L-1 IDENTITY SOLUTIONS, INC.
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 30, 2006.

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

L-1 IDENTITY SOLUTIONS, 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.)**
177 Broad Street, 12th Floor, Stamford, CT	**06901**

(Address of principal executive offices)	(Zip Code)

(203) 504-1100

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨

Indicate by a check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) ¨ Yes x 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 November 8, 2006
Common stock, $.001 par value	72,245,068

L-1 IDENTITY SOLUTIONS, INC.

FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2006

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

L-1 IDENTITY SOLUTIONS, INC.

Condensed Consolidated Balance Sheets

(in thousands)

(Unaudited)

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 30,319	$ 72,385
Accounts receivable, net	39,429	14,615
Inventory	10,180	4,903
Other current assets	4,920	948
Total current assets	84,848	92,851
Property and equipment, net	19,925	19,495
Goodwill	868,993	152,224
Intangible assets, net	158,747	27,287
Other assets, net	5,173	2,251
Total assets	$ 1,137,686	$ 294,108
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 57,056	$ 11,384
Current portion of deferred revenue	9,690	2,579
Other current liabilities	1,596	1,406
Total current liabilities	68,342	15,369
Deferred tax liability	3,640	1,964
Deferred revenue, net of current portion	4,634	1,712
Other long term liabilities	1,623	403
Total liabilities	78,239	19,448
Shareholders equity	1,059,447	274,660
Total liabilities and shareholders equity	$ 1,137,686	$ 294,108

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

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L-1 IDENTITY SOLUTIONS, INC.

Condensed Consolidated Statements of Operations

(in thousands, except per share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Revenues	$ 39,767	$ 14,306	$ 88,073	$ 51,265
Cost of revenues:				
Cost of revenues	24,852	7,624	51,868	27,783
Depreciation expense	1,823	1,670	5,585	4,515
Amortization of purchased intangible assets	3,405	1,143	7,293	3,639
Total cost of revenues	30,080	10,437	64,746	35,937
Gross Profit	9,687	3,869	23,327	15,328
Operating expenses:				
Sales and marketing	3,366	1,625	8,703	5,552
Research and development	3,323	1,321	6,868	3,942
General and administrative	9,008	2,876	17,126	9,178
Asset impairments and merger related expenses	22,767		22,767	
Amortization of purchased intangible assets	102	100	359	300
Total operating expenses	38,566	5,922	55,823	18,972
Operating Loss	(28,879)	(2,053)	(32,496)	(3,644)
Interest income	377	75	1,543	143
Interest expense	(56)	(31)	(105)	(85)
Other income, net		210	27	294
Loss before income taxes	(28,558)	(1,799)	(31,031)	(3,292)
Provision for income taxes	698	309	2,013	963
Net Loss	$ (29,256)	$ (2,108)	$ (33,044)	$ (4,255)
Net loss per share:				
Basic and diluted	$ (0.66)	$ (0.11)	$ (0.97)	$ (0.22)
Weighted average basic and diluted shares	44,448	19,246	34,234	19,208

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

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L-1 IDENTITY SOLUTIONS, INC.

Condensed Consolidated Statements of Changes in Shareholders Equity

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
Balance, January 1, 2005	$ 19	$ 204,167	$ (49,074)	$ (322)	$ 154,790
Exercise of stock options		802			802
Common stock issued for directors fees		330			330
Common stock issued under employee stock purchase plan		101			101
Common stock issued for acquisition	2	27,408			27,410
Private placement of common stock and warrants, net	8	98,715			98,723
Fair value of vested warrants issued for acquisition		1,933			1,933
Foreign currency translation adjustment				(2,076)	(2,076)
Net loss			(7,353)		(7,353)
Balance, December 31, 2005	29	333,456	(56,427)	(2,398)	274,660
Exercise of stock options		4,456			4,456
Common stock issued under employee stock purchase plan		159			159
Common stock issued for acquisition, net	43	769,931			769,974
Fair value of assumed stock options for acquisition		35,103			35,103
Retirement plan contributions paid in common stock		182			182
Stock-based compensation expense		5,896			5,896
Foreign currency translation adjustment				2,061	2,061
Net loss			(33,044)		(33,044)
Balance, September 30, 2006	$ 72	$ 1,149,183	$ (89,471)	$ (337)	$ 1,059,447

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

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L-1 IDENTITY SOLUTIONS, INC.

Condensed Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Nine Months Ended September 30, 2006	October 2, 2005
Cash Flows from Operating Activities:		
Net loss	$ (33,044)	$ (4,255)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	14,402	9,082
Directors fees paid in common stock		171
Stock-based compensation expense	5,896	34
Deferred tax provision	1,676	778
Asset impairments and in process research and development charge	17,341	
Retirement plan contributions paid in common stock	182	
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(8,491)	4,709
Inventory	799	(2,150)
Other assets	(3,127)	451
Deferred revenue	742	588
Accounts payable and accrued expenses	10,917	(5,598)
Net cash provided by operating activities	7,293	3,810
Cash Flows from Investing Activities:		
Cash paid for acquisitions, net of cash acquired	(43,364)	
Capital expenditures	(4,973)	(3,005)
Increase in restricted cash	(2,222)	
Proceeds from sale of equipment		500
Purchase of intangible and other assets	(549)	
Net cash used in investing activities	(51,108)	(2,505)
Cash Flows from Financing Activities:		
Payments on long-term debt	(309)	(70)
Financing fees	(483)	
Proceeds from issuance of common stock	4,615	169
Cost of issuance of common stock for acquisition	(2,012)	
Net cash provided by financing activities	1,811	99
Effect of exchange rate changes on cash	(62)	(38)
Net (decrease) increase in cash and cash equivalents	(42,066)	1,366
Cash and cash equivalents, beginning of period	72,385	11,309
Cash and cash equivalents, end of period	$ 30,319	$ 12,675

Supplemental Disclosure:				
Cash paid for interest	$	106	$	58
Cash paid for income taxes	$	110	$	85

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

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L-1 IDENTITY SOLUTIONS, INC.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. DESCRIPTION OF BUSINESS

L-1 Identity Solutions, Inc. (formerly Viisage Technology, Inc.) and its subsidiaries (L-1 or the Company) provides a full range of identity protection solutions that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy. L-1 s identity protection solutions are specifically designed for the identification of people and include secure credentialing, biometrics, automated document authentication, real-time identity databases, automated testing of identity and identity information, and biometrically-enabled background checks, as well as systems design, development, integration and support services. These identity protection solutions enable L-1 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.

The Company operates in two reportable segments: the Identity Solutions segment and the Services segment. The Identity Solutions segment provides biometric and identity solutions to federal, state and local government agencies, foreign governments and commercial entities. The Services segment currently provides fingerprinting services to federal and state governments and commercial enterprises, primarily financial institutions.

The Company has developed and acquired complimentary technologies and businesses that allow it to offer a full range of secure credentialing and biometric products, including facial, fingerprint and iris recognition products and technologies to customers.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying condensed consolidated financial statements reflect the application of certain significant accounting policies as described in this note and elsewhere in the accompanying condensed consolidated financial statements and notes.

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared by L-1 and reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a fair presentation of the financial statements for the interim periods. The unaudited condensed consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC) for interim financial statements, and in accordance with SEC rules, omit or condense certain information and footnote disclosures. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in L-1 s Annual Report on Form 10-K/A for the year ended December 31, 2005.

The accompanying condensed consolidated financial statements include the accounts of L-1 and its wholly-owned subsidiaries. All material intercompany transactions and balances have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions 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. The most significant assumptions and estimates relate to the allocation of the purchase price of the acquired businesses, assessing the impairment of goodwill, other intangible assets and property and equipment, revenue recognition, income taxes, litigation and valuation of financial instruments, including warrants and stock options. Actual results could differ materially from those estimates.

Revenue Recognition

The Company derives its revenue from sales of products and services and solutions that include both products and services. With respect to product revenue, the Company sells hardware, software or a combination of hardware and software products. The Company s service revenue is derived from maintenance consulting and training services related to product sales and as well as finger printing services. A customer, depending on its needs, may order a single hardware or software product or service or combine hardware products, software products and services to create a multiple element arrangement.

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The Company s revenue recognition policies are described in detail in the notes to the consolidated financial statements included in Form 10-K/A. The following policies supplement those policies to reflect the business acquisitions made by the Company during 2006.

In the case of hardware only sales, the Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*. Revenue related to product sales that require no installation as well as printers and other peripheral devices, is recognized in accordance with the terms of the sale, generally when the product is shipped, provided no significant obligations remain and collection of the receivable is deemed reasonably assured. Certain hardware sales to end users require installation subsequent to shipment and transfer of title. Revenue related to hardware sales that are contingent on installation is deferred until installation is complete, title has transferred and customer acceptance has been obtained. Due to current policy and practices, acceptance of these products is considered to be contingent upon successful installation. When hardware products are sold via authorized representatives, dealers, distributors or other third party sales channels the obligation to install the machines generally does not remain the Company s responsibility, but is rather an obligation between the authorized representative, dealer, distributor or other third party and their ultimate customer. As a result, for sales to third party distributors, revenue is recognized at the time title is transferred which is generally upon shipment. On rare occasions, the Company is required to install products on the behalf of third party distributors. In these cases, revenue is recorded in the same manner as products sold to end users where acceptance of the product by the third party distributor is contingent upon successful installation of the product.

For hardware arrangements (software products, if any, are incidental to the arrangement) with multiple elements, the Company applies the guidance in SAB 104 and Emerging Issues Task Force Issue (EITF) 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. Such elements typically include hardware, maintenance, training, and installation. For each multiple element arrangement, the Company determines if each element is a separate unit of accounting pursuant to EITF 00-21 by ensuring (1) that the element has stand alone value to the customer, (2) that there is objective evidence of the fair value for the element and (3) that if the arrangement includes a general right of return relative to the delivered item, that delivery of the undelivered items is considered probable and within the Company s control. The elements in a multiple element arrangement typically consist of hardware products, installation, training and maintenance services. To determine the fair value for each hardware element in an arrangement, the Company relies upon vendor specific objective evidence (VSOE) of fair value using the price charged when that element is sold separately. If VSOE of fair value is not available for hardware elements, the Company relies upon vendor objective evidence of fair value in the form of competitor pricing of the same or interchangeable products. To determine the fair value for training and installation services, the Company relies upon VSOE of fair value using the price charged when that element is sold separately. In the case where separation is not possible for an element, the element may be combined with other elements and the combined elements would be treated as a single unit of accounting and the appropriate revenue recognition methodology is applied.

In the event that a multiple element arrangement includes both hardware, software and services and the software is more-than-incidental to the arrangement, but not essential to the functionality of the hardware, the Company applies the guidance of EITF 03-05, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software* which allows the non-software elements and related services to be accounted for under SAB 104 and EITF 00-21 and the software elements and related services to be accounted for under SOP 97-2.

