UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended July 3, 2005.

OR

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

For the Transition Period from ______ to ______.

Commission File Number 000-21559

VIISAGE TECHNOLOGY, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**04-3320515** **(I.R.S. Employer** **Identification No.)**
296 Concord Road, Third Floor, Billerica, MA **(Address of principal executive offices)**	**01821** **(Zip Code)**

(978) 932-2200

Registrant s telephone number, including area code

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

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

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

Class	Outstanding at August 10, 2005
Common stock, $.001 par value	48,126,672

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VIISAGE TECHNOLOGY, INC.

FORM 10-Q FOR THE QUARTER ENDED JULY 3, 2005

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

VIISAGE TECHNOLOGY, INC.

Consolidated Balance Sheets

(in thousands)

	July 3, 2005	December 31, 2004*
	(Unaudited)	
Assets		
Current assets:		
Cash	$ 10,653	$ 11,309
Accounts receivable	17,826	17,075
Inventories and other costs and estimated earnings in excess of billings	4,239	3,382
Other current assets	667	1,213
Total current assets	33,385	32,979
Property and equipment, net	18,593	19,917
Goodwill	92,483	93,507
Intangible assets, net	22,641	26,046
Other assets	3,211	3,180
	$ 170,313	$ 175,629
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 12,483	$ 15,279
Current portion of long term debt	80	281
Current deferred revenue	2,914	1,992
Other current liabilities	14	194
Total current liabilities	15,491	17,746
Long term debt	111	149
Deferred tax liability	1,413	859
Deferred revenue	1,631	1,717
Other liabilities	368	368
Total Liabilities	19,014	20,839
Shareholders equity	151,299	154,790
	$ 170,313	$ 175,629

* Derived from audited financial statements.

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

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VIISAGE TECHNOLOGY, INC.

Consolidated Statements of Operations

(in thousands, except per share data)

(Unaudited)

	Three Months ended		Six Months ended	
	July 3, 2005	June 27, 2004	July 3, 2005	June 27, 2004
Services revenue	$ 10,586	$ 11,835	$ 20,978	$ 22,338
Product revenue	9,563	4,441	15,982	6,197
Total revenue	20,149	16,276	36,960	28,535
Services cost of revenue	7,685	8,107	14,953	15,637
Product cost of revenue	5,854	3,200	9,626	4,576
Total cost of revenue	13,539	11,307	24,579	20,213
Services gross margin	2,901	3,728	6,025	6,701
Product gross margin	3,709	1,241	6,356	1,621
Total gross profit	6,610	4,969	12,381	8,322
Operating expenses:				
Sales and marketing	2,139	1,578	4,355	3,071
Research and development	1,550	942	3,071	1,901
General and administrative	3,121	2,218	6,544	4,355
Total operating expenses	6,810	4,738	13,970	9,327
Operating income (loss)	(200)	231	(1,589)	(1,005)
Interest income	68	19	68	41
Interest expense	(38)	(596)	(54)	(1,010)
Other income (expense), net	(39)	54	84	75
Loss before income taxes	(209)	(292)	(1,491)	(1,899)
Provision for income taxes	(296)	(25)	(654)	(50)
Net loss	$ (505)	$ (317)	$ (2,145)	$ (1,949)
Basic and diluted net loss per share	$ (0.01)	$ (0.01)	$ (0.04)	$ (0.06)
Weighted average basic and diluted common shares outstanding	48,045	35,821	47,973	33,603

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

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VIISAGE TECHNOLOGY, INC.

Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Six Months Ended	
	July 3, 2005	**June 27, 2004**
Cash Flow from Operating Activities:		
Net Loss	$ (2,145)	$ (1,949)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation and amortization	5,900	5,135
Expenses paid in common stock	135	260
Changes in operating assets and liabilities:		
Accounts receivable	(751)	(399)
Inventories and costs and estimated earnings in excess of billings	(857)	599
Other current assets	515	(146)
Deferred revenue	426	
Deferred tax liability	554	
Accounts payable and accrued expenses	(2,987)	(1,161)
Net cash provided by operating activities	790	2,339
Cash Flow from Investing Activities:		
Restricted cash		3,191
Cash paid for acquisitions		(5,227)
Additions to property and equipment	(1,579)	(1,094)
Proceeds from sale of equipment	500	
(Increase) decrease in other assets	(235)	(169)
Net cash used for investing activities	(1,314)	(3,299)
Cash Flow from Financing Activities:		
Net proceeds from project financing		4,273
Principal payments on long term debt	(239)	(3,498)
Net proceeds from issuance of common stock	129	3,022
Net cash provided by (used for) financing activities	(110)	3,797
Effect of exchange rate changes on cash	(22)	
Net increase (decrease) in cash and cash equivalents	(656)	2,837
Cash and cash equivalents, beginning of period	11,309	6,666
Cash and cash equivalents, end of period	$ 10,653	$ 9,503
Supplemental Cash Flow Information:		
Cash paid for interest	$ 54	$ 534
Non-cash Transactions:		

Directors fees paid in common stock	$	135	$	260
Acquisitions paid in common stock	$		$	57,486
Acquisitions paid in related party financing	$		$	15,300
Asset purchased with extended payment terms	$		$	800
Services paid in common stock	$		$	14

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

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VIISAGE TECHNOLOGY, INC.

Notes to Financial Statements

1. DESCRIPTION OF BUSINESS

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

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

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

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial data as of July 3, 2005 and December 31, 2004, and for the three- and six-month periods ended July 3, 2005 and June 27, 2004, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2004 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. The accompanying consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2004.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows as of July 3, 2005 and for the three- and six-month periods ended July 3, 2005 and June 27, 2004, have been made. The results of operations for the period ended July 3, 2005 are not necessarily indicative of the operating results for the full year.

Principles of Consolidation

The 2005 consolidated financial statements include the accounts of the Company and the following wholly owned subsidiaries: Biometrica Systems, Inc., Viisage Technology AG, Trans Digital Technologies Corporation and Imaging Automation, Inc. The 2004 consolidated financial statements include the accounts of the Company and the following wholly owned subsidiaries from the dates of their acquisition: Biometrica Systems, Inc., Viisage Technology AG and Trans Digital Technologies Corporation.

Use of Estimates

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

Stock-Based Compensation

The Company accounts for its stock-based compensation plans using the intrinsic value method, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and comply

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with the disclosure provisions of Statements of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation- Transition and Disclosure*.

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

	Three Months Ended		Six Months Ended	
	July 3, 2005	**June 27, 2004**	**July 3, 2005**	**June 27, 2004**
Net loss as reported	$ (505)	$ (317)	$ (2,145)	$ (1,949)
Add: stock based employee compensation expense included in reported net income (loss), net of tax			34	
Deduct: total stock based employee compensation determined under fair value based method for all awards, net of tax	(761)	(818)	(1,114)	(1,811)
Pro forma net loss	$ (1,266)	$ (1,135)	$ (3,225)	$ (3,760)
Earnings per share:				
Basic and diluted, as reported	$ (0.01)	$ (0.01)	$ (0.04)	$ (0.06)
Basic and diluted, pro forma	$ (0.03)	$ (0.03)	$ (0.07)	$ (0.11)

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

	July 3, 2005	**June 27, 2004**
Risk free interest rate	4.26%	4.0%-5.0%
Expected dividend yield		
Expected lives	3-10 years	3-10 years
Expected volatility	85%	80%

Computation of Net Loss per Share

The basic net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. The impact of approximately 6,010,000 common equivalent shares consisting of all outstanding options and stock warrants were not reflected in the July 3, 2005 dilutive net loss per share calculations as their effect would be anti-dilutive. The impact of approximately 5,363,000 shares of common stock consisting of all outstanding options and stock warrants were not reflected in the June 27, 2004 dilutive net loss per share calculation. Potentially dilutive securities are excluded from the calculation of diluted earnings per share if their effect is anti-dilutive.

