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, 2005

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

Commission file number 000-50947

COGENT, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**95-4305768** **(I.R.S. Employer Identification No.)**
209 Fair Oaks Avenue	
South Pasadena, California **(Address of principal executive offices)**	**91030** **(Zip Code)**

Registrant s telephone number, including area code: (626) 799-8090

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

(Title of Class)

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.

Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2)

Yes ¨ No x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of November 1, 2005 there were 92,925,077 shares of the registrant s common stock outstanding.

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COGENT, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

COGENT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands, except share data)

(unaudited)

	December 31, 2004	September 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,004	$ 19,610
Investments in marketable securities	167,202	284,951
Billed accounts receivable, net of allowance for doubtful accounts of $229 at December 31, 2004 and $462 at September 30, 2005	14,761	32,368
Unbilled accounts receivable	1,308	1,565
Inventory and contract related costs	35,854	21,189
Prepaid expenses and other current assets	741	6,544
Deferred income taxes	10,744	28,372
Total current assets	257,614	394,599
Investments in marketable securities	28,517	62,944
Inventory and contract related costs	2,126	1,582
Property and equipment, net	8,478	7,273
Restricted cash	561	495
Deferred income taxes	3,568	26,094
Intangible and other assets	30	2,189
Total assets	$ 300,894	$ 495,176
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,790	$ 3,439
Accrued expenses	1,480	7,527
Income taxes payable	6,131	568
Deferred revenues	59,667	46,313
Total current liabilities	70,068	57,847
Deferred revenues	8,762	5,540

Commitments and contingencies (note 14)		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2004 and September 30, 2005, respectively		
Common stock, $0.001 par value; 245,000,000 shares authorized; 80,788,040 and 92,734,800 shares issued and outstanding at December 31, 2004 and September 30, 2005, respectively	120	120
Additional paid-in capital	251,871	412,974
Deferred stock-based compensation	(9,831)	(5,125)
Retained (deficit) earnings	(19,995)	24,622
Accumulated other comprehensive loss	(101)	(802)
Total stockholders equity	222,064	431,789
Total liabilities and stockholders equity	$ 300,894	$ 495,176

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2004	**2005**	**2004**	**2005**
Revenues:				
Product revenues	$ 19,933	$ 32,966	$ 46,248	$ 100,303
Maintenance and services revenues	3,515	5,479	9,660	13,337
Total revenues	23,448	38,445	55,908	113,640
Cost of revenues:				
Cost of product revenues (1)	7,577	8,027	13,094	36,458
Cost of maintenance and services revenues (1)	1,012	1,058	2,538	3,400
Amortization of deferred stock-based compensation	230	155	500	542
Total cost of revenues	8,819	9,240	16,132	40,400
Gross profit	14,629	29,205	39,776	73,240
Operating expenses:				
Research and development (1)	1,998	1,694	5,157	5,390
Selling and marketing (1)	840	1,415	2,444	4,525
General and administrative (1)	986	1,959	2,730	5,426
Amortization of deferred stock-based compensation	2,044	1,177	8,262	4,255
Total operating expenses	5,868	6,245	18,593	19,596
Operating income	8,761	22,960	21,183	53,644
Other income:				
Interest income	106	2,574	196	5,532
Other, net		341	362	737
Total other income	106	2,915	558	6,269
Income before income taxes	8,867	25,875	21,741	59,913
Income tax (benefit) provision	(11,578)	5,771	(10,930)	15,296
Net income	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Basic net income per share	$ 0.33	$ 0.22	$ 0.54	$ 0.51

Diluted net income per share	$ 0.29	$ 0.21	$ 0.47	$ 0.48
Shares used in computing basic net income per share	61,493	92,399	60,501	86,868
Shares used in computing diluted net income per share	70,987	96,079	69,545	93,377
Pro forma net income data (see Note 9)				
Income before income taxes, as reported	$ 8,867		$ 21,741	
Pro forma provision for income taxes	4,234		10,110	
Pro forma net income	$ 4,633		$ 11,631	
Pro forma net income per share				
Basic	$ 0.08		$ 0.19	
Diluted	$ 0.07		$ 0.17	

(1) Excludes amortization of deferred stock-based compensation as follows:

Cost of product revenues	$ 67	$ 50	$ 144	$ 187
Cost of maintenance and services revenues	163	105	356	355
Research and development expenses	519	324	1,331	1,337
Selling and marketing expenses	458	359	1,125	1,182
General and administrative expenses	1,067	494	5,806	1,736
	$ 2,274	$ 1,332	$ 8,762	$ 4,797

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended, September 30,	
	2004	**2005**
Cash Flows from operating activities:		
Net income	$ 32,671	$ 44,617
Adjustments to reconcile net income to net cash provided by operating activities:		
Tax benefit from stock option transactions		60,096
Depreciation and amortization	774	1,365
Allowance for doubtful accounts	52	233
Amortization of deferred stock-based compensation	8,762	4,626
Amortization of bond premium on available for sale securities		(356)
Deferred income taxes	(13,650)	(40,154)
Changes in assets and liabilities:		
Billed accounts receivable	(7,711)	(17,851)
Unbilled accounts receivable	(1,250)	(257)
Inventory and contract related costs	(28,275)	15,527
Prepaid expenses and other current assets	39	(5,799)
Other assets		(468)
Accounts payable	1,870	653
Accrued expenses	3,470	6,036
Income taxes payable	1,068	(5,562)
Deferred revenues	46,453	(16,576)
Net cash provided by operating activities	44,273	46,130
Cash Flows from investing activities:		
Deposit for purchase of building		(1,000)
Proceeds from sale of available-for-sale securities		687,182
Purchase of available-for-sale securities		(839,609)
Restricted cash	(1,400)	
Purchase of Intangible Assets		(750)
Purchase of property and equipment	(4,897)	(413)
Net cash used in investing activities	(6,297)	(154,590)
Cash Flows from financing activities:		
Distributions to stockholders	(77,826)	
Proceeds from the issuance of common stock, net of issuance costs incurred	228,932	96,769
Issuance of shares under ESPP Plan		801
Proceeds from the exercise of stock options	42	3,517
Net cash provided by financing activities	151,148	101,087

Effect of exchange rate changes on cash	(28)	(21)
Net increase in cash and cash equivalents	189,096	(7,394)
Cash and cash equivalents, beginning of period	17,457	27,004
Cash and cash equivalents, end of period	$ 206,553	$ 19,610
Supplemental disclosures of cash flow information:		
Cash received (paid) during the period for:		
Interest income	$ 196	$ 3,868
Income taxes	$ (1,651)	$ (6,465)
Non-cash financing activities:		
Declared but unpaid dividend to stockholder	$ 1,800	$
Deferred stock-based compensation, net	17,828	
Capitalized deferred stock-based compensation (Inventory & contract related costs)	$	$ 65
Conversion of property and equipment to inventories	$	$ 317

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. General

Company Background

Cogent, Inc. and subsidiaries (Cogent) was initially incorporated in the state of California on April 20, 1990 as Cogent Systems, Inc. and was reincorporated in Delaware on May 3, 2004 as Cogent, Inc. Cogent is a provider of advanced automated fingerprint identification systems (AFIS) solutions, which typically consist of Cogent s Programmable Matching Accelerator (PMA) servers and other AFIS equipment, including work stations and live-scans, bundled with Cogent s proprietary software, and other fingerprint biometrics products and solutions, to governments, law enforcement agencies and other organizations worldwide. Cogent also provides professional services and technical support and maintenance services to its customers.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2005 and the condensed consolidated statements of operations for the three and nine months ended September 30, 2004 and 2005 and condensed consolidated statements of cash flows for the nine months ended September 30, 2004 and 2005 are unaudited. These statements should be read in conjunction with the audited consolidated financial statements and related notes, together with management s discussion and analysis of financial position and results of operations, contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 22, 2005.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or (GAAP). In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2004 and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of September 30, 2005, its results of operations for the three and nine months ended September 30, 2004 and 2005 and its cash flows for the nine months ended September 30, 2004 and 2005. The condensed consolidated balance sheet as of December 31, 2004 has been derived from the December 31, 2004 audited financial statements. The interim financial information contained in this quarterly report is not necessarily indicative of the results to be expected for any other interim period or for the entire year.

