L-1 IDENTITY SOLUTIONS, INC.
Form 10-Q
November 09, 2006
Table of Contents

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	**04-3320515**
(State or other jurisdiction of incorporation or organization)	**(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

Table of Contents

INDEX

Table of Contents

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.

Table of Contents

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.

Table of Contents

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.

5

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.

Table of Contents

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.

Table of Contents

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

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)

Table of Contents

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.

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.

Table of Contents

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.

13

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.

Table of Contents

	Three months ended October 2, 2005		Nine months ended October 2, 2005		As of December 31, 2005	
	Revenues	Operating Loss	Revenues	Operating Loss	Total Assets	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