Inventory and Suppliers

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

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Comprehensive Income (Loss)

In accordance with SFAS No. 130, Reporting Comprehensive Income, the Company reports accumulated other comprehensive income (loss) in its Consolidated Balance Sheets. Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss), which includes current period foreign currency translation adjustments. The accumulated other comprehensive income (loss) consists of unrealized translation losses in accordance with SFAS No. 52, Foreign Currency Translation of $1.7 million for the three months ended July 3, 2005 and unrealized translation losses of approximately $1.7 million for the six months ended July 3, 2005. For the three and six months ended June 27, 2004, unrealized translation gains were approximately $16,000 and $14,000, respectively. The Company had approximately $2.0 million and $322,000 of accumulated other comprehensive loss as of July 3, 2005 and December 31, 2004, respectively.

Foreign Currency Translation

Assets and liabilities of the Company s operations in Germany are denominated in Euros and are translated into U.S. dollars at exchange rates as of July 3, 2005. Income and expense accounts are translated into U.S. dollars at the average rates of exchange prevailing during the period. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are included in other comprehensive loss with the accumulated other comprehensive loss included as a separate component in shareholders equity in accordance with SFAS No. 130. Other expense for the three months ended July 3, 2005 of $39,000 and other income of $84,000 for the six months ended July 3, 2005 was the result of realized and unrealized gains and losses related to foreign currency fluctuations on purchases that Viisage made in Japanese Yen in 2005. For the three and six months ended June 27, 2004, realized gains related to foreign currency fluctuations were $54,000 and $75,000, respectively.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment (SFAS 123R), which replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion no. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005. In April 2005, the Securities and Exchange Commission (the SEC) postponed the effective date of SFAS 123R until the issuer s first fiscal year beginning after June 15, 2005. Under the current rules, the Company will be required to adopt SFAS 123R in the first quarter of fiscal 2006.

Under SFAS 123R, pro forma disclosures previously permitted will no longer be an alternative to financial statement recognition. The Company must determine the appropriate fair value model to be used for valuing share-based payments to employees, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include modified prospective and retrospective adoption options. Additionally, SFAS 123R clarifies the timing for recognizing compensation expense for awards subject to acceleration of vesting on retirement and also specifies the treatment of excess tax benefits associated with stock compensation.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC s interpretation of SFAS 123R and the valuation of share-based payments for public companies. The Company is evaluating the requirements of SFAS 123R and SAB 107 and expects that the adoption of SFAS 123R will have a material impact on the consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs (SFAS 151), an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4, Inventory Pricing . SFAS 151 amends previous guidance regarding treatment of abnormal amounts of idle facility expense, freight, handling costs, and spoilage. This statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal which was the criterion specified in ARB No. 43. In addition, this Statement requires that allocation of fixed production overheads to the cost of the production be based on normal capacity of the production facilities. This pronouncement is effective for the Company for fiscal periods beginning October 1, 2005. The Company is currently evaluating the effect that the adoption of SFAS 151 will have on its consolidated results of operations and financial condition, but does not expect it will have a material impact.

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In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154) which replaces APB Opinions No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by the Company in the first quarter of fiscal 2006. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated results of operations and financial condition, but does not expect it will have a material impact.

3. INCOME TAXES

The deferred income tax provision for the three and six months ended July 3, 2005 includes $260,000 and $556,000, respectively, to record the deferred tax liability related to tax deductible amortization of certain goodwill. This deferred tax liability is created by taxable temporary differences related to certain goodwill for which the period the difference will reverse is indefinite. Following the adoption of SFAS 142, taxable temporary differences creating deferred tax liabilities as a result of different treatment of goodwill for book and tax purposes cannot offset deductible temporary differences that create deferred tax assets in determining the valuation allowance. In the fourth quarter of 2004, the Company made an election under Internal Revenue Tax Code Section 338(h)(10) to treat the acquisition of Trans Digital Technologies as an asset transaction for tax purposes. This election resulted in future tax deductible amortization expense related to certain goodwill for tax purposes. As a result, a deferred tax provision was required to record the deferred tax liability of tax deductible goodwill amortization. There was no current provision for federal income taxes for the three and six months ended July 3, 2005 or June 27, 2004 due to the net losses during those periods. The provision for state income taxes for the three months ended July 3, 2005 and June 27, 2004 was approximately $36,000 and $25,000, respectively. The provision for state income taxes for the six months ended July 3, 2005 and June 27, 2004 was $94,000 and $50,000, respectively.

4. RELATED PARTY TRANSACTIONS AND SHAREHOLDERS EQUITY

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

5. BUSINESS SEGMENTS, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK

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

During 2004, the Company completed three acquisitions which contributed intellectual property that changed the Company s product mix and service offerings. In 2004, the Company had proprietary products and service capability to deliver and did deliver fully integrated identity solutions projects across the Company s entire customer base. As a result, during the fourth quarter of 2004, the Company realigned its product and service revenues into three main categories identified by the markets which they serve: *State and Local, Federal, and Commercial/Emerging Markets.* The Company s Chief Executive Officer is the chief operating decision maker who evaluates performance based on revenues and total consolidated operating expenses of identity solutions products and services across all markets and geographic regions. This change in the structure of the Company s internal organization resulted in a change in the composition of the Company s reportable segments for 2004 into one reportable segment. The Company has restated the segment disclosure for the three and six months ended June 27, 2004 to conform to the segment reporting for the three and six months ended July 3, 2005.

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Net revenues by market for the three and six months ended July 3, 2005 and June 27, 2004 are disclosed in the following table (in thousands):

	Three Months Ended		Six Months Ended	
	July 3, 2005	**June 27, 2004**	**July 3, 2005**	**June 27, 2004**
State and Local	$ 9,016	$ 9,887	$ 17,999	$ 19,299
Federal	8,955	6,162	16,583	8,818
Commercial/Emerging Markets	2,178	227	2,378	418
	$ 20,149	$ 16,276	$ 36,960	$ 28,535

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

	Three Months Ended		Six Months Ended	
	July 3, 2005	**June 27, 2004**	**July 3, 2005**	**June 27, 2004**
Revenue				
United States	$ 16,990	$ 15,517	$ 32,774	$ 27,308
Rest of World	3,159	759	4,186	1,227
	$ 20,149	$ 16,276	$ 36,960	$ 28,535

Of the total revenue for the three- and six-months ended July 3, 2005, approximately $2.8 and $3.8 million was earned from export sales, respectively. Of the total revenue for the three and six months ended June 27, 2004, approximately $307,000 and $775,000 was earned from export sales, respectively. The Company did not have significant international sales to individual countries for the periods presented.

For the three- and six-month periods ended July 3, 2005, one customer accounted for 36.1% and 32.8% of the Company s revenue, respectively. As of July 3, 2005, the accounts receivable balance from this customer was approximately $6.5 million. As of December 31, 2004, the accounts receivable balance from this customer was approximately $2.6 million. For the three- and six-month periods ended June 27, 2004, one customer accounted for 22.9% and 18.9% of the Company s revenue, respectively.