Revenue from maintenance arrangements such as those typically sold with live scan systems are recognized ratably over the term of the arrangements. Maintenance that is bundled with other elements is deferred based upon fair value of the maintenance services. Fair value is based on the renewal rate for continued maintenance arrangements.

Stock Based Compensation

On January 1, 2006, L-1 adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which requires share-based payment transactions to be accounted for using a fair value-based method and the recognition of the related expense in the results of operations. Prior to the adoption of SFAS No. 123(R), as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company accounted for share-based payments to employees in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, utilizing the intrinsic value method. Therefore, the Company recognized compensation expense for restricted stock awards and directors fees paid in common stock and did not recognize compensation cost for employee stock options whose exercise price was equal to the fair value of the Company s common stock on the date of grant. SFAS No. 123(R) allows companies to choose one of two transition methods: the modified prospective transition method or the modified retrospective transition method. The Company chose the modified prospective transition methodology and, accordingly, has not restated the results of operations of prior periods. Under the provisions of SFAS No. 123(R), stock-based compensation cost is estimated at the grant date based on the fair value of the award and compensation cost is recognized as an expense over the requisite service period of the award, generally the vesting period. The fair value of non-vested stock awards was determined by reference to the fair market value of the Company s common stock on the date of grant. Consistent with the valuation method the Company used for

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disclosure-only purposes under the provisions of SFAS No. 123, L-1 uses the Black-Scholes valuation model to estimate the fair value of option awards. The modified prospective method of transition requires compensation expense related to share based payments to be recognized beginning on the adoption date: over the vesting period for awards granted after January 1, 2006 and over the remaining service period for the unvested portion of awards granted prior to January 1, 2006.

Determining the appropriate fair value model and related assumptions requires judgment, including estimating common stock price volatility, forfeiture rates and expected terms. The following weighted average assumptions were utilized in the valuation of stock option awards for the three and nine months ended September 30, 2006.

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Expected common stock price volatility	93.8%	105%
Risk free interest rate	4.4%	4.3%
Expected life of options	6.3 Years	6.3 Years
Expected annual dividends		

The expected volatility rate is based on the historical volatility of the Company s common stock. The expected life of options represents the average time options that vest are expected to be outstanding based on the vesting provisions and the Company s historical exercise, cancellation and expiration experience. The Company estimated forfeitures when recognizing compensation expense based on historical rates. The risk free interest rate is based on the 7 year treasury security as it approximates the 6.3 year term. The Company will update these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are warranted.

Stock-based compensation expense was $4,481 and $5,896 for the three and nine months ended September 30, 2006, respectively, and includes $585 and $632 related to restricted stock compensation expense, respectively. The Company recognized the full cost impact of the awards issued under its equity incentive plans in the condensed consolidated statements of operations for the three and nine months ended September 30, 2006 and did not capitalize any such costs. The following table presents stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenues	$ 246	$ 416
Research and development	375	603
Sales and marketing	142	501
General and administrative	493	1,151
Asset impairments and merger related expenses	3,225	3,225
Stock-based compensation expense	$ 4,481	$ 5,896

The Company had previously adopted the disclosure only provisions of SFAS No. 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. The following table illustrates the effect on net loss and net loss per share for the three and nine months ended October 2, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123(R) to stock-based awards. A reconciliation of net loss as reported to pro forma net loss and a presentation of per share amounts follows (in thousands, except per share data):

	Three Months Ended October 2, 2005	Nine Months Ended October 2, 2005
Net loss, as reported	$ (2,108)	$ (4,255)
Add: stock based employee compensation expense included in reported net loss		34
Deduct: stock-based compensation expense determined using fair value based method for all awards	(818)	(1,932)
Net loss, pro forma	$ (2,926)	$ (6,153)
Net loss per share:		
Basic and diluted, as reported	$ (0.11)	$ (0.22)
Basic and diluted, pro forma	$ (0.15)	$ (0.32)

Computation of Net Loss per Share

The basic and diluted net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. Incremental dilutive shares of 1,169,000 and 1,750,800 for the three and nine-month periods ended September 30, 2006 and October 2, 2005, respectively, resulting from the assumed exercise of dilutive options and warrants, were not reflected in the diluted net loss per share calculations as their effect would be anti-dilutive.

Inventory and Suppliers

L-1 obtains certain products and services from a limited group of suppliers. 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, L-1 may experience delays in manufacturing and shipping products and providing services to customers if it loses these sources or if supplies or services 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, the Company does not carry significant inventories of the products it purchases, and it has no guaranteed supply arrangements with its vendors. A loss of a significant supplier could delay sales and increase the costs. Approximately $2.5 million of inventory is maintained at customer sites at September 30, 2006.

The Company provides a warranty for manufacturing and material defects on all units sold. A reserve for warranty costs, based on estimates utilizing projected costs to repair units, is recorded and periodically adjusted to reflect actual experience (see Note 11).

Comprehensive Income (Loss)

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, the Company reports accumulated other comprehensive loss in its condensed consolidated balance sheets. Comprehensive loss includes net loss and other comprehensive income (loss). Other comprehensive income (loss) includes current period foreign currency translation adjustments. Assets and liabilities of L-1 s operations in Germany are denominated in Euros and are translated into U.S. dollars at exchange rates as of each balance sheet date. Income and expense accounts are translated into U.S. dollars at the average rates of exchange prevailing during the periods presented. Adjustments resulting from translating foreign 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. The accumulated other comprehensive income (loss) consists of unrealized translation losses in accordance with SFAS No. 52, *Foreign Currency Translation.* For the three and nine months periods ended September 30, 2006, the comprehensive loss was approximately $28.9 million and $31.0 million, respectively. For the three and nine months periods ended October 2, 2005 the comprehensive loss was approximately $1.8 million and $5.9 million, respectively.

Foreign Currency Contracts

In 2005, the Company began to utilize foreign currency forward contracts for specific purchase obligations denominated in foreign currencies. All gains and losses resulting from the change in fair value of the derivatives are recorded in operations. None of the contracts were terminated prior to settlement. As of September 30, 2006, the Company had committed to two foreign currency forward contracts to purchase approximately 77.7 million Japanese yen for approximately $0.7 million. The fair value of these contracts at September 30, 2006 was an unrealized loss of approximately $17,000.

Reclassification of Prior Year Amortization Expense

In the first quarter of 2006, the Company began classifying amortization expense related to acquired technology intangible assets in cost of revenues in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Market*ed. For the three and nine months ended October 2, 2005, the Company reclassified amortization expense of $0.4 million and $1.1 million, respectively from operating expenses to cost of revenues. There were no changes to operating loss or net loss per share as a result of this reclassification.

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Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*, which is effective for fiscal years beginning after December 15, 2006. The interpretation provides that a tax position is recognized if the enterprise determines that it is more likely than not that a tax position will be sustained based on the technical merits of the position, on the presumption that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods and transition. The Company is in the process of evaluating the impact that adoption of the interpretation will have on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements.* SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States of America, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, which for the Company will be as of the beginning of 2008. The Company is in the process of evaluating the impact that the adoption of SFAS No. 157 will have on its consolidated financial statements.

3. STOCK OPTIONS

Stock Based Compensation

L-1 has the following stock based incentive plans. The 1996 Management Stock Option Plan and the 1996 Director Stock Option Plan (the Option Plans) permit the Board of Directors to grant incentive and nonqualified stock options to employees and officers and nonqualified stock options to directors. In 2005, the Company adopted the 2005 Long-Term Incentive Plan (the 2005 Plan), which provides for the issuance of non-qualified stock options and incentive stock options, as well as stock purchase rights, stock appreciation rights and long-term performance awards to eligible employees, officers and directors. Incentive stock options are granted at fair market value and are subject to the requirements of Section 422 of the Internal Revenue Code of 1986, as amended. Nonqualified options are granted at exercise prices determined by the Board of Directors. To date, options granted to directors have vested either immediately or between one to four years from the date of grant. Options granted to officers and employees generally vest over four years or, in limited circumstances, earlier if certain performance criteria are achieved. All options granted under these plans expire ten years from the date of grant.

In 2001, the Company adopted the 2001 Stock in Lieu of Cash Compensation for the Directors Plan to compensate non-employee members of the Board of Directors. The number of shares that may be issued under the plan shall not exceed, in the aggregate, 320,000 shares of L-1 common stock. This plan allows directors to elect to receive their board compensation in cash or stock.

At September 30, 2006, the Company has reserved 493,160 shares of common stock for issuance under the 1996 Management Stock Option Plan, of which none are available for future issuance. The Company has reserved 2,000,000 shares of common stock for issuance under the 2005 Plan, of which 733,500 shares are available for future issuance. The Company had reserved 430,646 shares of common stock for issuance under the 1996 Director Stock Option Plan, prior to its expiration in 2005.

Assumed Plans

In connection with the ZN Vision Technologies AG (ZN) acquisition on January 23, 2004, as more fully described in the Company s annual report on Form 10-K/A for the year ended December 31, 2005, the Company assumed ZN s Employee Share Option Plan and accordingly has reserved 397,187 shares of L-1 common stock for issuance upon exercise of outstanding options held by participants in this plan. The options under this plan were fully vested prior to the consummation of the acquisition.

As part of the Imaging Automation, Inc. (iA) acquisition on October 5, 2004, as more fully described in the Company s annual report on Form 10-K/A for the year ended December 31, 2005, the Company assumed iA s stock option plans. Options previously issued under the plans were fully vested as of the close of the transaction and, accordingly, the Company has reserved 9,650 shares of L-1 common stock for issuance to the plans participants.

In connection with the Company s merger with Identix Incorporated (Identix) in 2006, the Company assumed all of the then outstanding options granted under the Identix Incorporated 2002 Equity Incentive Plan (the 2002 Plan), the Identix Incorporated New Employee Stock Incentive Plan, the Identix Incorporated Non-Employee Directors Stock Option Plan, the Identix Incorporated Equity Incentive Plan, the Visionics Corporation 1990 Stock Option Plan, the Visionics Corporation 1998 Stock Option Plan, and the Visionics Corporation Stock Incentive Plan to purchase an aggregate 6,361,905 shares of common stock of Identix, which, based on the exchange ratio of 0.473, are exchangeable into an aggregate of 3,009,181 shares of common stock of the Company. The Company reserved 3,009,181 shares of L-1 common stock for issuance upon exercise of outstanding options under the Identix plans.

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The 2002 Plan will expire in 2012 and provides for the discretionary award of options, restricted stock, stock purchase rights, performance shares or any combination of these awards to L-1 eligible employees and non-employee directors and consultants. Options generally vest on an annual basis over a period of four years. As of September 30, 2006, 2,070,224 shares of L-1 common stock were reserved for issuance pursuant to options outstanding under the 2002 Plan and 1,493,082 shares of L-1 common stock were reserved for future issuance pursuant to options to be granted under the 2002 Plan.