In the accompanying condensed consolidated statement of cash flows for the nine months ended September 30, 2005, the Company changed the classification of changes in restricted cash balances in the statement of cash flows to present such changes as an investing activity. The Company previously presented such changes as an operating activity. In the accompanying condensed consolidated statements of cash flows for the nine months ended September 30, 2004, the Company reclassified changes in restricted cash balances to be consistent with its 2005 presentation which resulted in a $1,400,000 decrease to investing cash flows and a corresponding increase to operating cash flows from the amounts previously reported.

Concentration

The Company derives a significant portion of its revenues from a limited number of customers. For the three months ended September 30, 2004 and 2005, the Company had one and two customers that collectively accounted for 64% and 72% of revenues for those periods, respectively. For the nine months ended September 30, 2004 and 2005, the Company had two customers that collectively accounted for 59% and 76% of revenues for those periods, respectively.

Note 2. Recent Accounting Pronouncements

In July 2004, the Emerging Issues Task Force (EITF) published its consensus on Issue No. 03-01, The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments. EITF Issue No. 03-01 addresses the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities certain debt and equity securities within the scope of SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting. However, implementation guidance related to this consensus was requested. In

November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 115-1 and 124-1 which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005. The Company continues to assess the potential impact that the adoption of this FSP could have on its financial statements.

In December 2004, the FASB issued SFAS 123 (Revised 2004)-Share Based Payment (SFAS 123R). SFAS 123R requires that the Company record stock option expense in its financial statements based on a fair value methodology. In March 2005 the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107. SAB 107 expresses views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules. In April 2005, the SEC adopted a rule that delayed the compliance dates for adoption of SFAS 123R. The SEC s rule allows companies to implement SFAS 123R at the beginning of the next fiscal year after September 15, 2005, which is January 1, 2006 for the Company. The Company is evaluating the impact of the new standard and the method and timing of adoption. Although the Company has not completed its analysis, it is anticipated that the expense related to stock options will increase under the new pronouncement, however, it cannot be quantified at this time.

In November 2004, the FASB issued SFAS No. 151 Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe SFAS No. 151 will have a significant impact on the Company s consolidated results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 replaces Accounting Principles Board (APB) Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Company is required to adopt SFAS No. 154 for accounting changes and error corrections at the beginning of the next fiscal year after December 15, 2005, which is January 1, 2006 for the Company. The Company s results of operations and financial condition will only be impacted by SFAS No. 154 if it implements changes in accounting principles that are addressed by the standard or corrects accounting errors in future periods.

Note 3. Stock-Based Compensation

The Company has two stock option plans, the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, which authorize the issuance of stock options, restricted stock and other stock-based incentives to employees. The Company accounts for these plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under APB Opinion No. 25, compensation for employee common stock option grants is calculated as the difference, if any, on the date of grant, between the fair value of the Company s common stock and the exercise price of the option. Stock-based compensation related to employee option grants is recorded on the grant date as deferred stock-based compensation, which is classified as a separate component of stockholders equity, and is amortized to expense based on the multiple option model, which results in more compensation expense being attributed to an option s initial vesting periods when compared to the straight-line method. The Company accounts for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

In accordance with SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the following pro forma net income and earnings per share information is presented as if the Company accounted for stock-based compensation awarded under the stock incentive plans using the fair value method. Under the fair value method, the estimated fair value of stock incentive awards is charged against income using the multiple option model over the vesting period.

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
	(in thousands, except per share data)			
Net income as reported	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Add: Total stock-based employee compensation expense included in reported net income net of related tax effects	1,891	1,267	6,945	4,545
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards net of the related tax effects	(2,151)	(1,643)	(7,761)	(5,207)
Pro forma net income	$ 20,185	$ 19,728	$ 31,855	$ 43,955
Net Income per share				
Basic as reported	$ 0.33	$ 0.22	$ 0.54	$ 0.51
Basic pro forma	$ 0.33	$ 0.21	$ 0.53	$ 0.51
Diluted as reported	$ 0.29	$ 0.21	$ 0.47	$ 0.48
Diluted pro forma	$ 0.28	$ 0.21	$ 0.46	$ 0.47

The Company used the Black-Scholes option-pricing model with the following weighted-average assumptions in determining the pro forma compensation costs:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Risk-free interest rate	2.92%	4.05%	2.56%	3.90%
Dividend yield	0.00%	0.00%	0.00%	0.00%
Expected life (years)	3.0	4.0	3.05	4.0
Volatility	88%	82%	94%	83%

The weighted-average estimated fair value of options granted was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Weighted average fair value	$ 5.52	$ 16.56	$ 7.19	$ 15.77

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Note 4. Fair Value of Investments in Marketable Securities

The Company has investments classified as available-for-sale securities included in short-term and long-term investments, categorized as follows:

	As of December 31, 2004	As of September 30, 2005
	(in thousands)	
Type of Security:		
Short-term instruments	$ 24,368	$ 109,229
Corporate debt securities with maturities of less than one year	58,962	82,698
Municipal securities with maturities of less than one year	75,460	61,718
U.S. government securities with maturities of less than one year	8,412	31,306
Total short-term investments	167,202	284,951
Corporate debt securities with maturities between one and three years	15,015	33,882
Municipal securities with maturities between one and three years	12,011	2,001
U.S. government securities with maturities between one and three years	1,491	27,061
Total long-term investments	28,517	62,944
	$ 195,719	$ 347,895

These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of stockholders equity. At December 31, 2004 and September 30, 2005, the gross unrealized loss on available-for-sale securities totaled $142,000 and $1,225,000, respectively. The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses are reported in other income and expense. Realized losses were approximately $13,000 for the three and nine months ended September 30, 2005, respectively. The Company s short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper.

Note 5. Inventory and Contract Related Costs

Inventory and contract related costs consist of the following:

	As of December 31, 2004	As of September 30, 2005
	(in thousands)	

Materials and components	$ 1,398	$ 1,089
Inventories and costs related to long-term contracts	1,257	174
Deferred costs of revenues	35,325	21,508
	$ 37,980	$ 22,771

Materials and components are stated at the lower of cost or market determined using the first-in, first-out method. Inventoried costs relating to long-term contracts are stated at actual production costs incurred to date reduced by amounts identified with revenue recognized on progress completed. Deferred costs of revenue relate to contracts for which revenue has been deferred, and such costs are stated at actual production costs incurred to date, which primarily include materials, labor and subcontract costs which are directly related to the contract. Deferred costs of revenue are amortized to cost of revenues at the time revenue is recognized. The long-term component of inventory and contract related costs of $2,126,000 and $1,582,000 at December 31, 2004 and September 30, 2005, respectively, consists of deferred costs relating to contracts where revenue recognition is deferred beyond one year (see Note 10).