6. ACQUISITIONS

On January 23, 2004 Viisage acquired all outstanding shares of ZN Vision Technologies AG (ZN) in exchange for an aggregate of 5,221,454 newly issued shares of Viisage common stock and $493.00 in cash. In addition, the Company agreed to assume ZN s employee share option plan, and accordingly has reserved 1,138,546 shares of Viisage common stock for issuance to the plan participants. The options under this plan were fully vested prior to the close of the transaction and accordingly have been included in the purchase price at their fair value. The purchase price for the acquisition was $31.6 million, based on the per share price of Viisage common stock of $4.32 per share which is the average trading price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following June 27, 2003, the date on which the purchase agreement was signed and the acquisition was announced. The operations of ZN are included in the financial statements since the effective date, the close of business on January 23, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. The Company engaged an independent third party appraiser to perform a review of the acquired assets and have allocated the purchase price based on the results of their findings. The Company recorded approximately $761,000 in amortization related to the acquired intangible assets from the date of the acquisition through July 3, 2005. ZN is a leading German provider of face recognition and computer vision products and services. ZN, now known as Viisage Technology AG, is a wholly owned subsidiary of Viisage and serves as the base of its European operations.

On February 14, 2004 Viisage acquired all outstanding shares of Trans Digital Technologies Corporation (TDT) for $56.6 million. The purchase price consisted of 5,850,000 newly issued shares of Viisage common stock, which were valued at

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$5.13 per share, which is the average price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following February 14, 2004, the date on which the purchase agreement was signed and the acquisition was announced, plus $15.3 million in notes and $5 million in cash. The operations of TDT are included in the financial statements since the effective date, the close of business on February 14, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. The Company engaged an independent third party appraiser to perform a review of the acquired assets and have allocated the purchase price based on the results of their findings. The Company recorded approximately $4.2 million in amortization related to the acquired intangible assets from the date of the acquisition through July 3, 2005. TDT is the sole source provider of high security technology and services to the U.S. Department of State for the production of U.S. passports. TDT is now a wholly owned subsidiary of Viisage.

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

On October 5, 2004, Viisage acquired all of the outstanding capital stock of Imaging Automation, Inc. through a merger between Imaging Automation and a wholly-owned subsidiary of Viisage valued at approximately $40.1 million. The purchase price consisted of 3,908,387 newly issued shares of our common stock approximately $5.0 million in cash and the assumption of $2.9 million in debt, which has subsequently been repaid in full. For accounting purposes the value of Viisage common stock was $6.27 which was the average price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following October 5, 2004, the date on which the purchase agreement was signed and the acquisition was announced. The Company issued fully vested stock options effective as of the close of the transaction to assume the options outstanding under the Imaging Automation stock option plans for which the Company reserved approximately 565,270 shares of Viisage common stock recorded as part of the purchase price at their fair value of approximately $3.7 million. The operations of Imaging Automation are included in the financial statements from and after the effective date of the transaction. The Company engaged an independent third party appraiser to perform a review of the acquired assets and allocated the purchase price based on the results of its findings. The Company recorded approximately $1.2 million in amortization related to the acquired intangible assets from the date of the acquisition through July 3, 2005.

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

	ZN	TDT	iA
Current assets	$ 1,639	$ 3,020	$ 468
Software license receivable			2,303
Property and equipment, net	140	42	183
Identified intangible assets	6,335	14,460	5,750
Goodwill	23,460	39,050	31,375
	$ 31,574	$ 56,572	$ 40,079

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

		July 3, 2005	Estimated Useful Life
Gross carrying amounts:			
Completed Technology	$	9,575	5 years
Customer lists		130	10 years
Acquired contracts		16,200	5 years
Non-competition agreements		490	2 years
Tradename and trademarks		150	3 years
Total intangible assets	$	26,545	
Accumulated amortization:			
Completed Technology		(1,619)	
Customer lists		(24)	
Acquired contracts		(4,286)	
Non-competition agreements		(181)	
Tradename and trademarks		(33)	
Translation adjustments		(331)	
Total accumulated amortization		(6,474)	
Intangible assets, net	$	20,071	

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Amortization expense resulting from the identifiable intangible assets from the acquisitions in 2004 for the next five years are as follows (in thousands):

For the year ended December 31, 2005	$ 5,254
For the year ended December 31, 2006	4,840
For the year ended December 31, 2007	4,633
For the year ended December 31, 2008	3,944
For the year ended December 31, 2009	1,084

The unaudited pro forma and combined selected operating data below present the acquisitions of ZN, TDT and Imaging Automation as if the acquisitions had occurred on January 1, 2005 and 2004 for the three and six months ended July 3, 2005 and June 27, 2004, respectively. The unaudited pro forma data is for informational purposes only and may not necessarily reflect future results of operations or what the results of operations would have been had Viisage, ZN, TDT and iA been operating as a combined entity for the periods presented. The unaudited pro forma revenue, loss and loss per share information for the three and six months ended July 3, 2005 and June 27, 2004 are as follows (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	July 3, 2005	**June 27, 2004**	**July 3, 2005**	**June 27, 2004**
Revenue	$ 20,149	$ 16,805	$ 36,960	$ 32,768
Net loss	(505)	(1,813)	(2,145)	(4,026)
Basic and diluted net loss per share	$ (0.01)	$ (0.05)	$ (0.04)	$ (0.11)

7. FOREIGN CURRENCY HEDGES

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

In 2005, the Company began to utilize foreign currency forward contracts. The Company elected to not use hedge accounting and all gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts was terminated prior to settlement. As of July 3, 2005, the Company had committed to four foreign currency forward contracts to purchase approximately 201,000,000 Japanese Yen for $1,854,000. The fair value of these contracts at July 3, 2005 was a liability of approximately $46,000. All of these contracts will be settled before October 2, 2005.

8. LEGAL PROCEEDINGS

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

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia s Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. In July 2003, the court had issued a preliminary injunction prohibiting DMVS from continuing to work with Viisage to install the State s new drivers license system. In July 2004, the Company reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay the Company $2.0 million in cash and the State agreed to purchase certain equipment from the Company for $500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers license system, but disallowed the $2.0 million cash payment described above. Without this payment, the Company believes either that the settlement agreement with DMVS is not effective and that its contract with DMVS remains in place, or that the Company s initial claim for an $8.2 million settlement payment is revived. The State has paid the Company the $500,000 for the equipment and the Company appealed the disallowance of the $2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted in a 4-3 decision not to hear the Company s appeal based on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge s ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, the Company has identified $2.2 million of assets deployed within the state that it has deemed to have no alternative use. The Company reduced the recorded value of these assets from approximately $2.2 million to their estimated fair value of approximately $200,000 based on its estimate of realizable value from liquidation of these assets, which resulted in a $2.0 million charge in the fourth quarter of 2004. In addition, the Company has removed the contract from its backlog, and it will lose up to $19.7 million in revenue that it expected to recognize over the next five and one-half years, unless the contract remains in place or the Company is able to win the new contract for the digital drivers license system and the revenues from such new contract are substantially similar to the prior contract. There are approximately $2.9 million of system assets remaining on the Company s balance sheet from the Georgia contract. These consist of approximately $1.1 million of assets that the Company anticipates using in Georgia if it wins the contract based on the new request for proposals, approximately $150,000 of assets that the Company anticipates could either be used in Georgia under a new contract or used in other projects, and approximately $1.6 million of assets constituting the Company s central production facility in Georgia. The Company has evaluated these assets for impairment and, based upon its current probability-weighted estimate of cash flows, it has determined that these assets are not currently impaired. While the Company believes it can utilize these assets either in Georgia, if it wins the new contract, or on alternative projects, to the extent that it is unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, the Company would be required to take a further charge to earnings.