Options granted under the Identix Incorporated New Employee Stock Incentive Plan, which will expire in 2010, generally vest on an annual basis over a period of four years. As of September 30, 2006, 1,182,500 shares of L-1 common stock were reserved for issuance pursuant to options outstanding under the plan.

Options granted under the Identix Non-Employee Directors Stock Award Plan vest over one year. As of September 30, 2006, 156,090 shares of L-1 common stock were reserved for issuance pursuant to outstanding options under this plan.

Options granted under Identix Equity Incentive Plan generally vest over a four year period. As of September 30, 2006, 132,440 shares of L-1 common stock were reserved for issuance upon exercise of options outstanding under this plan.

In connection with the Identix acquisition of Visionics Corporation, Identix had assumed the Visionics Corporation 1990 Stock Option Plan, the Visionics Corporation 1998 Stock Option Plan, and the Visionics Corporation Stock Incentive Plan (the Visionics Plans) in June 2002. The Company then assumed the Visionics Plans in connection with the Identix merger. As of September 30, 2006, 1,525,485 shares of L-1 common stock were reserved for issuance pursuant to options outstanding under the Visionics Plans.

Stock Options

The following table summarizes the stock option activity from January 1, 2006 through September 30, 2006:

	Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Weighted Average Fair Value
Outstanding at January 1, 2006	2,306,022	$ 9.97	5.9	$ 11.67
Assumed in connection with Identix merger	3,008,861	13.26	5.9	11.67
Granted	1,572,000	14.61	9.8	11.85
Exercised	(626,734)			
Canceled/expired/forfeited	(131,897)			
Outstanding at September 30, 2006	6,128,252	11.88	6.9	12.04
Exercisable at September 30, 2006	4,186,206	11.73	5.9	9.50

The aggregate unearned compensation cost of unvested options outstanding as of September 30, 2006 was $18.7 million and will be amortized over a weighted average period of 2.8 years. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was $2.2 million and $3.4 million, respectively. The intrinsic value is calculated as the difference between the market value of the Company s common stock and the exercise price of options.

The recognition of a tax benefit related to the exercise of stock options and subsequent sale of the underlying stock is being deferred per SFAS No. 123(R) and will be recognized when net operating loss carryforwards are fully utilized.

Restricted Shares

L-1 had 3,943 non-vested restricted shares outstanding at September 30, 2006, all of which were granted in 2005 and vest ratably over a four-year period and had an aggregate grant date fair value of approximately $45,000. In August 2006, in conjunction with the merger of Identix, 27,000 fully vested shares were granted to Identix board members that became L-1 board members, which resulted in recording compensation expense of approximately $0.4 million. The total unrecognized compensation cost related to non-vested restricted shares was approximately $39,000 at September 30, 2006.

Employee Stock Purchase Plan

In August 2006, the Company s shareholders approved the 2006 Employee Stock Purchase Plan which will make available 500,000 new shares for future issuance.

4. INCOME TAXES

The income tax provision for the three and nine month periods ended September 30, 2006 includes approximately $0.7 million and $1.7 million, respectively, and for the three and nine month periods ending October 2, 2005 approximately $0.3 million and $0.8 million, respectively, which represents aggregate impact of a deferred tax asset resulting from net losses incurred during the periods, a full valuation allowance against such deferred tax asset, and, pursuant to SFAS No. 109, a deferred tax liability related to the amortization of tax deductible goodwill for the period over which the related temporary difference will reverse is indefinite. This deferred tax liability cannot be used to offset the deferred tax asset in determining the valuation allowance. In the fourth quarter of 2005, the Company acquired Integrated Biometric Technology, Inc, (IBT) in a transaction partially accounted for as an asset purchase for income tax purposes, and acquired the assets of the AutoTest business of Openshaw Media Group. In 2004, the Company made an election under Internal Revenue Tax Code Section 338(h) (10) to treat the acquisition of Trans Digital Technologies, Inc. as an asset transaction for income tax purposes. These transactions resulted in future tax deductible amortization expense of the related goodwill for income tax purposes. The income tax provision also includes state income tax expense for the three and nine month periods ended September 30, 2006 of $43,000 and $0.3 million, respectively and of $49,000 and $0.2 million for the three month and nine months ended October 2, 2005, respectively. This is primarily the result of minimum taxes due in state jurisdictions in which the Company operates.

5. RELATED PARTY TRANSACTIONS

Aston Capital Partners, L.P. (Aston), an affiliate of L-1 Investment Partners LLC, Lau Technologies (Lau), an affiliate of Mr. Denis K. Berube, a member of the board of directors of the Company, and Mr. Buddy Beck, also a member of the board of directors of the Company beneficially own approximately 12.2%, 3.1%, and 3.2%, respectively, of L-1 s outstanding common stock. Mr. Robert LaPenta, Mr. James DePalma, Mr. Joseph Paresi and Ms. Doni Fordyce, each executive officers of the Company, directly and indirectly hold all the beneficial ownership in L-1 Investment Partners LLC and Aston Capital Partners GP LLC, the investment manager and general partner of Aston Capital Partners, L.P., respectively. Mr. LaPenta is also the Chairman of the Board of Directors and Chief Executive Officer of the Company. Mr. DePalma is also the Chief Financial Officer of the Company.

The Company has consulting agreements with Mr. Berube and his spouse, Ms. Joanna Lau, under which each receives annual compensation of $0.1 million. Each agreement terminates on the earlier of July 10, 2012 or commencement of full time employment elsewhere. During the three and nine months ended September 30, 2006, $0.1 million and $0.2 million, respectively, and for the three and nine months ended October 2, 2005, $0.1 million and $0.2 million, respectively, were paid in the aggregate to Mr. Berube and Ms. Lau for these services.

In connection with a consulting agreement which terminated in April 2006, Mr. Beck received annual compensation of $0.3 million. For the three and nine months ended September 30, 2006, zero and $0.1 million, respectively was paid to Mr. Beck for these services. For the three and nine months ended October 2, 2005, Mr. Beck was paid $0.1 million and $0.2 million, respectively, for these services. At September 30, 2006 there was no outstanding balance owed to Mr. Beck.

In connection with the merger of Identix and the acquisition of SecuriMetrics, Inc. (SecuriMetrics) in 2006, the Company paid L-1 Investment Partners LLC a one time fee of $2.5 million for professional services related to these acquisitions. Approximately $2.0 million and $0.5 million of this fee have been included in the cost of the acquisition of Identix and SecuriMetrics, respectively.

In connection with the merger with Identix, Aston and L-1 agreed in principle that the Company may, subject to approval of the Company s board of directors, purchase AFIX Technologies, Inc., a portfolio company of Aston, which provides fingerprint and palmprint identification software to local law enforcement agencies, at fair market value to be determined by an independent appraiser retained by the Company s board of directors. The independent valuation is expected to be performed in the fourth quarter of 2006 or early 2007.

In connection with the relocation of the corporate headquarters of L-1 in the third quarter of 2006 to the offices of L-1 Investment Partners LLC in Stamford, Connecticut, L-1 entered into a sublease with L-1 Investment Partners LLC under which L-1 will reimburse L-1 Investment Partners LLC for the rent and other costs payable by L-1, which is estimated at $0.7 million annually.

In connection with the merger with Identix, L-1 entered into an agreement with Bear Stearns Companies, Inc. (Bear Stearns) pursuant to which Bear Stearns provided financial advisory services related to the merger. The spouse of Ms. Fordyce, Executive Vice President, Corporate Communications is a partner and senior investment banker at Bear Stearns involved with the engagement and certain employees of Bear Stearns have substantial personal investments in Aston. Pursuant to the letter agreement, Bear Stearns is entitled to a fee of $2.5 million upon the closing of the merger, plus expense reimbursement, as well as exclusive rights to act as underwriter, placement agent and/or financial advisor to L-1 with respect to certain financings and other corporate transactions until August 2008. L-1 waived any claims it may have against Bear Stearns with respect to any actual or potential conflicts of interest that may arise with respect to these relationships in the context of the Bear Stearns engagement.

The Company has employment and non-competition agreements with all of the Company s executive officers. Such agreements provide for employment and related compensation and restrict the individuals from competing with the Company. The agreements also provide for the grant of stock options under the Company s stock option plans and for severance upon termination under circumstances defined in such agreements.

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As a condition to the closing of the Identix Merger, the Company and L-1 Investment Partners LLC entered into a Termination and Noncompete Agreement which, among other things, (1) terminated all arrangements whereby L-1 Investment Partners LLC and its affiliates provided financial, advisory, administrative or other services to the Company or its affiliates, and (2) prohibited L-1 Investment Partners LLC and its affiliates from engaging or assisting any person that competes directly or indirectly with the Company in the business of biometric, credentialing and ID management business anywhere in the United States or anywhere else in the world where the Company does business, or plans to do business or is actively evaluating doing business during the restricted period; provided however that the foregoing does not restrict L-1 Investment Partners LLC and its affiliates from retaining its investment in and advising AFIX Technologies, Inc. The restricted period runs co-terminously with the term of Robert LaPenta s employment agreement with the Company, dated as of August 29, 2006, and for a twelve (12) month period following the expiration of the term of Mr. LaPenta s employment agreement.

In connection with the acquisition of IBT in December 2005, the Company issued warrants to purchase 440,000 shares of common stock with an exercise price of $13.75 per share to L-1 Investment Partners LLC, of which 160,000 will vest upon IBT meeting specified a level of operating performance.

6. REPORTABLE SEGMENTS, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK

SFAS No. 131, *Disclosures about Segments of a Business Enterprise and Related Information*, establishes standards for reporting information regarding reportable and operating segments. Operating segments are defined as components of a company which the chief operating decision maker evaluates regularly in deciding how to allocate resources and assess performance. The Company s chief operating decision maker is its Chief Executive Officer. Effective with the acquisition of IBT in December 2005, the Company transitioned to two operating segments, the Identity Solutions segment and the Services segment. Effective with the acquisition of SecuriMetrics in February 2006, the Company began operating in a third segment, the SecuriMetrics segment. With the acquisition of Identix and Iridian in August 2006, the Company has established two reportable segments: the Identity Solutions segment and the Services segment. The Company s Identity Solutions segment includes the Viisage Division, the Identix Division and the SecuriMetrics Division, and provides biometrics-enabled solutions that allow governments, law enforcement agencies and commercial enterprises to enhance security, reduce identity theft and to protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and identity databases. The segment s solutions include products and devices utilizing fingerprinting, face recognition and iris recognition technologies. The Services segment provides solutions to government, civil, and commercial customers that require criminal background checks and screening. All periods reflect the results based on these two segments.