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Note 6. Net Income Per Share

The Company calculates net income per share in accordance with SFAS No. 128, Earnings Per Share . Under SFAS No. 128, basic net income per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share reflects the effects of potentially dilutive securities, which consist of stock options. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
	(in thousands, except per share data)			
Numerator:				
Net income available to common stockholders	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Denominator:				
Denominator for basic net income per share weighted average shares	61,493	92,399	60,501	86,868
Dilutive potential common stock				
Stock options	9,494	3,680	9,044	6,509
Denominator for diluted net income per share adjusted weighted average shares	70,987	96,079	69,545	93,377
Basic net income per share	$ 0.33	$ 0.22	$ 0.54	$ 0.51
Diluted net income per share	$ 0.29	$ 0.21	$ 0.47	$ 0.48

During the three and nine months ended September 30, 2005, options to purchase 14,000 and 85,000 shares of common stock were outstanding as of September 30, 2005 but were not included in the computation of diluted earnings per share because the options exercise price was greater than the average market price of the common shares for each of these respective periods.

Note 7. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income. Specifically, cumulative foreign currency translation adjustments and unrealized gains or losses on the Company s investments in marketable securities are included in accumulated other comprehensive income (loss).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005

	(In thousands)		(In thousands)	
Net income	$ 20,445	$ 20,104	$ 32,671	$ 44,617
Other comprehensive income (loss):				
Change in unrealized loss, net of tax		(128)		(608)
Change in foreign currency translation adjustment	1	7	(40)	(94)
Total comprehensive income	$ 20,446	$ 19,983	$ 32,631	$ 43,915

Note 8. Income Taxes

Prior to the Company s initial public offering, the Company elected to be treated as an S Corporation for U.S. federal income tax purposes. Under this election, the Company s stockholders, rather than the Company, were subject to federal income taxes on their respective share of the Company s taxable income. The Company elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at the corporate level of 1.5%. The Company was also subject to state income taxes in various other states in which it does business.

Effective September 22, 2004, the Company terminated its S Corporation status. As a result of the termination of the Company s S Corporation status, the Company is subject to federal and certain state income taxes at the corporate level at statutory rates.

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During the three and nine months ended September 30, 2005, the Company experienced disqualifying dispositions of incentive stock options. Disqualifying dispositions result in a tax deduction on the Company s corporate tax return equal to the intrinsic value of the option at exercise. To the extent the Company recorded stock-based compensation expense related to disqualifying dispositions of incentive stock options, the Company recorded the benefit from the disqualifying disposition of incentive stock options as a reduction to the Company s provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the financial statements is credited to additional paid-in capital.

During the nine months ended September 30, 2005, a total of 7,868,208 stock options were exercised resulting in net proceeds to the Company of $3,517,000. As a result of the disqualifying dispositions of incentive stock options during the three and nine months ended September 30, 2005, the Company recorded tax benefits from stock option transactions which totaled approximately $10.9 million and $60.1 million, respectively, as a credit to additional paid-in capital. Additionally, as a result of the tax benefits from stock option transactions, the Company recorded a $39.7 million increase in the deferred tax asset balance as of September 30, 2005. The Company s effective tax rates for the three and nine months ended September 30, 2005 were less than the statutory rate primarily as a result of the tax benefit resulting from the disqualifying dispositions and research and development tax credits.

Note 9. Pro Forma Net Income and Pro Forma Net Income Per Share

Pro forma net income reflects the income tax expense that would have been reported by the Company had it been subject to income taxes at the corporate level during the three and nine months ended September 30, 2004.

Pro forma net income per share is computed by dividing the pro forma net income available to common stockholders for the period by the weighted average number of shares of common shares and potentially dilutive common shares outstanding during the period.

Note 10. Deferred Revenues and Deferred Costs

In the third quarter of 2004, the Company entered into contracts with a total value of approximately $54 million with the National Electoral Council (CNE) of Venezuela. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contracts also provided for the short-term lease of equipment to be used by the CNE in connection with the October 15, 2004 Venezuela national election. The estimated value of the lease component of approximately $7.0 million, which was based upon an independent valuation, was recognized as revenue in the third quarter of fiscal 2004. Because vendor-specific objective evidence (VSOE) of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component was amortized over the life of the contracts. During the three and nine months ended September 30, 2004, the Company recognized approximately $15.0 million of revenue related to these contracts. During the three and nine months ended September 30, 2005, the Company recognized approximately $3.9 million and $27.6 million of revenue, respectively, representing the ratable recognition of the total remaining value of the contracts over the one-year maintenance period. As of September 30, 2005, all revenue and costs associated with these contracts have been recognized.

In the fourth quarter of 2004, the Company entered into a contract with a total value of approximately $20.2 million with the CNE. The contract required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the October 31, 2004 Venezuela regional elections. The estimated value of the lease component of approximately $3.7 million, which was based upon an independent valuation, was recognized as revenue in the fourth quarter of fiscal 2004. Because VSOE of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component is being amortized over the life of the contract. During the three and nine months ended September 30, 2005, the Company recognized approximately $4.2 million and $12.3 million, respectively, of revenue representing the ratable recognition of the total remaining value of the contract over the one-year maintenance period. The remaining $1.4 million of the contract value is included in deferred revenue at September 30, 2005. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In the second quarter of 2005, the Company entered into contracts with a total value of approximately $31.8 million with the CNE. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contract also provided for the short-term lease of equipment to be used by the CNE in connection with the August 7, 2005 Venezuela local elections. The estimated value of the lease

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component of approximately $3.0 million, which was based upon an independent valuation and relative fair value analysis of the contract components, was recognized as revenue in the third quarter of fiscal 2005. Because VSOE of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component will be amortized over the life of the contract once all software deliverables have been accepted by the customer. As of September 30, 2005, the Company has not completed all software deliverables required under the contract with CNE; therefore, no revenue in excess of the fair value of the lease component was recognized during the three and nine months ended September 30, 2005. As of September 30, 2005, deferred revenue related to this contract totaled $25.9 million. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately $15 million with a domestic customer to provide a customized AFIS solution for which VSOE of the maintenance element did not exist. Revenue from this contract is being recognized ratably over the contractual maintenance period of five years, commencing upon the acceptance of the AFIS solution by the customer in October 2003. During the three and nine months ended September 30, 2004, the Company recognized $707,000 and $2.1 million of revenue related to this contract, respectively. During the three and nine months ended September 30, 2005, the Company recognized $707,000 and $2.1 million of revenue related to this contract, respectively. As of December 31, 2004 and September 30, 2005, deferred revenue related to this contract totaled approximately $9.3 million and $7.6 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the remaining contractual maintenance period.

In 2003, the Company entered into a contract with a value of approximately $10 million with a domestic customer to provide a customized AFIS solution. This contract includes provisions that could require a refund of the entire contract value in the event of non-performance by the Company during the contract term. As a result of the refund provision, in accordance with of Statement of Position (SOP) 97-2, Software Revenue Recognition, the Company is deferring recognition of revenue from the contract until the expiration of the refund provision, which is expected to expire in the quarter ending December 31, 2005. As of December 31, 2004 and September 30, 2005, deferred revenue related to this contract totaled approximately $6.5 million and $6.8 million, respectively. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues upon the expiration of the refund provisions.

Note 11. Employee Stock Purchase Plan

In May 2004, the Company s board of directors and stockholders adopted the 2004 Employee Stock Purchase Plan (the Purchase Plan) which became effective immediately upon the closing of the Company s initial public offering. The Purchase Plan was intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. A total of two million shares of common stock were initially authorized and reserved for sale under the Purchase Plan. The Purchase Plan permitted eligible employees to purchase shares of common stock at a fifteen percent (15%) discount through payroll deductions during sequential six month offering periods. Unless the Board established a higher price, the price at which shares were purchased under the Purchase Plan for such six month offering period was equal to 85% of the lesser of the fair market value of the common stock on the first day of such offering period or the purchase date, which was the last day of the offering period.