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

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9. PROPERTY AND EQUIPMENT

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

	July 3, 2005	December 31, 2004
System assets held under capital leases	$ 250	$ 250
System assets	52,256	51,216
Computer and office equipment	3,910	3,269
Leasehold Improvements	242	147
	56,658	54,882
Less accumulated depreciation	38,065	34,965
	$ 18,593	$ 19,917

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

Depreciation expense for the three and six months ended July 3, 2005 was approximately $1.6 million and $3.1 million, respectively. Depreciation expense for the three and six months ended June 27, 2004 was approximately $1.6 million and $3.5 million, respectively.

10. SUBSEQUENT EVENTS

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

On August 2, 2005, the Company announced that William K. Aulet would be resigning as Chief Financial Officer, and that Bradley T. Miller would be joining the Company as its new Chief Financial Officer, effective September 6, 2005.

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VIISAGE TECHNOLOGY, INC.

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

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

COMPANY BACKGROUND

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

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

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

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

We generate revenue through the sale and license of products and services for verifying and managing identities. Our revenues increased to approximately $20.1 million for the three months ended July 3, 2005 from $16.3 million for the three months ended June 27, 2004. Our revenues for the six months ended July 3, 2005 increased to approximately $37.0 million from $28.5 million in the first six months of 2004. Our net loss for the three months ended July 3, 2005 increased to $505,000 from $317,000 for the three months ended June 27, 2004. Our net loss for the six months ended July 3, 2005 increased to $2.1 million from $1.9 million in the first six months of 2004.

On August 2, 2005, the Company announced that William K. Aulet would be resigning as Chief Financial Officer, and that Bradley T. Miller would joining the Company as its new Chief Financial Officer, effective September 6, 2005.

SEGMENTS AND GEOGRAPHIC INFORMATION

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

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

Revenues by market for the three and six months ended July 3, 2005 and June 27, 2004 are disclosed in the following table (in thousands):

	Three Months Ended		**Six Months Ended**	
	July 3, 2005	**June 27, 2004**	**July 3, 2005**	**June 27, 2004**
State and Local	$ 9,016	$ 9,887	$ 17,999	$ 19,299
Federal	8,955	6,162	16,583	8,818
Commercial/Emerging Markets	2,178	227	2,378	418
	$ 20,149	$ 16,276	$ 36,960	$ 28,535

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

	Three Months Ended		Six Months Ended	
	July 3, 2005	June 27, 2004	July 3, 2005	June 27, 2004
Revenue				
United States	$ 16,990	$ 15,517	$ 32,774	$ 27,308
Rest of World	3,159	759	4,186	1,227
	$ 20,149	$ 16,276	$ 36,960	$ 28,535

Of the total revenue for the three and six months ended July 3, 2005, approximately $2.8 and $3.8 million was earned from export sales, respectively. Of the total revenue for the three and six months ended June 27, 2004, approximately $307,000 and $775,000 was earned from export sales, respectively. The Company did not have significant international sales to individual countries for the periods presented.

DEPENDENCE ON SIGNIFICANT CUSTOMERS

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

- for the three-month and six-month periods ended July 3, 2005, one customer accounted for an aggregate of 36.1% and 32.8%, respectively; and
- for the three-month and six month periods ended June 27, 2004, one customer accounted for an aggregate of 22.9% and 18.9%, respectively.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES

We prepare our financial statements in accordance with generally accepted accounting principles in the United States, or US GAAP. Consistent with US GAAP, we have adopted accounting policies that we believe are most appropriate given the facts and circumstances of our business. The application of these policies has a significant impact on our reported results. In addition, some of these policies require management to make estimates. These estimates, which are based on historical experience and analysis of current conditions, have a significant impact on our reported results and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. If actual results differ significantly from these estimates, there could be a material effect on our financial statements.

Valuation of Goodwill and Other Long-Lived and Intangible Assets

Our long-lived assets include property, plant and equipment, other intangible assets and goodwill. As of July 3, 2005, the balances of property, plant and equipment, other intangible assets and goodwill, net of accumulated depreciation and amortization, were $18.6 million, $22.6 million, and $92.5 million, respectively.

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

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

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of acquired assets or the strategy for our overall business;
- underutilization of our tangible assets;
- discontinuance of product lines by ourselves or our customers;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- significant decline in our market capitalization relative to net book value.

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

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

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

- future expected cash flows from product sales, customer contracts and acquired developed technologies and patents;
- expected costs to complete any in-process research and development projects and commercialize viable products and estimated cash flows from sales of such products;
- the acquired companies brand awareness and market position;
- assumptions about the period of time over which we will continue to use the acquired brand; and
- discount rates.

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

As of July 3, 2005, we have recorded goodwill of $92.5 million. We will perform impairment reviews on the carrying values of goodwill arising from the aforementioned acquisitions at least annually. Because future cash flows and operating results used in the impairment review will be based on management s projections and assumptions, future events could cause such projections to differ from those used to originally value the acquisitions, which could lead to significant impairment charges of goodwill in the future.

Revenue and Cost Recognition

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

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

When elements such as products and services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. The price charged when the element is sold separately generally determines fair value. Viisage applies the provisions of Emerging Issues Task Force 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, or EITF 00-21, to all of its contracts.

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

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

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

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

- design and integration complexities;

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- nature and number of workstations and sites installed;
- projected number of secure credentials to be produced;
- size of the database;
- level of post-installation involvement that will be required of us; and
- competitive environment.

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

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

- a high level of certainty exists regarding expected cash flows from these contracts; and
- a reliable basis exists for determining the percentage of the contract that will be completed at the end of the accounting period.

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

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

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

persuasive evidence of an arrangement exists;

delivery has occurred;

the sales price is fixed and determinable;

collection is probable; and

there are no post delivery obligations.

On identity solutions contracts where the arrangement consists of build-to-suit software and solution design during the installation phase of the project, as well as ongoing services under a long-term contract, we apply the criteria in EITF 00-21 to separate the SOP 81-1 deliverables, the installation services, from the non SOP 81-1 deliverables, ongoing maintenance and support services. On these contracts we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. The price charged when the element is sold separately generally determines fair value.

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Derivative Instruments and Hedging Activities

In 2005, the Company began to utilize foreign currency forward contracts. The Company elected to not use hedge accounting and all gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts was terminated prior to settlement. As of July 3, 2005, the Company had committed to seven foreign currency forward contracts to purchase approximately 201,000,000 Japanese Yen for $1,854,000. The fair value of these contracts at July 3, 2005 was a liability of approximately $46,000. All of these contracts will be settled before October 2, 2005.

