research and development expenses increased to $6.9 million, or 7.9% of revenues, for the year ended December 31, 2004 compared to $5.7 million, or 17.7% of revenues for the year ended December 31, 2003. The increase was primarily due to an increase in research and development compensation expense of $772,000, which was primarily attributable to an increase in research and development personnel to support development efforts for the year ended December 31, 2004 compared to December 31, 2003. Additionally, outside development costs totaling approximately $288,000 also contributed to the increase in research and development expenses in fiscal 2004.

Selling and Marketing. Selling and marketing expenses increased to $3.8 million, or 4.4% of revenues, for the year ended December 31, 2004 from $2.8 million, or 8.6% of revenues, for the year ended December 31, 2003. The increase in absolute dollars was primarily due to an increase in selling and marketing compensation expense of $504,000, which was primarily due to an increase in sales and marketing personnel to support our expanded customer base. Additionally, a $186,000 increase in trade show, promotional and conference expenses and a $132,000 increase in travel costs also contributed to the increase in selling and marketing expenses.

General and Administrative. General and administrative expenses increased to $4.0 million, or 4.5% of revenues, for the year ended December 31, 2004 compared to $2.0 million, or 6.2% of revenues, for the year

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ended December 31, 2003. The increase in absolute dollars was primarily attributable to increased outside legal and accounting fees of $762,000 and a net increase in compensation expense of $345,000 related to an increase in general and administrative personnel, including the addition of a Chief Financial Officer, a Corporate Controller and a Director of Financial Planning and Analysis. Various costs, such as insurance and franchise taxes, board of directors fees and investor relations consulting fees associated with our growth and transition to a public company resulted in an increase in general and administrative expenses of $492,000.

Interest Income. We earned interest income of $1.1 million during the year ended December 31, 2004 compared to $120,000 during the year ended December 31, 2003. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds raised of approximately $228.6 million from our initial public offering and cash generated from operations partially offset by cash distributions to our stockholders.

Other, net. During the year ended December 31, 2