Pursuant to a resolution by the Company s Board of Directors, the purchase plan was terminated on April 30, 2005.

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Note 12. Segment Information

The Company considers its business activities to constitute a single segment. A summary of the Company s revenues by geographic area follows (in thousands):

	Three Months Ended September 30, 2004				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 17,721	$ 49	$ 3	$ 2,160	$ 19,933
Maintenance and services revenues	2,898	333	284		3,515
Total	$ 20,619	$ 382	$ 287	$ 2,160	$ 23,448

	Three Months Ended September 30, 2005				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 31,278	$ 846	$ 842	$	$ 32,966
Maintenance and services revenues	4,702	401	175	201	5,479
Total	$ 35,980	$ 1,247	$ 1,017	$ 201	$ 38,445

	Nine Months Ended September 30, 2004				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 38,258	$ 3,851	$ 443	$ 3,696	$ 46,248
Maintenance and services revenues	8,195	840	625		9,660
Total	$ 46,453	$ 4,691	$ 1,068	$ 3,696	$ 55,908

	Nine Months Ended September 30, 2005				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 94,806	$ 927	$ 2,670	$ 1,900	$ 100,303
Maintenance and services revenues	10,980	1,496	449	412	13,337
Total	$ 105,786	$ 2,423	$ 3,119	$ 2,312	$ 113,640

At December 31, 2004 and September 30, 2005, the Company s property and equipment, net of accumulated depreciation and amortization in the United States was approximately $5,505,000 and $5,282,000, respectively. At December 31, 2004 and September 30, 2005, the Company s property and equipment, net of accumulated depreciation and amortization in foreign countries was approximately $2,974,000 and $1,991,000, respectively. At September 30, 2005, the Company s intangible assets in the United States, net of accumulated amortization, were approximately $688,000.

Note 13. Public Offering

In June 2005, the Company completed an underwritten public offering of 12,650,000 shares of common stock (of which 4,000,000 shares were primary shares sold by the Company and 8,650,000 shares were secondary shares sold by selling stockholders), including the underwriters exercise of an over-allotment option to purchase up to 1,650,000 shares from a selling stockholder, at a price to the public of $25.50 per share. The Company raised a total of $102,000,000 in gross proceeds in the public offering. After deducting the underwriting discount of $4,335,000 and offering expenses of $896,000, net proceeds to the Company were $96,769,000.

Note 14. Commitments and Contingencies

The Company periodically evaluates all pending or threatened contingencies and any commitments, if any, which are reasonably likely to have a material adverse effect on its operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies. If information available prior to the issuance of the Company s financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred

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at the date of the Company s financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

During the normal course of business, the Company may be subject to litigation involving various business matters. Management believes that an adverse outcome of any such known matters would not have a material adverse impact on the Company.

Note 15. Subsequent Event

On September 29, 2005, the Company agreed to purchase a facility for $26.0 million in cash. The purchase of the property provides for the expansion of the Company s workforce in Pasadena, California. The purchase was closed on October 7, 2005 at which time the total purchase price less a $1.0 million deposit was paid. As of September 30, 2005, the $1.0 million property deposit is reflected on the balance sheet as intangible and other assets.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report to conform such statements to actual results or to changes in our expectations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, under the caption Risk Factors, and the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2004, previously filed with the Securities and Exchange Commission.

Overview

We are a leading provider of advanced Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. We were incorporated and commenced operations in 1990. We have been researching, designing, developing and marketing AFIS and other fingerprint biometrics solutions since inception. During most of our operating history, we have achieved positive income and cash flows from operations. We experienced a significant increase in our revenues and net income since the fourth quarter of 2003 as the market for our AFIS and other fingerprint biometric solutions expanded primarily due to increased demand by the Department of Homeland Security, or DHS, as well as the National Electoral Council of Venezuela, or CNE. There can be no assurance that our revenues or net income will continue to grow at the same rates as in the past or at the rate we expect or that we will achieve similar results in future periods.

Sources of Revenue

Revenues. We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator, or PMA, servers and other AFIS equipment, including work stations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. To a lesser extent, we generate product revenues from sales of our proprietary biometrics application specific integrated circuit, or ASIC, and biometrics products that incorporate our ASIC. Revenues from sales of our ASIC and products that incorporate our ASIC have historically been immaterial and accounted for less than 1% of our total revenue in both 2004 and the nine months ended September 30, 2005. We generate maintenance revenues from maintenance contracts that are typically included with the sale of our AFIS solutions. Maintenance contracts for technical support and software updates generally cover a period of one year, and after contract expiration, our customers have the right to purchase maintenance contract renewals, which generally cover a period of one year. Revenues from maintenance contracts are deferred and amortized on a straight-line basis over the life of the maintenance obligation. We generate services revenues from engineering services and AFIS system operation services that are not an element of an arrangement for the sale of products. These services are typically performed under fixed-price and time-and-material agreements.

We market our solutions primarily to U.S. and foreign government agencies and law enforcement agencies. In a typical contract with a government agency for an initial AFIS deployment, we agree to design the AFIS, supply and install equipment and software and integrate the AFIS within the agency s existing network infrastructure. These initial deployment contracts frequently require significant modification or customization of our solution as part of our integration services. These contracts provide for billings up to a fixed price total contract value upon completion of agreed milestones or deliveries, with each milestone or delivery typically having a value specified in the contract. These customers usually impose specific performance and acceptance criteria that must be satisfied prior to invoicing for each milestone or delivery. When customers purchase AFIS solutions that do not require significant modification or customization of our software, whether as an initial deployment or as an expansion of an existing AFIS, we typically agree to deliver the products and perform limited installation services subject to customer-specific acceptance criteria. Certain of our customers, including the DHS, submit purchase orders under blanket purchase order agreements. Blanket purchase order agreements set out the basic terms and conditions of our arrangement with the customer and simplify the procedures for ordering our products to avoid administrative processes that would otherwise apply, particularly with the federal government. The billing of these contracts is generally tied to delivery and acceptance of specific AFIS equipment, usually our PMA servers or live-scans. Most of our contracts for AFIS solutions also include an ongoing maintenance obligation that we honor over a term specified in the deployment contract or the blanket purchase order agreement. The nature of our business and our customer base is such that we negotiate a set of unique terms for each contract that are based upon the purchaser s standard form of documentation.

Our growth in revenues since the fourth quarter of 2003 is due principally to increased demand by the DHS and the CNE for our AFIS solutions. The DHS uses our solutions in connection with the implementation of the United States Visitor and Immigrant Status Indicator Technology, or US-VISIT, program, and the CNE uses our solutions for national and regional elections. We anticipate that both of these customers will account for a significant portion of our revenues for the foreseeable future. We do not have any long-term contracts with the DHS or the CNE for the sale of our products, and our future sales to the DHS and the CNE will depend upon the receipt of new orders. Any delay or other change in the rollout of US-VISIT or any failure to obtain new orders from the CNE could cause our revenues to fall short of our expectations.

We also expect to experience increased demand from a number of other governments as they deploy AFIS solutions in elections and, at points of entry and exit, including borders, seaports and airports, 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 security solutions in elections and at points of entry and exit are typically awarded in open competitive bidding processes. Therefore, our future level of sales of AFIS solutions for deployments in elections and at points of entry and exit may vary substantially, and will depend on our ability to successfully compete for this business.