RESULTS OF OPERATIONS

Revenue

Revenues in the state and local market of our business are derived principally from multi-year contracts for systems implementation, credential production and related services. Secondarily we derived state and local revenues from the sale of our document authentication products and services which were acquired from Imaging Automation, Inc. in October 2004. Revenues from our federal market are derived principally from products and solutions delivered to the Department of State and the Department of Defense. Revenues for the three- and six-month periods ending July 3, 2005 increased 23.8% and 29.5%, respectively, from approximately $16.3 million and $28.5 million for the three- and six-month periods ending June 27, 2004 to approximately $20.1 million and $37.0 million for the three- and six-month periods ending July 3, 2005, respectively. During the three-month period ending July 3, 2005, state and local market revenue decreased by $871,000 from approximately $9.9 million in the second quarter of 2004 to $9.0 million. This decrease was primarily due to contracts ending in the first quarter of 2005 in New York and Ohio which resulted in a decrease in revenue of approximately $1.0 million in the three months ended July 3, 2005 compared to the three months ended June 27, 2004. In addition, we generated approximately $464,000 less revenue due to lower card volume in Florida whose contract with us is ending in the third quarter 2005. During the three-month period ending July 3, 2005, there also was a decrease in revenue from our contract in Pinellas County, Florida of approximately $431,000 and a decrease in revenue on our contract to deliver drivers licenses in Maryland of approximately $448,000 from the second quarter of 2004 as a result of our entering the maintenance phase of these contracts in 2005 as installation was complete. These decreases in revenue in the state and local market were offset by an increase in revenues of approximately $429,000 generated from initial sales of document authentication products and services contributed through our acquisition of Imaging Automation in late 2004. Our contract with Connecticut contributed additional revenue of approximately $572,000 for the three months ended July 3, 2005 compared to the three months ended June 27, 2004 due to our delivery on a biometric services contract to the state. The remaining increase in revenues in the state and local market resulted from additional card volume in four other states that contributed approximately $500,000 of additional revenue. Revenue in the federal market increased to approximately $9.0 million for the three months ended July 3, 2005 compared to $6.2 million for the three months ended June 27, 2004. This increase was primarily driven by $2.4 million of additional product and service sales to the Department of State. In addition, sales of document authentication product, contributed through the acquisition of Imaging Automation in 2004, to government customers increased by approximately $500,000 during the three months ended July 3, 2005 compared to the three months ended June 27, 2004. For the six months ended July 3, 2005, our state and local revenue decreased by approximately $1.3 million to $18.0 million from $19.3 million for the six months ended June 27, 2004. This decrease was the result of revenue decreases in New York and Ohio of approximately $1.8 million for the first six months of 2005 compared to the prior year. We also experienced a decrease in revenue in our contract with Massachusetts of approximately $300,000 for the six-month period where our contract to produce welfare cards is ending in 2005. We also entered the maintenance phase on contracts in three states which resulted in a revenue decrease of approximately $1.1 million. The decreases in the state and local market for the six months ended July 3, 2005 compared to the six months ended June 27, 2004 were offset by sales of document authentication product, contributed by our acquisition of Imaging Automation in October 2004, of approximately $1.2 million into this market. In addition, card volume increases and new card production on other contracts contributed approximately $500,000 of additional revenue for the six month period. Revenue in the federal market increased by approximately $7.8 million to $16.6 million for the six months ended July 3, 2005 from $8.8 million for the six months ended June 27, 2004. Approximately $6.5 million of this increase for the six month period was related to additional sales of products and services to the Department of State. The remaining $1.3 million increase was the result of an increase in document authentication and biometric products and services to government customers internationally. Revenue in the commercial / emerging markets increased by approximately $2.0 million for the three and six months ended July 3, 2005 compared to the comparable periods in the prior year. This increase was related to additional sales of document authentication products into this market in the second quarter of 2005. Revenue for the three months ended July 3, 2005 includes a full quarter of sales of document authentication products and services acquired from Imaging Automation of approximately $3.0 million compared to zero in the prior year. For the six months ended July 3, 2005, revenue includes six months of Imaging Automation, TDT, and ZN Revenue compared to zero months, five months and five months of revenue from these entities in the prior year, respectively.

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Gross Margin

Gross margin increased to 32.8% in the second quarter of 2005 from 30.5% in the second quarter of 2004. Gross margin increased to 33.5% for the first six months of 2005 compared to 29.2% for the same period in 2004. The increase in our gross margin for the quarter and for the first six months are both related to a change in the mix of products and solutions that we are delivering to our customers. For the three and six months ended July 3, 2005, we delivered additional products and services to our federal customers of approximately $2.8 million and $7.8 million, respectively compared to the prior year periods. The products and services delivered to these customers carried gross margins in excess of 35% which contributed to a higher average margin for each period. For the three and six months ended July 3, 2005 we generated less revenue from state and local customers of approximately $871,000 and $1.3 million, respectively compared to the prior year periods. We generated revenue in the state and local market primarily from drivers license contracts which, due to the competitive nature of that market, have historically carried margins on products and services below 25%.

Sales and Marketing Expenses

Sales and marketing expenses increased by approximately $561,000, from $1.6 million in the second quarter of 2004 to $2.1 million in the second quarter of 2005. Approximately $552,000 of this increase was related to personnel and resources from the three acquisitions that we completed in 2004. In addition, we continue to invest in sales and marketing to support our products organization and our federal government sales initiatives in 2005. For the six months ended July 3, 2005, sales and marketing expenses increased by approximately $1.3 million to $4.4 million from $3.1 million for the same period in the prior year. Acquisitions accounted for approximately $1.1 million of the increase during this period. As a percentage of revenue, sales and marketing expenses increased from 9.7% in the second quarter of 2004 to 10.6% in the second quarter of 2005 and from 10.8% for the first six months of 2004 to 11.7% in the first six months of 2005. The ZN and TDT acquisitions which were both closed in the first quarter of 2004 represented a partial quarter of expense. We expect that we will continue to invest in sales and marketing resources primarily in the federal market and in commercial/emerging markets in 2005.

Research and Development Expenses

Research and development expenses increased by approximately $608,000, from $942,000 in the second quarter of 2004 to $1.6 million in the second quarter of 2005. Approximately $492,000 of this increase was related to personnel and resources from the three acquisitions that we completed in 2004. For the six months ended July 3, 2005, research and development expenses increased by approximately $1.2 million to $3.1 million from $1.9 million for the same period in the prior year. Acquisitions accounted for approximately $1.0 million of the increase during this period. We continue to invest in biometric technologies and new product development to broaden our product offerings of advanced technology identity solutions. This investment included enhancing existing products as well as contributing new products with the intellectual property and product offerings that were acquired through our acquisitions in 2004. As a percentage of revenue, research and development expenses increased from 5.8% in the second quarter of 2004 to 7.7% in the second quarter of 2005 and from 6.7% for the first six months of 2004 to 8.3% in the first six months of 2005. We expect to continue to invest in research and development in order to add functionality to our current advanced technology identity solutions offerings, as well as to develop new offerings in 2005.

General and Administrative Expenses

General and administrative expenses increased by approximately $902,000, from $2.2 million in the second quarter of 2004 to $3.1 million in the second quarter of 2005. The increase in general and administrative expenses was the result of increases in accounting and legal fees of approximately $744,000 in the second quarter of 2005 compared to the comparable period in the prior year, and increases in salary and related costs of approximately $93,000 from new headcount additions in information technology, finance and accounting. The remaining increase of approximately $65,000 resulted from resources and other general and administrative costs from the acquisitions in 2004. For the six months ended July 3, 2005, general and administrative expenses increased by $2.1 million to $6.5 million from $4.4 million for the same period in the prior year. The increase during this six month period was primarily attributed to headcount additions in administrative functions, compliance consulting fee increases, accounting and legal fees increases, and additional costs from acquisitions. As a percentage of revenue, general and administrative expenses increased from 13.6% in the second quarter of 2004 to 15.5% in the second quarter of 2005 and from 15.3% for the first six months of 2004 to 17.7% in the first six months of 2005.

Interest Income and Expense

Interest income increased by $49,000 from $19,000 in the second quarter of 2004 to $68,000 in the second quarter of 2005. Interest income for the six months ended July 3, 2005 increased by $27,000 to $68,000 from $41,000 for the six months

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ended June 27, 2004. These increases in interest income are related to a higher average cash balance during the second quarter and first six months of 2005 compared to the comparable periods in 2004. Interest expense decreased by $558,000 from $596,000 in the second quarter of 2004 to $38,000 in the second quarter of 2005. Interest expense for the six months ended July 3, 2005 decreased by approximately $956,000 to $54,000 from $1.0 million for the six months ended June 27, 2004. These decreases in interest expense are related to our repayment during 2004 of approximately $31.4 million of debt that was on our balance sheet as of June 27, 2004.