The Company measures segment performance primarily based on revenues and operating income (loss). Operating results by segment for the three and nine months ended September 30, 2006 and October 2, 2005 were as follows (in thousands):

	Three months ended September 30, 2006		Nine months ended September 30, 2006		As of September 30, 2006	
	Revenues	Operating Loss	Revenues	Operating Loss	Total Assets	Goodwill
Segment:						
Identity Solutions	$ 30,604	$ (24,404)	$ 68,327	$ (25,510)	$ 1,042,520	$ 810,076
Services	9,163	(1,150)	19,746	(1,473)	77,697	58,917
Corporate		(3,325)[1]		(5,513)[1]	17,469	
	$ 39,767	$ (28,879)	$ 88,073	$ (32,496)	$ 1,137,686	$ 868,993

[1] Includes stock-based compensation charges of $1.3 million.

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	Three months ended October 2, 2005 Revenues	Three months ended October 2, 2005 Operating Loss	Nine months ended October 2, 2005 Revenues	Nine months ended October 2, 2005 Operating Loss	As of December 31, 2005 Total Assets	As of December 31, 2005 Goodwill
Segment:						
Identity Solutions	$ 14,306	$ (1,150)	$ 51,265	$ (767)	$ 214,152	$ 93,853
Services					67,281	58,371
Corporate		(903)		(2,877)	12,675	
	$ 14,306	$ (2,053)	$ 51,265	$ (3,644)	$ 294,108	$ 152,224

Corporate assets consist mainly of cash.

Revenues by market for the three and nine months ended September 30, 2006 and October 2, 2005 were as follows (in thousands):

	Three months ended September 30, 2006	Three months ended October 2, 2005	Nine months ended September 30, 2006	Nine months ended October 2, 2005
State and local	$ 18,724	$ 8,291	$ 46,304	$ 26,238
Federal	20,508	5,658	38,999	22,287
Commercial	535	357	2,770	2,740
	$ 39,767	$ 14,306	$ 88,073	$ 51,265

Revenues are attributed to each region based on the location of the customer. The following is a summary of revenues by geographic region (in thousands):

	Three Months Ended September 30, 2006	Three Months Ended October 2, 2005	Nine Months Ended September 30, 2006	Nine Months Ended October 2, 2005
United States	$ 37,166	$ 13,446	$ 82,378	$ 46,221
Rest of world	2,601	860	5,695	5,044
	$ 39,767	$ 14,306	$ 88,073	$ 51,265

The Company did not have significant international sales to individual countries for the periods presented.

For the three and nine month periods ended September 30, 2006, the U.S. Transportation Security Administration accounted for 11% and 14%, respectively, of consolidated revenues. For the three month periods ended September 30, 2006 and October 2, 2005, the U.S. Department of State accounted for 15% and 21%, respectively, of consolidated revenues. For the nine month periods ended September 30, 2006 and October 2, 2005, the U.S. Department of State accounted for 18% and 27%, respectively, of consolidated revenues. As of September 30, 2006 and December 31, 2005, the U.S. Department of State was the only customer that had a balance of greater than 10% of consolidated accounts receivable, which was approximately $4.0 million and $4.4 million, respectively.

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7. ACQUISITIONS

SpecTal, LLC

On October 19, 2006, the Company acquired privately-held SpecTal, LLC, (SpecTal) which provides comprehensive security and intelligence solutions, specializing in government consulting, training, and technology development. Under the terms of the definitive agreement with SpecTal, the Company paid SpecTal shareholders $100.0 million in cash, of which $5 million was placed in escrow. SpecTal shareholders may receive additional consideration of up to $10.0 million if specified performance thresholds are met through 2009. The acquisition of SpecTal was funded by bank debt (see Note 12).

The results of operations of the following acquisitions have been included in the consolidated financial statements from their respective dates of acquisition.

Identix Incorporated

On August 29, 2006, the merger between L-1 and Identix Incorporated (Identix) was approved by shareholders and the Boards of Directors of both companies, with the combined company operating as L-1. The Identix merger was a tax-free reorganization for federal income tax purposes, and Identix stockholders received 0.473 of a share of L-1 common stock for each share of Identix common stock owned (the Exchange Ratio). L-1 assumed Identix stock option plans and outstanding stock options and assumed all outstanding warrants to purchase Identix common stock, which were converted into the right to receive L-1 common stock based on the Exchange Ratio.

Under the terms of the Identix merger, Identix stockholders received approximately 42.6 million shares of L-1 common stock. The transaction was valued at approximately $814 million, including the approximate fair value of $35 million of Identix warrants and stock options to purchase 3.0 million shares which were assumed by L-1 and direct acquisition expenses of $7.3 million. The Identix warrants and options assumed by L-1 have been valued using the Black-Scholes valuation model. After the merger, L-1 shareholders owned approximately 41% of the combined company. The transaction has been accounted for as an acquisition of Identix by L-1, based on, among other considerations, the significant share holdings in the combined company by L-1 directors and management as a group, L-1 s right to select the majority of the board of directors of the combined company, L-1 management s dominant position in senior management of the combined company and the L-1 payment of a premium over the quoted market value of the Identix stock based on the average closing price for the ten days prior to the merger announcement.

Identix sells and markets biometric solutions incorporating fingerprint, facial and skin biometrics and system components necessary for the biometric capture and knowledge discovery. Product offerings include Live Scan and mobile systems and services for biometric capture and identification, and systems, modules and software for biometric matching and verification.

The Company and Identix merged primarily to take advantage of complementary strengths, to more effectively serve their markets and to provide greater long-term growth opportunities. The combined company will be better able to meet customers needs for end-to-end identity protection solutions and unlock the potential of both organizations strengths in biometrics, credentialing and imaging solutions. Using their combined technological assets, the merger enables the combined company to blend complementary assets and leverage them to provide end-to-end product, service and integration solutions; to support the growing market for multiple identity programs and to meet rigorous government mandates; to better serve the needs of customers by providing a comprehensive portfolio of products and service offerings; to utilize an extensive network and product suite and continue development and deployment of new and improved technologies and equipment; to take advantage of financial synergies; and, have the scale, size and flexibility to better compete in the marketplace.

The aggregate purchase price of Identix is as follows (in thousands):

Shares issued	$ 771,987
Stock options assumed	35,103
Direct acquisition costs	7,330
Total purchase price	$ 814,420

The purchase price of Identix was allocated to the fair values of various assets and liabilities as follows (in thousands):

Current assets	$ 50,080
Property and equipment	4,253
Deposits	801
Liabilities assumed	(32,726)
Identified intangible assets:	
Completed technology	107,900
Core technology	2,100
In process research and development	2,700
Trade name	20,800
Goodwill	658,512
	$ 814,420

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The purchase price allocation is preliminary. The final allocation will be based on final analyses of identifiable intangible assets, property and equipment, contingent liabilities and income taxes, among other things, and will be finalized after the data necessary to complete the analyses of fair values of assets and liabilities are obtained and analyzed. Differences between preliminary and final allocations are not expected to have a material impact on the consolidated results of operations. None of the goodwill is expected to be deductible for income tax purposes.

Iridian Technologies, Inc.

On August 16, 2006, the Company acquired 100% of the common stock of Iridian Technologies, Inc., (Iridian) for $35.3 million in cash, of which $2.0 million was placed in escrow. The acquisition price includes approximately $0.7 million of direct acquisition costs. The purchase price is subject to adjustment based on the final net assets of Iridian. The Company acquired Iridian because of its extensive intellectual property portfolio related to iris recognition technology and for the potential of accelerating the acceptance of iris technology in the marketplace under new ownership and management.

The purchase price of Iridian is as follows (in thousands):

Cash paid	$ 34,593
Direct acquisition costs	684
Total purchase price	$ 35,277

The purchase price of Iridian was allocated to the fair values of various assets and liabilities as follows (in thousands):

Current assets	$ 948
Property and equipment	29
Liabilities assumed	(5,066)
Identified intangible assets:	
Completed technology	11,000
Contract backlog	200
Goodwill	28,166
	$ 35,277

The purchase price allocation is preliminary. The final allocation will be based on final analyses of identifiable intangible assets, property and equipment, contingent liabilities and income taxes, among other things, and will be finalized after the data necessary to complete the analyses of fair values of assets and liabilities are obtained and analyzed. Differences between preliminary and final allocations are not expected to have a material impact on the consolidated results of operations. None of the goodwill is expected to be deductible for income tax purposes.

SecuriMetrics, Inc.

On February 17, 2006, the Company acquired 100% of the common stock of SecuriMetrics, Inc., (SecuriMetrics), the sole U.S. based manufacturer of iris recognition products, for $30 million in cash, including $2 million placed in escrow for 18 months. In addition, the SecuriMetrics stockholders had an opportunity to earn up to an additional $13 million in consideration if key performance thresholds were reached and contingencies were resolved. Following the Iridian acquisition, SecuriMetrics stockholders agreed to reduce the potential amount of additional consideration to $1.5 million in exchange for a cash payment of $6.5 million. In addition, the Company received $1.4 million of cash previously placed in escrow. The remaining $1.5 million contingent consideration is payable in cash to shareholders subject to SecuriMetrics meeting performance thresholds and will be included in goodwill, if paid. As a result of this transaction, the net purchase price of SecuriMetrics aggregates $35.8 million, includes direct acquisition costs.

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The Company acquired SecuriMetrics to complement and expand its biometrics product and services offerings to include iris recognition. In addition, SecuriMetrics is the sole U.S. based manufacturer of iris recognition products and has strong relationships with the agencies of the U.S. government.

The purchase price of SecuriMetrics is as follows (in thousands):

Cash paid	$ 35,080
Direct acquisition costs	735
Total purchase price	$ 35,815

The purchase price of SecuriMetrics was allocated to the fair values of various assets and liabilities as follows (in thousands):

Current assets	$ 4,325
Property and equipment	658
Liabilities assumed	(3,162)
Identified intangible assets:	
Completed technology	2,700
Core technology	3,100
Contract backlog	100
Trade name	300
Goodwill	27,794
	$ 35,815

The purchase price allocation is preliminary. The final allocation will be based on final analyses of identifiable intangible assets, property and equipment, contingent liabilities and income taxes, among other things, and will be finalized after the data necessary to complete the analyses of fair values of assets and liabilities are obtained and analyzed. Differences between preliminary and final allocations are not expected to have a material impact on the consolidated results of operations. None of the goodwill is expected to be deductible for income tax purposes.