Cost of Revenues and Operating Expenses

Cost of Revenues. Cost of product revenues consists principally of compensation costs incurred in designing, integrating, installing and in some cases, customizing AFIS solutions and the costs associated with manufacturing, assembling and testing our AFIS solutions. A substantial portion of these costs is comprised of the costs of components, such as servers, integrated circuits, workstations, live-scans and other hardware. Cost of product revenues also includes related overhead, compensation, final assembly, quality-assurance, inventory management, support costs and payments to contract manufacturers that perform assembly functions. Cost of maintenance and services revenues consists of customer support costs, training and professional service expenses, including compensation. Cost of revenues also includes amortization of deferred stock-based compensation allocable to personnel performing services related to cost of revenues. We expect our gross margin to be affected by many factors, including our mix of products and our resale of third party hardware included in our AFIS solutions. Other factors that may affect our gross margin include changes in selling prices of our products, maintenance and services, fluctuations in demand for our products, the timing and size of customer orders, fluctuations in manufacturing volumes, changes in costs of components and new product introductions by us and our competitors and agreements entered into with our subcontractors.

Research and Development. Research and development expenses consist primarily of salaries and related expenses for engineering personnel, fees paid to consultants and outside service providers, depreciation of development and test equipment, prototyping expenses related to the design, development, testing and enhancements of our products, and the cost of computer support services. We expense all research and development costs as incurred. Under our customer contracts, we typically obtain the rights to use any improvements to our technology developed on a particular customer deployment on other customer deployments. As a result, we have historically been able to moderate our research and development expenses by leveraging the improvements developed by our personnel working on customer engagements. Research and development expenses do not include amortization of deferred stock-based compensation allocable to personnel performing services related to research and development.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses do not include amortization of deferred stock-based compensation allocable to personnel performing services related to sales and marketing.

General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses do not include amortization of deferred stock-based compensation allocable to personnel performing general and administrative services.

Amortization of Deferred Stock-Based Compensation. In connection with the grant of stock options during the year ended December 31, 2004, and the nine months ended September 30, 2005, we recorded $17.9 million and $0 in deferred stock-based compensation within stockholders equity, respectively. Options issued during the year ended December 31, 2004 were considered compensatory because the deemed fair value of the underlying common stock for financial reporting purposes was greater than the exercise prices determined by the board of directors on the date of grant. The determination of the fair value prior to our initial public offering of the underlying shares of common stock involves subjective judgment and the consideration of a variety of factors, including our historical and anticipated operating results and the earnings and revenue multiples implicit in the trading prices of securities of comparable companies. Because there was no public market for our common stock prior to our initial public offering, the amount of the compensatory charge is not based on an objective measure such as the trading price of our common stock. For the nine months ended September 30, 2004 and 2005, we recognized expense for amortization of deferred stock compensation of $8.8 million and $4.8 million, respectively. As of September 30, 2005, we had an aggregate of $5.1 million of deferred stock-based compensation remaining to be amortized. This deferred compensation balance will be amortized as follows: $1.1 million in the remainder of 2005; $2.9 million in 2006; $1.0 million in 2007; and $61,000 in 2008. We are amortizing the deferred compensation on an accelerated basis over the vesting period of the related options, which is generally four years. The amount of stock-based compensation amortization actually recognized in future periods could decrease if options for which accrued but unvested deferred compensation has been recorded are forfeited.

Prior S Corporation Status

In 1992, we elected to be treated for federal and certain state income tax purposes as an S Corporation under Subchapter S of the Internal Revenue Code of 1986, as amended, or the Code, and comparable state laws. As a result, our earnings since such initial election and through September 21, 2004, were included in the taxable income of our stockholders for federal and certain state income tax purposes, and we were subject only to reduced amounts of state income tax on such earnings. By reason of our treatment as an S Corporation for federal and state income tax purposes, since 1992 we have paid dividends to our stockholders. We terminated our S Corporation status effective September 22, 2004, and beginning on that date we were and are treated for federal and state income tax purposes as a C Corporation under Subchapter C of the Code and, as a result, are now subject to state and federal income taxes.

We declared as a dividend to Ming Hsieh, our sole stockholder prior to our initial public offering, the undistributed balance of our federal tax-exempt earnings and taxable earnings included or includable in the taxable income of our stockholders as a result of our S Corporation status through December 31, 2003. We also declared as a dividend to Mr. Hsieh in the same manner and at the same time our estimate of such amounts for the period beginning on January 1, 2004 and ending on the day before we terminated our S Corporation election (September 22, 2004). The total final dividend was $65.5 million.

We have entered into a tax matters agreement with Mr. Hsieh pursuant to which we have agreed, among other things, to indemnify Mr. Hsieh and Mr. Hsieh has agreed to indemnify us against certain income tax consequences which may occur if a taxing authority increases our income for tax periods prior to or after the termination of our S election, as applicable, but only to the extent of the actual tax benefit, if any, to the indemnifying party attributable to the circumstances resulting in additional tax to the indemnified party. Mr. Hsieh has further agreed to indemnify us for any tax liability resulting from our failure to qualify as an S Corporation at the initial election or at any time prior to the our termination of our S Corporation status.

All pro forma income taxes and pro forma net income data reflect adjustments for federal and state income taxes as if we had been taxed as a C Corporation rather than an S Corporation.

Application of Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to percentage-of-completion, bad debts, inventories, investments, income taxes, commitments, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We consider the following accounting policies to be both those most important to the portrayal of our results of operations and financial condition and those that require the most subjective judgment:

- revenue recognition;
- commitments and contingencies;
- allowance for doubtful accounts;
- accounting for taxes; and
- accounting for stock-based compensation.

Revenue Recognition. Because our proprietary software is essential to the functionality of our AFIS solutions and other biometrics products, we apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. For arrangements that require significant production, modification, or customization of software, we apply the provisions of Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. To the extent an element within our software arrangements falls within a level of accounting literature that is higher than SOP 97-2, we record revenue on such element in accordance with the relevant authoritative literature. For arrangements that contain the lease of equipment, we account for the lease element in accordance with SFAS No. 13 Accounting for Leases and account for the remaining elements in the arrangement in accordance with SOP 97-2. The application of the appropriate accounting principle to our revenue is dependent upon the specific transaction and whether the sale includes systems, software and services or a combination of these items. As our business evolves, the mix of products and services sold will impact the timing of when revenue and related costs are recognized. Additionally, revenue recognition involves judgments, including estimates of costs to complete contracts accounted for using the percentage of completion method of accounting and assessments of the likelihood of nonpayment. We analyze various factors, including a review of specific transactions, the credit-worthiness of our customers, our historical experience and market and economic conditions. Changes in judgments on these factors could materially impact the timing and amount of revenue and costs recognized.

Product Revenues

The timing of product revenues recognition is dependent on the nature of the product sold.

- Revenues associated with AFIS solutions that do not require significant modification, or customization of our software, exclusive of amounts allocated to maintenance for which we have vendor-specific objective evidence of fair value, or VSOE, is recognized upon installation and receipt of written acceptance of the solution by the customer when required by the provisions of the contract, provided all other criteria for revenue recognition have been met. For example, we recognize revenue in this manner from sales of our PMA servers to the DHS under our blanket purchase agreement with the DHS. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the maintenance period.

Revenues associated with AFIS solutions that require significant modification, or customization of our software, are recognized using the percentage-of-completion method as described by SOP 81-1. The percentage-of-completion method reflects the portion of the anticipated contract revenue, excluding maintenance that has VSOE, which has been earned, equal to the ratio of labor effort expended to date to the anticipated final labor effort, based on current estimates of total labor effort necessary to complete the project. Material differences may result in the amount and timing of our revenue for any period if actual results differ from our judgments and estimates. We recognize revenue in this manner from sales of significant initial AFIS deployments. Revenue resulting from arrangements for which VSOE of the maintenance element does not exist is recognized ratably over the contractual maintenance period.