Income Taxes

The deferred income tax provision for the three- and six-month periods ended July 3, 2005 includes $260,000 and $554,000, respectively, to increase the deferred tax valuation allowance. This deferred tax liability is created by taxable temporary differences related to certain goodwill for which the period the difference will reverse is indefinite. Following the adoption of SFAS 142, taxable temporary differences creating deferred tax liabilities as a result of different treatment of goodwill for book and tax purposes cannot offset deductible temporary differences that create deferred tax assets in determining the valuation allowance. In the fourth quarter of 2004, the Company made an election under Internal Revenue Tax Code Section 338(h)(10) to treat its acquisition of TDT as an asset transaction for tax purposes. This election resulted in future tax deductible amortization expense for tax purposes. As a result, a deferred tax provision is required to increase the Company s valuation allowance. No current provision for federal income taxes was made for the three- and six-month periods ended July 3, 2005 and June 27, 2004. The provision for state income taxes for the three- and six-month periods ended July 3, 2005 was approximately $36,000 and $94,000, respectively. The provision for state income taxes for the three and six months ended June 27, 2004 was $25,000 and $50,000, respectively.

LIQUIDITY AND CAPITAL RESOURCES

Cash was approximately $10.7 million at July 3, 2005. As of July 3, 2005, there were no restrictions on the Company s cash. Cash at December 31, 2004 was approximately $11.3 million.

In the six month period ended July 3, 2005, cash provided by operating activities was approximately $790,000, which resulted from our net loss of approximately $2.1 million, offset by non-cash charges for depreciation and amortization of approximately $5.9 million, $135,000 for expenses paid in common stock and deferred tax liability of $554,000, and cash used by the net change in operating assets and liabilities of approximately $3.7 million.

Accounts receivable increased approximately 4.4% from $17.1 million at December 31, 2004 to $17.8 million at July 3, 2005. The increase of approximately $751,000 was primarily due to product sales at the end of the quarter offset by an improvement of our overall days sales outstanding.

Inventories and other costs and estimated earnings in excess of billings increased approximately 25.3% from $3.4 million at December 31, 2004 to $4.2 million at July 3, 2005. This increase of approximately $857,000 was primarily due to additional inventory of document authentication products for delivery on future contracts.

Accounts payable and accrued expenses decreased approximately 18.3% from $15.3 million at December 31, 2004 to $12.5 million at July 3, 2005. This decrease was the result of payments to certain vendors related to our federal government contracts as well as payments made prior to the end of the quarter for professional services fees.

On December 14, 2004, we entered into a Loan and Security Agreement with Citizens Bank of Massachusetts. The Loan and Security Agreement permits us to borrow up to $25,000,000, subject to certain financial covenants which may restrict the amounts borrowed. As of July 3, 2005, we estimate that the amount available to us under the Loan and Security Agreement was approximately $5.7 million based on the financial covenants. Any amounts borrowed under the Loan and Security Agreement bear interest at the rate of Citizens prime rate minus 0.25% or the London Interbank Offered Rate (LIBOR) plus 2.5%, at our option, and must be repaid on or before May 30, 2007. In March 2005, we entered into an amendment to the Loan and Security Agreement to modify the financial covenants and make certain other changes. We are in compliance with the amended financial covenants for the quarter ended July 3, 2005. If we do not remain in compliance with the applicable covenants, Citizens could refuse to lend funds to us and could require repayment of any amounts outstanding at the time that we are not in compliance with such covenants. Currently, there are no borrowings outstanding under the Loan and Security Agreement other than a commitment of $2.3 million in letters of credit issued by Citizens to certain of our customers.

In April 2003 we entered into an arrangement for approximately $1.5 million of equipment financing with three of our suppliers. These project lease arrangements are accounted for as capital leases. There are no financial covenants associated with these leasing arrangements. As of July 3, 2005 we had outstanding approximately $158,000 under these arrangements. The interest rates on these capital leases are between 6% and 8% and are fixed. The terms of these leases range from 12 months to 60 months. In August 2003 we entered into an arrangement for financing of database licenses with another vendor. As of July 3, 2005, we had outstanding approximately $33,000 under this arrangement.

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In the first quarter of 2004, we purchased an asset totaling $800,000 which is payable in installments over four years. As of July 3, 2005, $368,000 is included in other liabilities which represent the unpaid principal balance net of imputed interest. Total remaining installment payments due total $400,000.

We believe that our existing cash balances and anticipated cash flows from operations will be sufficient to meet our operating and debt service requirements for the next 12 months. However, if we cannot achieve our operating goals in 2005 or if we win additional drivers license contracts in 2005, we may be required to seek additional financing. There can be no assurance that such financing will be available on commercially reasonable terms, or at all. Our ability to meet our business forecast is dependent on a number of factors, including those described in the section of this report entitled Factors that May Affect Future Results.

CONTRACTUAL OBLIGATIONS

The following table sets forth our contractual obligations as of July 3, 2005 (in thousands).

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Capital Lease Obligations	$ 191	$ 80	$ 111	$	$
Operating Lease Obligations	$ 3,141	$ 339	$ 1,416	$ 1,104	$ 282

As of July 3, 2005, we had standby letters of credit issued by Citizens Bank for approximately $2.3 million to certain of our customers.

CONTINGENT OBLIGATIONS

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

INFLATION

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

FORWARD-LOOKING STATEMENTS

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

FACTORS THAT MAY AFFECT FUTURE RESULTS

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

We have a history of operating losses.

We have a history of operating losses. Our business operations began in 1993 and, except for fiscal years 1996 and 2000, have resulted in net losses in each fiscal year, including a net loss of $7.0 million in 2004 and $2.1 million for the six months July 3, 2005. At July 3, 2005, we had an accumulated deficit of approximately $51.2 million. We will continue to invest in the development of our secure credential and biometric technologies. Accordingly, we cannot predict when or if we will ever achieve profitability on an annual basis.

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

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

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

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

- include provisions that allow the government agency to terminate the contract without penalty under some circumstances;
- be subject to purchasing decisions of agencies that are subject to political influence;
- contain onerous procurement procedures; and
- be subject to cancellation if government funding becomes unavailable.

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

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

For the three- and six-month periods ended July 3, 2005, one customer, the U.S. Department of State, accounted for an aggregate of 36.1% and 32.8%, respectively, of our revenue. Since a small number of customers account for a substantial portion of our revenues, the loss of any of our significant customers would cause revenue to decline and could have a material adverse effect on our business.

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

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

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

We failed to timely file our Annual Report on Form 10-K for the year ended December 31, 2004 and our Quarterly Report on Form 10-Q for the quarter ended April 3, 2005. As a result, we are not eligible to use a short form registration statement on Form S-3 until June 30, 2006. Our inability to use a short form registration statement until June 30, 2006 may impair our ability or increase the costs and complexity of our efforts, to raise funds in the public markets or use our stock as consideration in acquisitions should we desire to do so during this one year period. In addition, if we are unable to remain current in our future filings, we may face additional adverse consequences, including (1) an inability to have a registration statement under the Securities Act of 1933 covering a public offering of securities declared effective by the SEC, (2) an inability to make offerings pursuant to existing registration statements (including registration statements on Form S-8 covering employee stock plans) or pursuant to certain private placement rules of the SEC under Regulation D to any purchasers not qualifying as accredited investors, (3) the possible delisting of our common stock from the Nasdaq National Market, and (4) limitations on the ability of our affiliates to sell our securities pursuant to Rule 144 under the Securities Act. These restrictions may adversely affect our ability to attract and retain key employees and may further impair our ability to raise funds in the public markets should we desire to do so or use our stock as consideration in acquisitions.