Pro Forma Information:

The following unaudited pro forma operating data are presented as if the acquisitions of Identix, Iridian, and SecuriMetrics had occurred at the beginning of each period presented. The unaudited pro forma data is for informational purposes only and may not necessarily be indicative of future results of operations or what the results of operations would have been had the acquisitions operated as a combined entity for the periods presented. Unaudited pro forma revenues, net loss and net loss per share information for the three and nine months ended September 30, 2006 and October 2, 2005 were as follows (in thousands, except per share amounts):

	For the Three months ended		**For the Nine months ended**	
	September 30, 2006	**October 2, 2005**	**September 30, 2006**	**October 2, 2005**
Revenues	$ 46,313	$ 39,345	$ 133,841	$ 119,878
Net loss	44,591	8,017	67,796	25,886
Basic and diluted net loss per share	0.62	0.13	0.94	0.42

The pro forma net loss for the three and nine months ended September 30, 2006 includes approximately $9.2 million of direct acquisition costs incurred by the sellers and acquisitions related costs such as one time bonuses and severance in connection with the transactions.

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8. IMPAIRMENTS AND MERGER RELATED EXPENSES

Asset impairments and merger related expenses comprise the following (in thousands):

	Total Charges	Cash Payments
In process research and development	$ 2,700	$
Asset impairments	14,641	
Separation costs	3,167	1,852
Change in control costs	1,403	349
Other stock-based compensation related to merger	856	
Total	$ 22,767	$ 2,201

In accordance with SFAS No. 144, the Company identified indications of in asset impairments which consist of intangible assets of $10.5 million, fixed assets of $3.0 million related to a terminated contract with the State of Georgia and other charges of $1.1 million. Separation costs include cash charges for severance payments of $1.9 million and stock-based compensation charges of $1.3 million to certain of the Company s former executives. Change in control costs represent stock-based compensation resulting from the acceleration of vesting of stock options and restricted stock that were due to contractual obligations embedded in the option arrangements of certain executives of the Company of $1.1 million and cash payments of $0.3 million made to retiring members of the Company s board of directors.

9. ADDITIONAL INFORMATION

Inventory (in thousands):

	September 30, 2006	December 31, 2005
Purchased parts and materials	$ 6,933	$ 2,892
Work in progress	826	
Finished goods	2,421	2,011
Inventory	$ 10,180	$ 4,903

Property and equipment (in thousands):

	September 30, 2006	December 31, 2005
System assets	$ 47,325	$ 54,558
Machinery, demo and tooling	2,719	
Computer and office equipment	6,109	5,882
Leasehold improvements	425	199
	56,578	60,639
Less accumulated depreciation and amortization	36,653	41,144
Property and equipment, net	$ 19,925	$ 19,495

For the three and nine months ended September 30, 2006, the depreciation and amortization expense of property and equipment was $2.2 million and $6.5 million, respectively. For the three and nine month periods ending October 2, 2005, the depreciation and amortization expense of property and equipment was $1.9 million and $5.1 million, respectively.

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Goodwill (in thousands):

The following summarizes the activity in goodwill for the nine months ended September 30, 2006 (in thousands):

	September 30, 2006		
	Identity Solutions	Services	Total
Balance beginning of year	$ 93,853	$ 58,371	$ 152,224
Identix merger	658,812		658,812
Iridian acquisition	28,166		28,166
SecuriMetrics acquisition	27,794		27,794
IBT additional costs and adjustments		546	546
Other	1,451		1,451
	$ 810,076	$ 58,917	$ 868,993

Intangible Assets (in thousands):

	September 30, 2006		December 31, 2005	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Completed technology	$ 124,300	$ (2,435)	$ 12,164	$ (2,040)
Core technology	5,200	(508)		
Tradenames and trademarks	21,800	(225)		
Contract backlog	18,438	(8,569)	20,789	(6,562)
Other	946	(200)	5,155	(2,219)
	$ 170,684	$ (11,937)	$ 38,108	$ (10,821)

Amortization of intangible assets was $3.7 million and $7.9 million for the three and nine months ended September 20, 2006, respectively, and $1.2 million and $3.9 million for the three and nine months ended October 2, 2005, respectively. Amortization for the fourth quarter of 2006 and the subsequent five years and are thereafter as follows: $6.5 million, $26.0 million, $24.4 million, $20.1 million, $18.3 million, $17.1 million and $46.3 million.

10. WARRANTS

In connection with the acquisition of Identix, the Company assumed Identix obligation under a warrant which was issued in exchange for the technology and intellectual property rights acquired by Identix. The warrant was issued with contingent future vesting rights to purchase up to 378,400 shares of common stock at $9.94 per share. The fair value of the warrant at the time of vesting will be recorded as additional cost of the acquisition of Identix. The warrant vests upon successful issuance of certain patents with the U.S. government related to the technology acquired. As of September 30, 2006, the warrant had not vested. The warrant expires in 2014.

In connection with Identix merger with Visionics in 2002, the Company also assumed warrants to purchase shares of Visionics common stock outstanding immediately prior to the consummation of the merger, which were converted into warrants to purchase shares of Identix common stock. At September 30, 2006, the remaining warrants to purchase 38,789 shares of common stock of the Company expire upon its fulfilling its registration obligations, and have exercise prices between $20.78 and $26.53.

11. CONTINGENCIES

In March and April 2005, eight putative class action lawsuits were filed in the United States District Court for the District of Massachusetts against L-1, Mr. Bernard C. Bailey, Mr. William K. Aulet (the Company s former Chief Financial Officer) and Mr. Denis K. Berube and other members of the Board of Directors of Viisage Technology, Inc. These lawsuits have been consolidated into one action under one case name: In re: Viisage Technology Securities Litigation, Civil Action No. 05-10438-MLW. The so-called Turnberry Group has been designated as lead plaintiff and its counsel has been designated as lead counsel. The amended consolidated complaint which was filed in February 2006 alleges violations of the federal securities laws by Viisage (now named L-1 Identity Solutions, Inc.) and certain officers and directors arising out of purported misstatements and omissions in Viisage s SEC filings related to certain litigation involving the Georgia drivers license contract and related to the Viisage s reported material weaknesses in internal controls over financial reporting, which allegedly artificially inflated the price of the Company s stock during the period May 12, 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 the Company and officers and directors. The Company believes that the allegations and claims made in this lawsuit are without merit and the Company intends to defend the action vigorously. In April 2006, the Company filed a motion to dismiss this case. If the Company is unsuccessful in defending itself in this litigation, this lawsuit could adversely affect the Company s business, financial condition, results of operations and cash flows as a result of the damages that the Company could be required to pay. It is possible that the existing 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 directors, naming Viisage as a nominal defendant. The suits claim that these directors breached their fiduciary duties to its shareholders and to Viisage generally in connection with the same set of circumstances alleged in the class action lawsuit. 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. An amended complaint in the federal court derivative action was filed in July 2006 in which the plaintiff added allegations regarding disclosures by Viisage s representatives that generally appear to be intended to support her contention that she was excused from making a demand on the board of directors before filing a derivative complaint. The Company has filed a motion to dismiss the federal court action. The Company believes that the allegations and claims made in the remaining derivative lawsuit are likewise without merit and intend to defend the action vigorously.

From time to time in the ordinary course of business, the Company is involved in disputes with third parties, including former employees of the Company. Identix Incorporated, a wholly owned subsidiary of the Company, is a defendant in one lawsuit filed by a former employee of Identix in the Fresno County Superior Court of California alleging, among other things, wrongful discharge. L-1 believes the claims are without merit and is vigorously defending the lawsuit. In a separate dispute, in June 2006 another former employee of Identix filed a lawsuit in the U.S. District Court for the Central District of California alleging, among other things, unlawful wage rate discrimination based on gender. The employee had previously initiated an arbitration proceeding in California containing the same allegations. The former employee of Identix filed the lawsuit after Identix prevailed in its declaratory judgment action in federal court in Minnesota in April 2006 when the court enjoined the plaintiff from further prosecuting plaintiff s arbitration proceeding in California and further ordered plaintiff to arbitrate their dispute in Minnesota in accordance with the terms of plaintiff s sales commission agreement with the Company. L-1 believes that the plaintiff s claims are without merit and is vigorously defending the lawsuit and the pending arbitration proceeding.

In January 2004, LG Electronics USA, Inc. and LG Electronics, Inc. (a Korean Corporation) (LG) filed a lawsuit against Iridian Technologies, Inc., a wholly owned subsidiary of the Company, in federal court in New Jersey seeking to cancel Iridian s federal trademark registration for its IrisAccess trademark, and alleging that Iridian had made false statements by announcing that it had discontinued its IrisAccess line of products. At the time LG filed this lawsuit, the parties had been engaged in an ongoing negotiation regarding Iridian s introduction of new standard pricing for its licenses. LG contended that Iridian was not entitled to impose its new standard per user pricing on LG pursuant to the terms of the parties 2000 Amended and Restated Development, Distribution and Supply agreement (the License Agreement). In August 2004, LG filed a demand for arbitration before the American Arbitration Association, seeking a finding that its fee for using Iridian s iris recognition technology remained at the original per unit pricing structure under the License Agreement. Shortly thereafter, Iridian terminated the License Agreement due to LG s failure to pay royalties as required under Iridian s new standard pricing. In response, LG filed another lawsuit in New Jersey federal court, asking the court to enter a finding that Iridian s termination of the License Agreement was improper and that LG s continued use of Iridian s technology did not infringe upon Iridian s patent rights. The issues in all three cases have since been consolidated into one action pending in New Jersey federal court, and are being litigated pursuant to a series of amended complaints filed by LG. Iridian vigorously denies all of LG s claims and is counterclaiming for LG s breach of contract, infringement of Iridian s patents and copyrights, and misappropriation of Iridian s trade secrets. LG has replied to Iridian s counterclaims and has asserted defenses that include, among other things, the alleged invalidity or unenforceability of Iridian s patents, copyrights and trade secrets. LG has also sought leave to amend its complaint to add antitrust claims against Iridian for attempted monopolization. Iridian believes that it has strong defenses to all of LG s claims and a strong basis to pursue all of Iridian s counterclaims, and intends to vigorously defend against LG s claims and pursue its own counterclaims. At this time, the parties have not completed discovery and accordingly, it is not possible to predict with certainty the outcome of this litigation. However, a material adverse ruling against Iridian respecting either the underlying contract claims or enforceability of Iridian s intellectual property rights could materially adversely impact the value of the Company s investment in Iridian and its iris recognition technology.

In September 2006, L-1 received a notice of a claim from a former employee and consultant of Iridian alleging that Iridian owes such individual $2.0 million pursuant to a consulting agreement entered into between Iridian and the individual in 1997. L-1 and Iridian are in the process of investigating the allegations. To the extent the individual s claims against Iridian have merit, L-1 believes that any payments due to such individual will be eligible for offset, in whole or in part, pursuant to the indemnification escrow account established as part of L-1 s acquisition of Iridian.