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Revenue associated with the sale of our ASIC applications and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable. We recognize revenue in this manner upon shipment of our BioGate and MobileIdent products. The amount of these revenues has historically not been significant.

Revenue associated with service offerings where we maintain and operate a portion of the AFIS systems on an outsourced application-hosting basis is recognized on a per transaction basis provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable.

Cash received from customers in advance of recognition of the related revenue is recorded as deferred revenue.

Maintenance Revenues

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. We recognize all maintenance revenue ratably over the applicable maintenance period. We determine the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions contained in a particular arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. We consider substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to our normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is included in product revenues and recognized ratably over the term of the maintenance period.

Services Revenues

Professional services revenue is primarily derived from engineering services and AFIS system operation and maintenance services that are not an element of an arrangement for the sale of products. These services are generally billed on a time-and-materials basis. The majority of our professional services are performed either directly or indirectly for U.S. government organizations. Revenue from such services is recognized as the services are provided.

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

Revenue Recognition Criteria

We recognize revenue when persuasive evidence of an arrangement exists, the element has been delivered, the fee is fixed or determinable, collection of the resulting receivable is probable and VSOE of the fair value of any undelivered element exists.

Persuasive evidence of an arrangement: We use either contracts signed by both the customer and us or written purchase orders issued by the customer that legally bind us and the customer as evidence of an arrangement.

Product delivery: We deem delivery to have occurred when AFIS solutions are installed and, when required under the terms of a particular arrangement, upon acceptance by the customer. Shipments of our ASICs and other biometric products are recognized as revenue when shipped and title and risk of ownership has passed to the buyer.

Fixed or determinable fee: For product arrangements not accounted for using the percentage-of-completion method, we consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment and the payment terms are within normal established practices. If the fee is not fixed or determinable, we recognize the revenue as amounts become due and payable.

Collection is deemed probable: We conduct a credit review for all significant transactions at the time of the arrangement to determine the credit-worthiness of the customer. Collection is deemed probable if we expect that the customer will pay amounts under the arrangement as payments become due.

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Deferred Revenues

Our deferred revenue balance results primarily from payments received from customers in advance of recognition of the related revenue and, to a lesser extent, from invoicing of customers prior to recognition of the related revenue. For example, certain customers, such as the CNE, make upfront payments resulting in cash collected prior to our recognition of revenue. These payments can be significant. We record this upfront payment as deferred revenue and reduce the deferred revenue balance as revenue is recognized. As a result, our deferred revenue balance fluctuates from quarter to quarter because it is a function of the timing of (i) the receipt of cash payments from those customers who pay in advance of revenue recognition, (ii) invoicing of customers in advance of revenue recognition and (iii) amortization of deferred revenues into revenues. Deferred revenues also consist of payments received in advance from our customers for maintenance agreements, under which revenues are recognized ratably over the term of the maintenance period. However, the fluctuation in the deferred revenue balance from quarter to quarter is generally not significantly affected by the deferred maintenance revenue. Because the mix of customers who pay or are invoiced in advance of revenue recognition changes from period to period, fluctuations in our deferred revenue balance are not a reliable indicator of total revenue to be recognized in any future period. Our cash flow from operations is also affected each quarter as a result of fluctuations in the deferred revenue balance.

Commitments and Contingencies. We periodically evaluate all pending or threatened contingencies and commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position. We assess the probability of an adverse outcome and determine if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, Accounting for Contingencies. If information available prior to the issuance of our financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of our financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Allowances for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in a provision for bad debt expense. We determine the adequacy of this allowance by evaluating individual customer accounts receivable, through consideration of the customer s financial condition, credit history and current economic conditions. If the financial condition of our customers was to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Accounting for Taxes. In preparing our consolidated financial statements, we estimate our income tax liability in each of the jurisdictions in which we operate by estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. As of September 30, 2005, our net deferred tax assets were approximately $54.5 million. Management judgment is required in assessing the realizability of our deferred tax assets. In performing this assessment, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from our estimates or we adjust our estimates in future periods, we may need to make or adjust valuation allowances with respect to our deferred tax assets, which could materially impact our financial position and results of operations. Our income tax provision is based on calculations and assumptions that may be subject to examination by the Internal Revenue Service and other tax authorities. Should the actual results differ from our estimates, we would have to adjust the income tax provision in the period in which the facts that give rise to the revision become known. Tax law and rate changes are reflected in the income tax provision in the period in which such changes are enacted.

Our effective tax rate for the first nine months of 2005, and for the remainder of 2005, has been and is expected to continue to be impacted as a result of the disqualifying disposition of incentive stock options and research and development tax credits. We expect our effective tax rate to fluctuate from quarter to quarter primarily as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place thus impacting the effective tax rate on a quarterly basis. The benefit resulting from disqualifying dispositions results in a tax deduction on our corporate tax return with no expense recorded in our consolidated financial statements. To the extent we have previously recorded stock-based compensation expense related to incentive stock options in our consolidated financial

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statements, we record the benefit from the disqualifying disposition of incentive stock options as a reduction to our provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the consolidated financial statements is credited to additional paid-in capital. As a result of the disqualifying dispositions of incentive stock options during the nine months ended September 30, 2005, the Company recorded a tax benefit from stock option transactions which totaled approximately $60.1 million as a credit to additional paid-in capital.

Accounting for Stock-Based Compensation. We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations, and comply with the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. Under APB Opinion No. 25, compensation cost, if any, is recognized over the respective vesting period based on the difference between the deemed fair value of our common stock and the exercise price on the date of grant. The determination of the volatility, expected term and other assumptions used to determine the fair value of stock options granted under SFAS 123 for footnote disclosure purposes involves subjective judgment and the consideration of a variety of factors, including our historical stock price, option exercise activity to date and the review of assumptions used by comparable companies. We have recorded compensation charges for issuances of stock awards where the exercise price was less than the deemed fair value of the underlying stock for financial accounting purposes. See Costs of Revenues and Operating Expenses Amortization of Deferred Stock-Based Compensation.

We account for stock options issued to non-employees, in which goods or services are the consideration received for the equity instruments issued, in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and FASB Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. See Recent Accounting Pronouncements.

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Results of Operations

The following table sets forth selected statements of operations data for each of the periods indicated expressed as a percentage of total revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Consolidated Statements of Operations Data:				
Revenues:				
Product revenues	85.0%	85.7%	82.7%	88.3%
Maintenance and services revenues	15.0	14.3	17.3	11.7
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product revenues	32.3	20.9	23.4	32.1
Cost of maintenance and services revenue	4.3	2.8	4.5	3.0
Amortization of deferred stock-based compensation	1.0	0.4	0.9	0.5
Total cost of revenues	37.6	24.1	28.8	35.6
Gross profit	62.4	75.9	71.2	64.4
Operating expenses:				
Research and development	8.5	4.4	9.2	4.7
Selling and marketing	3.6	3.7	4.4	4.0
General and administrative	4.2	5.1	4.9	4.8
Amortization of deferred stock-based compensation	8.7	3.1	14.8	3.7
Total operating expenses	25.0	16.3	33.3	17.2
Income from operations	37.4	59.6	37.9	47.2
Income before income taxes	37.8	67.3	38.9	52.7
Income tax (benefit) provision	(49.4)	15.0	(19.5)	13.5
Net income	87.2%	52.3%	58.4%	39.2%