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In addition, our future success depends largely upon the support of our customers, suppliers and investors. The late SEC filings have resulted in negative publicity and a Nasdaq delisting proceeding, and may have a negative impact on the market price of our common stock. The effects of the late SEC filings could cause some of our customers or potential customers to refrain from purchasing or defer decisions to purchase our products and services. Additionally, current or potential suppliers may re-examine their willingness to do business with us, to develop critical interfaces to our products or to supply products and services if they lose confidence in our ability to fulfill our commitments. Any of these losses could have a material adverse effect on our financial and business prospects.

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

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

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

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia s Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. In July 2003, the court had issued a preliminary injunction prohibiting DMVS from continuing to work with us to install the State s new drivers license system. In July 2004, we reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay us $2.0 million in cash and the State agreed to purchase certain equipment from us for $500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers license system, but disallowed the $2.0 million cash payment described above. Without this payment, we believe that either the settlement agreement with DMVS is not effective and that our contract with DMVS remains in place, or that our initial claim for an $8.2 million settlement payment is revived. The State has paid us the $500,000 for the equipment and we appealed the disallowance of the $2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted not to hear our appeal of the summary judgment ruling on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge s ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, we have identified $2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately $2.2 million to their estimated fair value of approximately $200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a $2.0 million charge in the fourth quarter of 2004. In addition, we have removed the contract from our backlog, and we will lose up to $19.7 million in revenue that we expected to recognize over the next five and one-half years, unless the contract remains in place or we are able to win the new contract for the digital drivers license system and the revenues from such new contract are substantially similar to the prior contract. We also have evaluated for impairment the remaining $2.9 million in assets being retained by us from the Georgia contract. These consist of approximately $1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately $150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately $1.6 million of assets constituting our central production facility in Georgia. Based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these either in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

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

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

Our external auditors notified management and the audit committee of our board of directors that they believed there were material weaknesses due to insufficient personnel resources and technical accounting expertise within the accounting function to effect a timely financial close process and to evaluate and resolve non-routine and/or complex accounting transactions, and in the control processes around information technology systems. These material weaknesses could result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Management has determined that it is in agreement with the auditors initial assessment that these control deficiencies constituted a material weakness as of December 31, 2004. Because of these material weaknesses, management has concluded that we did not maintain effective internal control over financial reporting as of December 31, 2004. Our management has identified the steps necessary to address the material weaknesses described above, and has begun to execute remediation plans, as discussed in Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2004.

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

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

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

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

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

- the success of our marketing efforts and publicity campaigns and those of our competitors; and
- customer satisfaction with our products and services, as well as those of our competitors.

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We do not know when, if ever, face recognition security solutions will gain widespread commercial acceptance.

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

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

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

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

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

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

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

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

We obtain certain hardware components and complete products from a limited group of suppliers. Our reliance on these suppliers involves significant risks, including reduced control over quality and delivery schedules. In particular, we obtain all of the printers and consumables for the U.S. Department of State passport contract and the Department of Defense common access card contract from Toppan Printing Co. Ltd. Moreover, any financial instability of our manufacturers or contractors could result in our having to find new suppliers. We may experience significant delays in manufacturing and shipping our products to customers if we lose these sources or if supplies from these sources are delayed. As a result, we may be required to incur additional development, manufacturing and other costs to establish alternative sources of supply. It may take several months to locate alternative suppliers, if required, or to re-tool our products to accommodate components from different suppliers. We cannot predict if we will be able to obtain replacement components within the time frames we require at an affordable cost, or at all. Any delays resulting from suppliers failing to deliver components or products on a timely basis, in sufficient quantities and of sufficient quality or any significant increase in the price of components from existing or alternative suppliers could have a severe negative impact on our business, financial condition and results of operations.

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

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

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

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

- liability for damages and litigation costs, including attorneys fees;
- lawsuits that prevent us from further use of the intellectual property;
- having to license the intellectual property from a third party, which could include significant licensing fees;
- having to develop a non-infringing alternative, which could be costly and delay projects;
- having to indemnify clients with respect to losses they incurred as a result of the alleged infringement; and
- having to establish alternative sources for products supplied to us by third parties, as discussed above in the risk factor regarding our dependence on limited source suppliers.

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

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

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

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

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

In the fiscal years ended December 31, 2003 and 2004, and six-month periods ended July 3, 2005 and June 27, 2004, we sold substantially all of our services and licensed substantially all of our products through our direct sales organization. Our future success depends on substantially increasing the size and scope of our direct sales force and partnering arrangements, both domestically and internationally. We will face intense competition for personnel, and we cannot guarantee that we will be able to attract, assimilate or retain additional qualified sales personnel on a timely basis. Moreover, given the large-scale deployment required by some of our customers, we will need to hire and retain a number of highly trained customer service and support personnel. We cannot guarantee that we will be able to increase the size of our customer service and support organization on a timely basis to provide the high quality of support required by our customers. Failure to add additional sales and customer service representatives could result in our inability to increase our sales and support our customers.

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

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

- challenges related to technology innovation;
- possible difficulty implementing uniform standards, controls, procedures and policies and
- possible loss of key employees

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

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

To date, we have incurred approximately $5.0 million of costs in connection with the acquisitions of ZN, TDT and Imaging Automation, including:

- costs associated with integrating personnel, products and services;
- financial advisory fees; and
- costs and expenses for services provided by our lawyers and accountants.

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

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

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

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

We expect that the acquisition of ZN will enhance our leadership in face recognition technology through the combination of our technologies with those of ZN. Although the results of the initial tests of our combined technologies have been positive, the combination of such technologies might not meet the demands of the marketplace. If our technologies fail to meet such demand, customer acceptance of our face recognition solutions could decline, which would have an adverse effect on our results of operations and financial condition. In addition, we expect that the acquisition of ZN will enable us to market our systems and products on a global scale. Our face recognition customers are primarily located in the United States, and ZN s customers are primarily located in Europe. We might not be able to market successfully our products and services to ZN s customers or ZN s products and services to our customers. We expect that the acquisition of TDT will enhance our position in the market for secure credentials, particularly the U.S. government. We expect that the acquisition of Imaging Automation will provide us with a market leadership position in identity document authentication and will complement our core competencies in secure credentials and biometrics. We expect that this addition to our product portfolio will extend our reach

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into our current markets and provide a critical component to our comprehensive offering for new markets in need of identity solutions. However, there can be no assurance that our current customers or customers in new markets will be receptive to these additional offerings. If our product offerings and services fail to meet the demands of this marketplace, our results of operations and financial condition could be adversely affected. There is also a risk that we will not achieve the anticipated benefits of the acquisitions as rapidly as, or to the extent, anticipated by financial or industry analysts, or that such analysts will not perceive the same benefits to the acquisitions as we do. If these risks materialize, our stock price could be adversely affected.

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

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

- economic conditions in European markets, including fluctuations in the relative values of the U.S. dollar and the Euro;
- taxes and fees imposed by European governments that may increase the cost of products and services; and
- laws and regulations imposed by individual countries and by the European Union.