In September 2003, SecuriMetrics, a wholly-owned subsidiary of L-1 since February 2006, commenced an action in the United States District Court for the District of New Jersey against Iridian to obtain a determination of the meaning of disputed terms in a series of interrelated license agreements between SecuriMetrics and Iridian regarding certain iris recognition technology owned by Iridian. Iridian asserted counterclaims alleging that SecuriMetrics was in breach of or default under certain provisions of such license agreements. These lawsuits were settled as part of the acquisition of Iridian by L-1 (see Note 7).

In July 2006, Identix received an ordinary course call from the Office of Export Enforcement (BIS) requesting copies of shipping documentation related to a prior shipment of Identix products. In the process of retrieving the documentation, Identix determined that its shipping department had incorrectly completed the relevant documentation, and Identix promptly informed BIS of the error. Identix promptly thereafter initiated an internal review of compliance with its own export compliance policies and export regulations. During the course of the internal review, additional shipping documentation discrepancies were identified. In September 2006, Identix voluntarily disclosed such discrepancies to BIS and retained an independent consultant to supplement Identix internal review of export compliance. While the review of the independent expert is continuing, and while monetary penalties arising out of these inadvertent discrepancies are a possible result of these discrepancies, based on information currently available, L-1 does not believe that liabilities or penalties arising out of these discrepancies will have a material adverse effect on the business, operations or financial results of L-1.

In connection with Identix sale of Legislative Demographic Services, Inc. (LDS) Identix is obligated to indemnify the buyer against certain potential liabilities, including for breaches of representations and warranties Identix made in the sales agreement, for an amount not to exceed $0.3 million. This indemnification expires January 2007.

From time to time, the Company agrees to indemnify its customers against liability if the products infringe a third party s intellectual property rights. As of September 30, 2006, the Company is not subject to any pending litigation alleging that the Company s products infringe the intellectual property rights of any third parties.

The Company offers a warranty on various products and services. The Company estimates the cost that may be incurred under its warranties and records a liability in the amount of such costs at the time the product is sold. Factors that affect the Company s warranty liability include the number of units sold, historical and anticipated rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The amount of the reserve recorded is equal to the estimated costs to repair or otherwise satisfy the claim.

The following table presents changes in the warranty liability for nine month periods ending September 30, 2006 and October 2, 2005 respectively (in thousands):

	September 30, 2006	October 2, 2005
Balance beginning of period	$ 34	$ 34
Obligation assumed in connection with Identix merger	1,996	
Warranty expense	7	
Closed warranty claims	(276)	
Balance at end of period	$ 1,761	$ 34

12. SUBSEQUENT EVENT

On October 19, 2006, the Company entered into an Amended and Restated Credit Agreement (the Agreement) by and among the Company, Bank of America (the Bank), Bear Stearns, Wachovia Bank, N.A., Credit Suisse, Societe Generale, and TD Bank North, to amend and restate the Credit Agreement, dated as of August 16, 2006, by and between the Company and the Bank. The Agreement provides for a revolving credit facility of up to $150 million, with the potential for up to $50 million in additional borrowings. The Company is required to comply with certain financial covenants, some of which may limit the amounts borrowed or available. The Agreement provides that up to $25 million of the total facility amount may be used for the issuance of letters of credit. Borrowings under the Agreement are secured by all assets of the Company and certain of its affiliates. The Company used proceeds from the facility to fund the SpecTal acquisition (see Note 7).

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 audited consolidated financial statements and accompanying notes contained in our 2005 Annual Report on Form 10-K/A and in this Quarterly Report on Form 10-Q.

COMPANY BACKGROUND

L-1 Identity Solutions, Inc. (L-1 or the Company) provides identity protection solutions that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft, and protect personal privacy. Our solutions are specifically designed for the identification of people and include secure credentialing, biometrics, automated document authentication, real-time identity databases, automated testing of identity and identity information, and biometrically-enabled background checks, 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 these 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 revenues through the sale and licensing of products and services for verifying and managing identities. Our revenues increased to approximately $39.8 million for the three months ended September 30, 2006 from $14.3 million for the three months ended October 2, 2005. Our net loss for the three months ended September 30, 2006 increased to $29.3 from $2.1 for the three months ended October 2, 2005. The net loss for the three month period ended September 30, 2006 includes approximately $22.8 million of asset impairments, separation costs, change in control and other costs, of which $3.2 million comprises stock-based compensation charges. The results from the period also includes additional stock-based compensation charges of $1.3 million and amortization expense of intangible assets of approximately $2.2 million related to businesses acquired subsequent to October 2, 2005. The Company adopted the provision of SFAS 123(R) effective January 1, 2006.

Our identity protection solutions ensure the production of secure credentials, enable automated background checks and help prevent and detect identity theft and fraud. Annually, our identity protection solutions produce more than 30 million secure government-issued credentials at more than 2,000 locations. We are the second largest provider of U.S. drivers licenses with a market share of approximately 30%, and we are the sole source provider of passport production capability to the U.S. Department of State. We also are a recognized leader in biometrics in the fields of face recognition, iris identification and fingerprinting products, services and solutions. In addition, we are a leader in document authentication technology with approximately 3,000 installations in 17 countries. Our customers include governments, law enforcement agencies and businesses around the world.

The market for identity protection solutions has continued to develop at a rapid pace over the past 24 months. In particular, consumers of identity protection solutions are demanding end-to-end solutions with increased functionality that can solve their spectrum of needs across the identity life cycle. Our objective is to meet those growing needs by continuing to broaden our product and solution offerings to meet our customer needs, leveraging our existing customer base to provide additional products and services, expanding our customer base both domestically and abroad, and augmenting our competitive position through strategic acquisitions. We evaluate our business primarily through financial metrics such as revenues, operating income (loss) and EBITDA. As an expanding company, we believe that our greatest challenge is choosing the right markets and best opportunities to pursue that will enable us to successfully grow our business.

Sources of Revenues

Identity Solutions

Our SecuriMetrics, Inc. (SecuriMetrics) / Iridian Technologies, Inc. (Iridian) division generates revenues through the development, customization and sale of biometrics solutions using iris technology which typically consist of proprietary biometrics capture devices bundled together with our proprietary software, as well as, sales of licenses and software.

Our Viisage Technology, Inc. (Viisage) division generates product revenues principally from sales of biometrics solutions which typically consist of our proprietary software together with commercial off-the-shelf cameras and workstations; document authentication solutions which typically consist of our proprietary document authentication system bundled with our proprietary software; and our secure printing solutions which typically consist of specialized printers and related consumables. Viisage generates services revenues from the design, customization and installation of secure credential issuance systems and customized biometrics solutions. Viisage generates maintenance revenues from maintenance contracts that are typically included with the sale of our solutions and on the renewals of those contracts.

Our Identix Incorporated (Identix) division generates revenues from the sale of biometric solutions incorporating fingerprint, facial and skin biometrics and system components necessary for the biometric capture and knowledge discovery. Product offerings include Live Scan and mobile systems and services for biometric capture and identification, and systems, modules and software for biometric matching and verification.

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Services

Our Integrated Biometric Technology, Inc (IBT) / Identix Identification Services, Inc. (IIS) division generates revenues through the sale of background screening products and services.

We market our solutions primarily to U.S. and foreign federal, state and local government agencies and law enforcement agencies. We also are working to expand the use of our solutions in commercial markets, particularly financial services and transportation. In a typical contract with a government entity for an identity solution, we design the system, supply and install equipment and software and integrate the solution within the entity s existing network infrastructure. These contracts may be structured as fixed price contracts with payments made upon completion of agreed milestones or deliveries and with each milestone or delivery typically having a value specified in the contract. Alternatively, these contracts may be paid at a fixed price per credential issued as is typical in the drivers license market, or per fingerprint delivered in the case of our fingerprinting products and Services segment. We also sell products and services that incorporate fingerprinting, facial recognition and iris recognition technology. These include Live Scan products, Identification Based Information Systems (IBIS), Automated Biometric Identification Systems (ABIS) and biometric and professional services. Our customers usually impose specific performance and acceptance criteria that must be satisfied prior to acceptance of the system and corresponding payment.

Our growth in revenues since the fourth quarter of 2003 is due principally to acquisitions we consummated as well as increased demand for our solutions corresponding to heightened emphasis on secure credential issuance, document authentication and biometrics. We anticipate that the U.S. Department of State will continue to be one of our major customers for the foreseeable future due to the continuing increase in the number of passports issued each year. We also anticipate steadily increasing funding for major government programs such as TWIC, HSPD-12, REAL ID and e-passport. Any delay or other changes in the rollout of these programs could cause our revenues to fall short of our expectations. We also expect to experience increased demand from a number of other government entities as they deploy identity solutions, particularly document authentication, at points of entry and exit, including borders, seaports and airports, and in connection with national identification programs. Notwithstanding our expectations regarding demand for these solutions, the quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations. Government contracts for identity solutions at points of entry and exit and in connection with national identification programs are typically awarded in open competitive bidding processes. Therefore, our future level of sales of our solutions for these deployments may vary substantially, and will depend on our ability to successfully compete for this business.

STRATEGIC ACQUISITIONS

We have pursued a strategy of strategic acquisitions to complement and expand our existing products, services and solutions. Recent acquisitions include:

- our October 2006 acquisition of SpecTal LLC, which provides security and intelligence solutions specializing in government consulting, training and technology development;

- our August 2006 merger with Identix Incorporated, whose multi-biometric technology provides a broad range of fingerprint and facial recognition technology offerings, which we believe will expand and better serve our addressable market;

- our August 2006 acquisition of Iridian Technologies, Inc., which holds the leading iris recognition technology in the industry;

- our February 2006 acquisition of SecuriMetrics, Inc., a provider of the world s only full-function handheld iris recognition and multi-modal biometric devices, enabling us to now offer multiple and multi-modal biometric capabilities that include finger, face and iris;

- our December 2005 acquisition of Integrated Biometric Technology, Inc., a provider of proprietary fingerprint technology and background screening solutions, an important multi-modal recognition capability, which added to our identity software and services portfolio, allows us to offer end-to-end protection and security of personal identities; and our December 2005 acquisition of the assets of the AutoTest Division of Openshaw Media Group, a provider of automated web-based applicant testing technologies for state departments of motor vehicles and other credential issuing agencies.

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IMPACT OF MERGER WITH IDENTIX AND ACQUISITIONS OF IRIDIAN AND SPECTAL

The results of operations of the Identix merger and the acquisition of Iridian have been included in the consolidated financial statements subsequent to the dates of acquisition.