Comparison of Results for the Three Months Ended September 30, 2005 and 2004

Revenues. Revenues were $38.4 million for the three months ended September 30, 2005 compared to $23.4 million for the three months ended September 30, 2004. This substantial increase in revenues resulted from a number of factors which are driving the growth in the market for AFIS solutions. These factors include the implementation of fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics, the threat of terrorist attacks and increased demand in the civil sector, particularly for voting applications. Product revenues were $33.0 million for the three months ended September 30, 2005 compared to $19.9

million for the three months ended September 30, 2004. The $13.1 million increase in product revenues resulted primarily from additional orders for AFIS solutions from the DHS as well as sales to a number of other domestic and international customers partially offset by a decrease in revenues related to AFIS solutions delivered to the CNE. We experienced a significant increase in revenues from the DHS due to additional orders associated with the continued expansion of the US-VISIT program. During the three months ended September 30, 2005, we recognized revenue of approximately $11.1 million for AFIS solutions delivered to the CNE compared to $15.0 million in the third quarter of 2004. The decrease in revenue related to AFIS solutions delivered to the CNE is primarily attributed to the timing of revenue recognition relative to the lease component included in the contracts with CNE as well as timing relative to the ratable recognition of revenue. Maintenance and services revenues increased by 56% to $5.5 million for the three months ended September 30, 2005 from $3.5 million for the three months ended September 30, 2004. The $2.0 million increase was due to an increase in maintenance revenues and engineering services associated with higher product sales as well as to the generally increasing size of the installed base of customers who purchase maintenance. Additionally, maintenance and service revenues increased due to the receipt of purchase orders for maintenance renewals from government customers in the third quarter of 2005 for maintenance terms that commenced in a prior period.

Gross Profit. Gross profit as a percentage of revenues was 76.0% for the three months ended September 30, 2005 compared to 62.4% for the three months ended September 30, 2004. Amortization of deferred stock-based compensation included in cost of revenues decreased to $155,000 for the three months ended September 30, 2005 from $230,000 for the three months ended September 30, 2004, which accounted for less than one percentage point of revenues for the three months ended September 30, 2005 and approximately one percentage point of revenues for the three months ended September 30, 2004. Product gross margins were 75.5% for the three months ended September 30, 2005 compared to 61.7% for the three months ended September 30, 2004. The portion of deferred stock-based compensation included in cost of revenues related to product cost of revenues was $50,000 and $67,000 for the three months ended September 30, 2005 and 2004, respectively, which reduced product gross margins by less than one percentage point for these respective periods. The increase in product gross margins was primarily due to product mix which was more weighted to higher margin AFIS PMA servers in the third quarter of 2005 compared to the third quarter of 2004 as well as the allocation of fixed overhead costs over a higher revenue base. Maintenance and services gross margins were 78.8% for the three months ended September 30, 2005 compared to 66.6% for the three months ended September 30, 2004. The increase in maintenance and services gross margins was primarily due to the receipt of purchase orders for maintenance renewals from government customers in the third quarter of 2005 which resulted in additional revenue as the maintenance term commenced in a prior period. The portion of deferred stock-based compensation included in cost of revenues related to maintenance and services cost of revenues was $105,000 and $163,000 for the three months ended September 30, 2005 and 2004, respectively, which reduced maintenance and service margins by approximately two percentage points for the three months ended September 30, 2005 and approximately five percentage points for the three months ended September 30, 2004.

Research and Development. Research and development expenses decreased to $1.7 million, or 4% of revenues, for the three months ended September 30, 2005 compared to $2.0 million, or 9% of revenues for the three months ended September 30, 2004. In the third quarter of 2004, research and development personnel were paid a one-time bonus as a result of the successful deployment of the full identification solution to the CNE. As a result of these bonuses paid to research and development personnel during the three months ended September 30, 2004, research and development expenses decreased for the three months ended September 30, 2005 compared to the same period in September 30, 2004. A decrease in travel and various other expenses for research and development personnel also contributed to the decrease in research and development expenses.

Selling and Marketing. Selling and marketing expenses increased to $1.4 million, or 4% of revenues, for the three months ended September 30, 2005 compared to $840,000, or 4% of revenues, for the three months ended September 30, 2004. The increase in absolute dollars was primarily due to an increase in compensation expenses of approximately $248,000 due to additional headcount in sales and marketing, an increase in consulting and professional service fees of approximately $128,000 to support increased business development and proposal activities as well as an increase in spending on marketing activity including trade show expenses and an increase in travel expenses related to an expanded customer base.

General and Administrative. General and administrative expenses increased to $2.0 million, or 5% of revenues, for the three months ended September 30, 2005 compared to $986,000 or 4% of revenues, for the three months ended September 30, 2004. The increase in absolute dollars was primarily due to an increase in consulting, legal and accounting fees of approximately $665,000 related primarily to meeting the requirements of the Sarbanes-Oxley Act of 2002, increases in board fees, directors and officers and business insurance costs and investor relations expenses of approximately $307,000, and increased compensation expenses of approximately $109,000 as a result of an increase in headcount in finance and accounting personnel.

Interest Income. We earned interest income of $2.6 million during the three months ended September 30, 2005 compared to $106,000 during the three months ended September 30, 2004. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds raised of approximately $228.6 million from our initial public offering in the third quarter of fiscal 2004 and $96.8 million from our public offering in June 2005 as well as cash generated from operations.

Income Tax Provision. We recognized an income tax provision of $5.8 million, with an effective tax rate of 22.3%, during the three months ended September 30, 2005 as a result of the net income earned in the period. Our effective tax rate

of 22.3% for the three months ended September 30, 2005 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may continue to occur related to outstanding incentive stock options. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place. During the three months ended September 30, 2004, we recognized a net income tax benefit of $11.6 million primarily as a result of the termination of our S Corporation status and the related recognition of previously unrecognized net deferred tax assets in the quarter ended September 30, 2004.

Comparison of Results for the Nine Months Ended September 30, 2005 and 2004

Revenues. Revenues were $113.6 million for the nine months ended September 30, 2005 compared to $55.9 million for the nine months ended September 30, 2004. This substantial increase in revenues resulted from a number of factors which are driving the growth in the market for AFIS solutions. These factors include the implementation of fingerprint systems at points of entry and exit such as the US-VISIT program, increased government spending on the infrastructure for fingerprint biometrics, the threat of terrorist attacks and increased demand in the civil sector, particularly for voting applications. Product revenues were $100.3 million for the nine months ended September 30, 2005 compared to $46.2 million for the nine months ended September 30, 2004. The $54.1 million increase in product revenues resulted primarily from AFIS solutions delivered to the CNE, additional orders for AFIS solutions from the DHS as well as sales to a number of other domestic and international customers. We experienced a significant increase in revenues from the DHS due to additional orders associated with the continued expansion of the US-VISIT program. During the nine months ended September 30, 2005, we recognized revenue of approximately $43.0 million for AFIS solutions delivered to the CNE compared to $15.0 million for the nine months ended September 30, 2004. The increase in revenue related to AFIS solutions delivered to the CNE is primarily attributed to the continued business generated from the CNE with the initial contract entered into in the third quarter of 2004 and subsequent contracts entered into in the fourth quarter of 2004 and second quarter of 2005. Maintenance and services revenues increased by 38% to $13.3 million for the nine months ended September 30, 2005 from $9.7 million for the nine months ended September 30, 2004. The $3.6 million increase was due to an increase in maintenance revenues and engineering services associated with higher product sales as well as to the generally increasing size of the installed base of customers who purchase maintenance. Maintenance and services revenues as a percentage of total revenues declined from period to period due to the increase in product revenues in the nine months ended September 30, 2005 in comparison to the nine months ended September 30, 2004.