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

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

As a result of our acquisitions of ZN, TDT and Imaging Automation, we expect that we will have increased exposure to foreign currency fluctuations. Net revenue and related expenses generated from our international location in Germany are denominated in euros. The results of operations and certain of our inter-company balances associated with this international location are exposed to foreign exchange rate fluctuations. As of July 3, 2005 and December 31, 2004, the cumulative loss from foreign currency translation adjustments was $2.0 million and $322,000, respectively. In addition to our German operation, we will have increased transactions with Japanese vendors supplying hardware and consumables for the delivery of the TDT contracts. These transactions will increase our exposure to foreign currency fluctuations with the yen. To the extent the U.S. dollar weakens against these foreign currencies, the translation of these foreign currencies denominated transactions results in increased net revenue, operating expenses and net income. Similarly, our net revenue, operating expenses and net income will decrease when the U.S. dollar strengthens against these foreign currencies. For the quarter ended July 3, 2005, we had unrealized losses related to transactions with Japanese vendors of approximately $46,000.

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

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

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

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

- the proprietary nature or protection of our methodologies is not recognized in the United States or foreign countries;
- third parties misappropriate our proprietary methodologies and such misappropriation is not detected; and
- competitors create applications similar to ours but which do not technically infringe on our legally protected rights.

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

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

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

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

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

- challenges associated with integrating acquired technologies and the business and operations of acquired companies;
- exposure to unknown liabilities;
- diversion of managerial resources from day-to-day operations;
- possible loss of key employees, customers and suppliers;
- higher than expected transaction costs; and
- additional dilution to our existing stockholders if we use our common stock as consideration.

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

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

We believe that the continued service of our executive officers will be important to our future growth and competitiveness. We have entered into employment agreements with Bernard C. Bailey, our Chief Executive Officer, William K. Aulet, our Chief Financial Officer, Iftikhar Ahmad, our Senior Vice President, Worldwide Services, Mohamed Lazzouni, our Chief Technology Officer, and James P. Ebzery, our Senior Vice

President, Customer Solutions. These agreements are intended to provide the executives with incentives to remain employed by us. However, we cannot assure you that they will remain employed by us. In addition, we believe that the continued employment of key members of our technical and sales staff is important to us. Most of our employees are entitled to voluntarily terminate their relationship with us, typically without any, or with only minimal, advance notice. The process of finding additional trained personnel to carry out our strategy could be lengthy, costly and disruptive. We might not be able to retain the services of all of our key employees or a sufficient number of them to execute our plans. In addition, we might not be able to continue to attract new employees as required.

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

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

- the size and timing of contract awards;
- the timing of our contract performance;
- variations in the mix of our products and services; and
- contract losses and changes in management estimates inherent in accounting for contracts.

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

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

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

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

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

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

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

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

As of August 10, 2005, there were 48,126,672 shares of our common stock outstanding. Lau and Mr. Buddy Beck own approximately 11.4% and 11.9%, respectively, of our common stock. If either of these stockholders sell a significant number of shares of our common stock in the open market, our stock price could decline.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Since our January 2004 acquisition of ZN, our international operating results from transactions by our German operations have been denominated in euros. As of July 3, 2005, the cumulative loss from foreign currency translation adjustments was approximately $2.0 million. Hardware and consumables purchases related to contracts associated with the TDT acquisition are denominated in Japanese yen. We mitigate exchange rate volatility by utilizing foreign currency forward contracts. Prior to 2005, we did not hedge foreign currencies using derivative instruments. Subsequent to year end, we entered into derivatives contracts as cash flow hedges to mitigate exchange risk associated with our Japanese yen purchases. For the quarter ended July 3, 2005, we had unrealized losses related to transactions with Japanese vendors of approximately $46,000. Our international operations and transactions are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign currency exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

ITEM 4 CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures*. We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

In connection with the preparation of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including the CEO and CFO, of the effectiveness of the design

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

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

With respect to the lack of accounting resources, we:

- Hired an experienced Accounting Manager with 17 years experience in three public companies who started in January 2005;
- Hired an Assistant Controller who is a Certified Public Accountant with eight years of experience who started at the beginning of April 2005; and
- Hired an experienced Business Systems Administrator with eight years of experience working on the same financial management and accounting system currently being implemented company-wide who started at the beginning of March 2005.

As a result of these additional resources, management believes that it no longer has a significant deficiency that constitutes a material weakness in our control processes with respect to the lack of accounting resources.

With respect to our information technology, or IT, systems, we:

- Identified gaps in IT policies and procedures as noted above in November 2004;
- Developed a detailed plan to remediate identified deficiencies which was completed in November 2004;
- Completed policy and procedure documentation of all key processes in December 2004;
- Implemented all identified general IT controls in the first quarter of 2005, other than those related to change control and access control of the newly-implemented financial application system and related spreadsheets;
- Plans to complete implementation of all identified general IT controls in 2005; and

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

There were no material changes to any reported financial results that have been released by us in this or any other filing as a result of these identified deficiencies. The impact of the above conditions was relevant to the fiscal year ended December 31, 2004 and the six months ended April 3, 2005 and July 3, 2005 only and did not affect the results of any prior periods. Management believes that the steps taken to date, along with certain other remediation plans it is currently undertaking, will address the material weaknesses that affected our internal controls over financial reporting in fiscal year 2004 and the first two quarters of fiscal 2005. Management will continue with its on-going evaluation and will improve our internal controls over financial reporting as necessary to assure their effectiveness. Notwithstanding, the effectiveness of our system of internal control over financial reporting is subject to certain limitations, including the exercise of management s judgment in evaluating the same. As a result, there can be no assurance that our internal controls over financial reporting will prevent all errors.

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

VIISAGE TECHNOLOGY, INC.

PART II - OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

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

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia s Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. In July 2003, the court had issued a preliminary injunction prohibiting DMVS from continuing to work with us to install the State s new drivers license system. In July 2004, we reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay us $2.0 million in cash and the State agreed to purchase certain equipment from us for $500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers license system, but disallowed the $2.0 million cash payment described above. Without this payment, we believe either that the settlement agreement with DMVS is not effective and that our contract with DMVS remains in place, or that our initial claim for an $8.2 million settlement payment is revived. The State has paid us the $500,000 for the equipment and we appealed the disallowance of the $2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted in a 4-3 decision not to hear our appeal based on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge s ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, we have identified $2.2 million of assets deployed within the state that we have deemed to have no alternative use. We reduced the recorded value of these assets from approximately $2.2 million to their estimated fair value of approximately $200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a $2.0 million charge in the fourth quarter of 2004. In addition, we have removed the contract from our backlog, and we will lose up to $19.7 million in revenue that we expected to recognize over the next five and one-half years, unless the contract remains in place or we are able to win the new contract for the digital drivers license system and the revenues from such new contract are substantially similar to the prior contract. There are approximately $2.9 million of system assets remaining on our balance sheet from the Georgia contract. These consist of approximately $1.1 million of assets that we anticipate using in Georgia if we win the contract based on the new request for proposals, approximately $150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately $1.6 million of assets constituting our central production facility in Georgia. We have evaluated these assets for impairment and, based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these assets in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

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

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5 OTHER INFORMATION

None.

ITEM 6 EXHIBITS

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

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VIISAGE TECHNOLOGY, INC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 12, 2005	By:	/s/ Bernard C. Bailey
		Bernard C. Bailey **President and Chief Executive Officer** **(Principal Executive Officer)**
Date: August 12, 2005	By:	/s/ William K. Aulet
		William K. Aulet **Senior Vice President and Chief Financial Officer** **(Principal Financial Officer)**

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EXHIBIT INDEX

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

Note	Description
(a)	Filed herewith.