Merger with Identix

On January 11, 2006, L-1 entered into an Agreement and Plan of Reorganization, which was amended on July 7, 2006 (referred to as the Identix Merger Agreement) with Identix Incorporated. Under the Identix Merger Agreement, our wholly-owned subsidiary merged with and into Identix, and Identix survived as our wholly-owned subsidiary. The merger is intended to be a tax-free reorganization for federal income tax purposes, and Identix stockholders received 0.473 of a share of our common stock for each share of Identix common stock they own (referred to as the Exchange Ratio). At closing of the merger, we assumed Identix stock option plans and outstanding stock options and assumed all outstanding warrants to purchase Identix common stock. The assumed stock option plans and assumed outstanding options and warrants entitle Identix option and warrant holders to the right to receive L-1 common stock based on the Exchange Ratio. In accordance with the provisions of Statement of Financial Accounting Standards No. 141, *Business Combinations,* we accounted for the merger as a purchase transaction for financial reporting purposes.

Acquisition of Iridian

On August 16, 2006, the Company acquired 100% of the common stock of Iridian for $35.3 million in cash, of which $2.0 million was placed in escrow, including direct acquisition costs. The purchase price is subject to adjustment based on the net asset value at closing. Iridian has an extensive portfolio related to iris recognition technology and will be integrated with the Company s SecuriMetrics division.

Acquisition of SpecTal

On October 19, 2006, the Company acquired SpecTal LLC (SpecTal), which provides comprehensive security and intelligence solutions specializing in government consulting, training and technology development, for $100.0 million in cash, of which $5.0 million was placed in escrow. SpecTal shareholders may receive additional consideration of up to $10.0 million if specified performance thresholds are met through 2009.

The Identix merger and the acquisitions of Iridian, IBT, SecuriMetrics and SpecTal are expected to have a material effect on our operations including, but not limited to:

- Expected synergies resulting from providing a comprehensive product line to current and future customers.
- Expected future growth in revenues and profits from expanded markets for identity solutions.
- Enhancement of technical capabilities resulting from combining the intellectual capital of the combined entities.
- Consolidation of marketing resources and facilities.
- Consolidation of corporate functions of the separate entities in Stamford, Connecticut.
- Appointment of a new corporate executive team, including CEO, CFO and new head of sales and marketing.

Rationalization technology costs and research and development activities.

Realignment business divisions to complement each division s unique capabilities and rationalizing costs.

REPORTABLE SEGMENTS AND GEOGRAPHIC INFORMATION

During the three and nine months ended October 2, 2005, we operated in a single reportable segment, the Identity Solutions segment, and thus all revenues and the operating loss were generated from that segment. Effective with the acquisitions of Identix and Iridian in August 2006, we have established two reportable segments. We measure segments based on revenues and operating income (loss). Operating results by segment for the three and nine months ended September 30, 2006 and October 2, 2005 were as follows (in thousands):

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	Three Months Ended September 30, 2006	Three Months Ended October 2, 2005	Nine Months Ended September 30, 2006	Nine Months Ended October 2, 2005
Identity Solutions:				
Revenues	$ 30,604	$ 14,306	$ 68,327	$ 51,265
Operating loss	(24,404)	(1,150)	(25,510)	(767)
Services:				
Revenues	$ 9,163		$ 19,746	
Operating loss	(1,150)		(1,473)	
Corporate:				
Operating loss	$ (3,325)[1]	$ (903)	$ (5,513)[1]	$ (2,877)
Consolidated:				
Revenues	$ 39,767	$ 14,306	$ 88,073	$ 51,265
Operating loss	(28,879)	(2,053)	(32,496)	(3,644)

[1] Includes stock-based compensation charges of $1.3 million.

Revenues by market for the three and nine months ended September 30, 2006 and October 2, 2005 were as follows (in thousands):

	Three months ended September 30, 2006	Three months ended October 2, 2005	Nine months ended September 30, 2006	Nine months ended October 2, 2005
State and local	$ 18,724	$ 8,291	$ 46,304	$ 26,238
Federal	20,508	5,658	38,999	22,287
Commercial	535	357	2,770	2,740
	$ 39,767	$ 14,306	$ 88,073	$ 51,265

Revenues are attributed to each region based on the location of the customer. The following is a summary of revenues by geographic region (in thousands):

	Three Months Ended September 30, 2006	Three Months Ended October 2, 2005	Nine Months Ended September 30, 2006	Nine Months Ended October 2, 2005
United States	$ 37,166	$ 13,446	$ 82,378	$ 46,221
Rest of world	2,601	860	5,695	5,044
	$ 39,767	$ 14,306	$ 88,073	$ 51,265

DEPENDENCE ON SIGNIFICANT CUSTOMERS

For the near future, we believe that we will continue to derive a significant portion of our revenues from a limited number of large contracts. For the three and nine month periods ended September 30, 2006, the U.S. Transportation Security Administration accounted for 11% and 14%, respectively, of our consolidated revenues. For the three month periods ended September 30, 2006 and October 2, 2005, the U.S. Department of State accounted for 15% and 21%, respectively, of our consolidated revenues. For the nine month periods ended September 30, 2006 and October 2, 2005, the U.S. Department of State accounted for 18% and 27%, respectively, of our consolidated revenues. As of September 30, 2006 and December 31, 2005, the U.S. Department of State was the only customer that had a balance of greater than 10% of consolidated accounts receivable, which was approximately $4.0 and $4.4, respectively.

RESULTS OF OPERATIONS

Consolidated Results of Operations

The 2006 results of operations were significantly affected by the December 2005 acquisition of IBT, the February 2006 acquisition of SecuriMetrics, the August 2006 acquisition of Iridian and the August 2006 Identix merger. The 2005 results are for Viisage which is now a division of L-1 Identity Solutions, Inc. However, in 2005, it encompassed all of the Company s operations. Approximately $4.3 million and $5.9 million of the operating loss recorded in 2006 are related to the aforementioned acquisitions.

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Revenues

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Revenues	$ 39,767	$ 14,306	$ 88,073	$ 51,265

Revenues for the three and nine months ended September 30, 2006 aggregate $39.8 million and $88.1 million, respectively, of which approximately $20.8 million and $34.1 million, respectively, is related to the acquisitions of IBT, SecuriMetrics, Iridian and Identix. Excluding the impact of the acquisitions, revenues increased by $4.8 million or 34% and $2.8 million or 5% for the three and nine months ended September 30, 2006, respectively. Revenue for the third quarter increased primarily as a result of increased volumes of US passports to the revenue from U.S. Department of State and increased sales to U.S. Department of Defense relating to the common access card program totaling $2.7 million, higher document authentication revenues of $0.9 million and higher face recognition revenues of $0.9 million. Revenues for the nine months ended September 30, 2006 increased primarily as a result of revenues from state drivers license departments of $2.5 million.

Cost of revenues and gross margins

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Cost of revenues	$ 24,852	$ 7,624	$ 51,868	$ 27,783
Depreciation expense	1,823	1,670	5,585	4,515
Amortization of purchased intangible assets	3,405	1,143	7,293	3,639
Cost of revenues	$ 30,080	$ 10,437	$ 64,746	$ 35,937
Gross margins	24%	27%	26%	30%

Cost of revenues increased by $19.6 million and $28.8 million for the three and nine months ended September 30, 2006, respectively, of which $15.8 million and $26.8 million related to the IBT, SecuriMetrics, Identix, and Iridian acquisitions. Gross margins in 2006 were adversely impacted by higher than normal inventory and other charges, which reduced gross margins by 5 percentage points and 2 percentage points for the three and nine months ended September 30, 2006, respectively. Excluding the impact of the acquisitions, gross margins for the three and nine months ended September 30, 2006 were 25% and 30%, respectively. Included in the cost of revenues for the three and nine months periods is approximately $3.4 million and $7.3 million of amortization of purchased intangible assets of which $2.1 million and $3.2 million related to the IBT, SecuriMetrics, Identix, and Iridian acquisitions, respectively. Amortization of purchased intangible assets reduced gross margins by 9% and 8% of revenues for the three months ended September 30, 2006 and October 2, 2005, respectively, and 8% and 7% for the nine months ended September 30, 2006 and October 2, 2005, respectively.

Sales and marketing expenses

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Sales and marketing expenses	$ 3,366	$ 1,625	$ 8,703	$ 5,552
As a percentage of revenues	8%	11%	10%	11%

Sales and marketing expenses increased by approximately $1.7 million and $3.2 million for the three and nine month periods, respectively. The acquisitions of IBT, SecuriMetrics, Iridian, and Identix accounted for approximately $1.2 million and $2.2 million of the increase for the three and nine month periods respectively. Additional increases of $0.1 million and $0.5 million for the three and nine month periods, respectively, are related to stock-based compensation expense.

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The remaining increases of $0.3 million and $0.5 million for the three and nine month periods, respectively, were due to the investment in our sales and marketing function with increased headcount resulting in increased salaries and related personnel costs including stock-based compensation, commissions, travel and entertainment expenses, promotions and other marketing and sales support expenses. We expect our sales and marketing expenses to decline as a percentage of revenues in future quarters.

Research and development expenses

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Research and development expenses	$ 3,323	$ 1,321	$ 6,868	$ 3,942
As a percentage of revenues	8%	9%	8%	8%

Research and development expenses increased by approximately $2.0 million and $2.9 million for the three and nine months ended September 30, 2006, respectively, of which approximately $2.0 million and $3.2 million, respectively, are due to the acquisitions of IBT, SecuriMetrics, Iridian, and Identix. Excluding the effects of the acquired businesses, expenses in 2006 increased by $0.3 million and $0.4 million due to stock-based compensation expense for the three and nine months ended September 30, 2006.

Research and development expense consists primarily of salaries, stock-based compensation and related personnel costs and prototype costs related to the design, development, testing and enhancement of our products. We expect our research and development expenses to decline as a percentage of revenues in future quarters.

General and administrative expenses

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
General and administrative expenses	$ 9,008	$ 2,876	$ 17,126	$ 9,178
As a percentage of revenues	23%	20%	19%	18%

General and administrative expenses increased approximately $6.1 million and $7.9 million for the three and nine months ended September 30, 2006, respectively of which approximately $3.2 million and $4.9 million, respectively, is due to the acquisitions of IBT, SecuriMetrics, Iridian, and Identix. Excluding acquired businesses, stock-based compensation expense added $0.7 million and $1.2 million for the three and nine month periods ended September 30, 2006. Other increases for the three and nine months ended September 30, 2006, respectively, relate to legal, professional and outside services incurred, in connection with the merger with Identix and integration of several of our acquisitions.

General and administrative expenses consist primarily of salaries and related personnel costs, including stock-based compensation for our executive and administrative personnel, professional and board of directors fees, public and investor relations and insurance. We expect our general and administrative expenses to decline as a percentage of revenues in future quarters.

Asset impairment and merger related expenses

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Asset impairment and merger related expenses	$ 22,767	$	$ 22,767	$

In connection with our merger with Identix, the Company incurred significant personnel costs for severance and other contractual compensation arrangements with the former management team and the Board of Directors of Viisage. These personnel and other severance costs totaled approximately $5.4 million. Additionally, the Company reviewed its long-term assets in light of the strategy and plans of the combined Company and evaluated the carrying value of the assets that would be impacted by that strategy. This resulted in impairment charges of $13.5 million relating to facial recognition technology, documentation authentification technology, patents, and other long-term assets. Additionally, the Company reviewed its long-term commitments and determined that it would cease to use certain services in the future, accordingly, the

Company recorded a charge of $1.1 million pursuant to SFAS No. 146. The Company also recorded a charge for in process research and development of $2.7 million related to the Identix merger.

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Amortization of purchased intangible assets

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Amortization of purchased intangible assets	$ 102	$ 100	$ 359	$ 300
As a percentage of revenues	%	1%	%	1%

Amortization expense of purchased intangible assets were relatively unchanged for the three and nine month periods ending September 30, 2006 from the comparable periods in the prior year, respectively, due to the acquisitions of IBT, SecuriMetrics, Iridian, and Identix.

Interest income and expense

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Interest income	$ 377	$ 75	$ 1,543	$ 143
Interest expense	(56)	(31)	(105)	(85)
Interest income, net	$ 321	$ 44	$ 1,438	$ 58

For the three and nine months ended September 30, 2006, net interest income increased by approximately $0.3 million and $1.4 million, respectively, primarily as a result of interest income related to higher average cash balances during 2006, due to the $100.0 million investment made by L-1 Investment Partners made in late 2005.

Other income, net

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Other income, net	$	$ 210	$ 27	$ 294

Other income includes realized and unrealized currency transaction gains and losses on yen-denominated purchases. We typically purchase forward exchange contracts to hedge currency transaction exposure.

Income Taxes

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Provision for income taxes	$ 698	$ 309	$ 2,013	$ 963

The provision for income taxes represents a deferred tax provision related to the amortization, tax deductible goodwill and minimum state and local tax provisions. The provision increased as a result of increased amortization of the deductible goodwill resulting from the acquisitions of IBT and AutoTest.

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LIQUIDITY AND CAPITAL RESOURCES

Liquidity

As of September 30, 2006, we had $16.5 million of working capital including $30.3 million in cash and cash equivalents. In addition, we have financing arrangements, as further described below, available to support our ongoing liquidity needs. We believe that our existing cash and cash equivalent balances, existing financing arrangements and cash flows from operations will be sufficient to meet our operating and debt service requirements for the next 12 months. However, we will require additional financing to further implement our acquisition strategy. We also evaluate the terms and conditions of our credit facility on a regular basis in the ordinary course of business. If we cannot achieve our business plan in 2006, or if we enter into material new contracts, or require cash to pursue strategic acquisitions, or determine that modifications to our existing financing arrangements are required, we may be required to seek additional capital, either in the form of debt or equity. There can be no assurance that such financing will be available on commercially reasonable terms, or at all. Our ability to meet our business plan is dependent on a number of factors, including those described in the section of this report entitled Risk Factors. We will continue to evaluate our capital requirements in order to meet the objectives of our growth strategy.

On October 19, 2006, we entered into an Amended and Restated Credit Agreement (the Agreement) by and among the Company, Bank of America, N.A. (the Bank), Bear Stearns, Wachovia Bank, Credit Suisse, Societe Generale and TD Bank North, to amend and restate the Credit Agreement, dated as of August 16, 2006, by and between the Company and the Bank. The Agreement provides for a revolving credit facility of up to $150 million, with the potential for up to $50 million in additional borrowings. In order to borrow under the facility, we are required to comply with certain covenants as more fully described below, some of which may limit the amounts borrowed or available. The Agreement provides that up to $25 million of the total facility amount may be used for the issuance of letters of credit. As of September 30, 2006 no borrowings were outstanding under the facility. As of November 1, 2006 the outstanding balance was $90 million.

Amounts borrowed under the Agreement bear interest for any interest period (as defined in the Agreement) at the British Bankers Association LIBOR Rate, plus a margin of 1.75% (subject to adjustment to a minimum margin of 1.50% and a maximum margin of 2.00% based on the Company s indebtedness to EBITDA ratio described below), and must be repaid on or before October 19, 2011. We also have the option to borrow at a fluctuating rate per annum equal to the higher of (a) the Federal Funds Rate plus 1/2 of 1% and (b) the rate of interest in effect for such day as publicly announced from time to time by Bank of America as its prime rate , with respect to base rate loans plus the margin described above. If we have not borrowed all available amounts under the facility, we must pay a commitment fee of 0.375% per annum on such unutilized amounts. Subsequent to September 30, 2006, the Company borrowed $105 million under the Agreement, the proceeds of which were used to fund our acquisition of SpecTal, LLC, a Virginia limited liability company (SpecTal) as more fully described below.

In accordance with the Agreement, borrowings are secured by all assets of the Company and certain of its affiliates. The Company is required to maintain the following financial covenants under the Agreement:

As of the end of any fiscal quarter, the ratio of the Company s consolidated EBITDA (as defined in the Agreement) to consolidated interest charges (as defined in the Agreement) for the period of the prior four fiscal quarters may not be less than 2.50: 1.00, beginning with the fiscal quarter ending on December 31, 2006; and

As of the end of any fiscal quarter, the ratio of the Company s consolidated funded indebtedness (as defined in the Agreement) to its consolidated EBITDA for the period of the prior four fiscal quarters may not be more than: (i) 5.00: 1.00 at December 3 I, 2006, March 31, 2007 and June 30, 2007, (ii) 4.75:1.00 at September 30,2007, (iii) 4.50:1.00 at December 31, 2007, March 31, 2008 and June 30, 2008, (iv) 4.25: 1.00 at September 30, 2008, and (v) 4.00: 1.00 at December 31, 2008 and at the end of each fiscal quarter thereafter.

Under the terms of the Agreement, we may incur, assume or guarantee unsecured subordinated indebtedness of up to $200 million and a future parent holding company of the Company may incur an additional $200 million of unsecured subordinated indebtedness. Among other restrictions, the Agreement limits our ability to (i) pay dividends or repurchase capital stock, except with the proceeds of equity issuances or permitted subordinated debt, (ii) incur indebtedness (subject to the exceptions described above, among others), (iii) incur liens upon the collateral pledged to the Bank, (iii) sell or otherwise dispose of assets, including capital stock of subsidiaries, (iv) merge, consolidate, sell or otherwise dispose of substantially all of our assets, (v) make capital expenditures above certain thresholds, (vi) make investments, including acquisitions for cash in excess of $300,000,000 in the aggregate and (vii) enter into transactions with affiliates. These covenants are subject to a number of additional exceptions and qualifications. The Agreement provides for customary events of default which include (subject in certain cases to customary grace and cure periods), among others: nonpayment, breach of covenants or other agreements in the Agreement, payment defaults or acceleration of other indebtedness, a failure to pay certain judgments and certain events of bankruptcy, insolvency or reorganization. Generally, if an event of default occurs, the Bank, with the consent of lenders holding a majority of the aggregate commitments under the facility, may declare all outstanding indebtedness under the Agreement to be due and payable.

In 2004, we purchased an asset for $0.8 million which is payable in installments over four years. As of September 30, 2006, we had approximately $0.2 million outstanding, which represents the present value of future payments remaining under this agreement, $0.1 million of which was included in the current portion of long-term debt and $0.1 million of which was included in long-term debt, net of current portion.

In October 2005, we entered into an investment agreement with L-1 Investment Partners, LLC, subsequently assigned by L-1 Investment Partners LLC to its affiliate, Aston Capital Partners, L.P., or Aston, under which we issued and sold to Aston 7,619,047 shares of our common stock at $13.125 per share, and issued to Aston warrants to purchase an aggregate of 1,600,000 shares of our common stock at an exercise price of $13.75 per share. The proceeds of the issuance, net of transaction costs, were approximately $98.7 million and were deposited in unrestricted cash accounts. Under the investment agreement with Aston, $85 million of the proceeds was to be used to finance acquisitions subject to approval by L-1 s board of directors, of which $18 million was available for working capital at September 30, 2006.

Cash flows

	Nine Months Ended	
	September 30, 2006	October 2, 2005
Consolidated Cash Flow Data:		
Net cash provided by (used in):		
Operating activities	$ 7,293	$ 3,810
Investing activities	(51,108)	(2,505)
Financing activities	1,811	99
Effect of exchange rates on cash and cash equivalents	(62)	(38)
Net (decrease) increase in cash and cash equivalents	$ (42,066)	$ 1,366

Cash flows from operating activities increased by approximately $3.5 million for the nine months ended September 30, 2006 as compared to the corresponding period for the prior year. The net loss for the nine months ending September 30, 2006 was $33.0 million, which included non-cash charges of $17.3 million related to the asset impairments, $14.4 million for depreciation and amortization, $5.9 million for stock-based compensation, approximately $1.7 million for deferred taxes and $0.2 million for retirement contributions paid in the Company s common stock. Excluding the impact of working capital changes described below, cash flows from operating activities increased to $6.5 million from $5.8 million for the nine months ended September 30, 2006 compared to the corresponding period in the prior year. Other changes in operating assets and liabilities resulted in a net decrease in cash and cash equivalents as discussed below.

On February 17, 2006, we acquired 100% of the common stock of SecuriMetrics, the sole U.S. based manufacturer of iris recognition products, for $30 million in cash, including $2 million placed in escrow for 18 months. In addition, the SecuriMetrics stockholders had an opportunity to earn up to an additional $13 million in consideration if key performance thresholds were reached and contingencies were resolved. Following the Iridian acquisition, SecuriMetrics stockholders agreed to reduce the potential amount of additional consideration to $1.5 million in exchange for a cash payment of $6.5 million. In addition, we received $1.4 million of cash previously placed in escrow. The remaining $1.5 million contingent consideration is payable in cash to shareholders subject to SecuriMetrics meeting performance thresholds and will be included in goodwill, if paid. As a result of this transaction the net purchase price of SecuriMetrics aggregates $35.8 million, including transaction costs.

On August 16, 2006, we acquired Iridian for $35.3 million in cash including direct acquisition costs, of which $2.0 million was placed in escrow. The purchase price is subject to adjustment based on net asset value at closing. In parallel with the negotiation of the Iridian transaction, we also negotiated a reduction in potential contingency payments to SecuriMetrics under the terms of our February 2006 acquisition of

SecuriMetrics.

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In connection with the merger with Identix on August 29, 2006, the Company acquired cash of $29.2 million and incurred direct acquisition costs of $4.9 million.

On October 19, 2006, the Company acquired SpecTal. We paid at closing a purchase price of $100 million in cash, which purchase price may be subject to a post-closing adjustment based on the n