Gross Profit. Gross profit as a percentage of revenues was 64.4% for the nine months ended September 30, 2005 compared to 71.1% for the nine months ended September 30, 2004. Amortization of deferred stock-based compensation included in cost of revenues increased to $542,000 for the nine months ended September 30, 2005 from $500,000 for the nine months ended September 30, 2004, which accounted for less than one percentage point of revenues for the nine months ended September 30, 2005 and approximately one percentage point for the nine months ended September 30, 2004. Product gross margins were 63.5% for the nine months ended September 30, 2005 compared to 71.4% for the nine months ended September 30, 2004. The portion of deferred stock-based compensation included in cost of revenues related to product cost of revenues was $187,000 and $144,000 for the nine months ended September 30, 2005 and 2004, respectively, which reduced product gross margins by less than one percentage point for these respective periods. The decrease in product gross margins was primarily due to lower gross margins associated with our significant AFIS installations, particularly the CNE contracts, resulting from the resale of third party hardware, which was partially offset by the allocation of fixed overhead costs over a higher revenue base. Costs of product revenues increased to $36.5 million for the nine months ended September 30, 2005 from $13.1 million for the nine months ended September 30, 2004. Maintenance and services gross margins were 71.8% for the nine months ended September 30, 2005 compared to 70.0% for the nine months ended September 30, 2004. The portion of deferred stock-based compensation included in cost of revenues related to maintenance and services cost of revenues was $355,000 and $356,000 for the nine months ended September 30, 2005 and 2004, respectively, which reduced maintenance and service margins by approximately three percentage points for the nine months ended September 30, 2005 and approximately four percentage points for the nine months ended September 30, 2004. Costs of maintenance and service revenues increased to $3.4 million for the nine months ended September 30, 2005 from $2.5 million for the nine months ended September 30, 2004.

Research and Development. Research and development expenses increased to $5.4 million, or 5% of revenues, for the nine months ended September 30, 2005 compared to $5.2 million, or 9% of revenues for the nine months ended September 30, 2004. The increase was primarily due to an increase in compensation costs of approximately $178,000 for the nine months ended September 30, 2005 compared to September 30, 2004.

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Selling and Marketing. Selling and marketing expenses increased to $4.5 million, or 4% of revenues, for the nine months ended September 30, 2005 compared to $2.4 million, or 4% of revenues, for the nine months ended September 30, 2004. The increase in absolute dollars was primarily due to an increase in consulting and professional service fees of approximately $812,000 to support increased business development and proposal activities, increased compensation costs of approximately $643,000 due to increased headcount in sales and marketing, an increase in travel costs related to an expanded customer base and increased marketing and promotional activities.

General and Administrative. General and administrative expenses increased to $5.4 million, or 5% of revenues, for the nine months ended September 30, 2005 compared to $2.7 million, or 5% of revenues, for the nine months ended September 30, 2004. The increase in absolute dollars was primarily due to an increase in consulting, legal and accounting fees of approximately $1.2 million related primarily to meeting the requirements of the Sarbanes-Oxley Act of 2002, increases in board fees, directors and officers and business insurance costs and investor relations expenses of approximately $690,000, and increased compensation expenses of approximately $458,000 as a result of an increase in headcount in finance and accounting personnel.

Interest Income. We earned interest income of $5.5 million during the nine months ended September 30, 2005 compared to $196,000 during the nine months ended September 30, 2004. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds raised of approximately $228.6 million from our initial public offering in the third quarter of fiscal 2004 and approximately $96.8 million from our public offering in June 2005 as well as cash generated from operations.

Other, net. During the nine months ended September 30, 2005, we recorded other income of $284,000 primarily related to receipt of a payment to the Company for royalty obligations under a settlement agreement. Additionally, the net amount for amortization of discounts and premiums related to our investments in marketable securities also contributed to other income during the nine months ended September 30, 2005. During the nine months ended September 30, 2004, we recorded other income of $362,000 related to receipt of a dividend from an equity investment in China.

Income Tax Provision. We recognized an income tax provision of $15.3 million, with an effective tax rate of 25.5%, during the nine months ended September 30, 2005 as a result of the net income earned in the period. Our effective tax rate of 25.5% for the nine months ended September 30, 2005 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may continue to occur related to outstanding incentive stock options. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place. During the nine months ended September 30, 2004, we recorded a net income tax benefit of $10.9 million primarily as a result of the termination of our S Corporation status and the related recognition of previously unrecognized net deferred tax assets in the quarter ended September 30, 2004.

Liquidity and Capital Resources

Since inception, we have financed our operations by generating cash from operations and since September 2004 we have supplemented our cash resources through public offerings of our common stock, raising $228.6 million in our initial public offering in September 2004 and $96.8 in a subsequent public offering in June 2005. As of September 30, 2005, we had $19.6 million in cash and cash equivalents and $347.9 million in investments in marketable securities.

We derive cash from operations primarily from cash collected on product sales and maintenance contract sales. Net cash provided by operating activities was $46.1 million and $44.3 million in the nine months ended September 30, 2005 and 2004, respectively. The cash provided by operating activities during the nine months ended September 30, 2005 primarily resulted from net income of $44.6 million adjusted for non-cash reconciling items, the most significant of which were amortization of deferred stock-based compensation of $4.6 million and the tax benefit from stock option transactions of $60.1 million, a decrease in inventory and contract related costs (including deferred cost of sales) of $15.5 million and an increase in accrued expenses of $6.0 million. These items were partially offset by a decrease in deferred revenues of $16.6 million, an increase in billed accounts receivable of $17.9 million, an increase in deferred income taxes of $40.2 million, an increase in prepaid expenses and other current assets of $5.8 million and a decrease in income taxes payable of $5.6 million.

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For the nine months ended September 30, 2005 and 2004, cash used in investing activities was $154.6 million and $6.3 million, respectively. Investing activities consisted of purchases and sales of available-for-sale securities, changes in the restricted cash balance and capital expenditures, which consisted primarily of computer equipment and software for our engineering and service and information technology departments. Additionally, during the nine months ended September 30, 2005, we paid $750,000 for the purchase of patents and paid a deposit of $1.0 million for the purchase a property in Pasadena.

For the nine months ended September 30, 2005 and 2004, cash provided by financing activities was $101.1 million and $151.1 million, respectively. For the nine months ended September 30, 2005, cash provided by financing activities resulted primarily from the net proceeds of $96.8 million from the Company s public offering in June 2005 and the proceeds collected related to the exercise of employee stock options totaling $3.5 million and purchase of shares under the Company s employee stock purchase plan totaling $801,000. For the nine months ended September 30, 2004, cash provided by financing activities consisted of $228.9 million in net proceeds from our initial public offering in September 2004 and $42,000 in proceeds from the exercise of stock options partially offset by $77.8 million of cash distributions to our previous stockholders including dividends paid to our previous stockholders.

Effective October 2005, we purchased a property in Pasadena for $26.0 million to provide for the expansion of our workforce. It is likely that the development of such acquired property will require an expenditure of a material amount of capital resources. We currently have no other material cash commitments, except our normal recurring trade payables, expense accruals and operating leases, all of which are currently expected to be funded through existing working capital and future cash flows from operations. We believe that our cash and cash equivalent balances will be sufficient to satisfy our cash requirements for at least the next twelve months. Although we cannot accurately anticipate the effect of inflation or foreign exchange markets on our operations, we do not believe these external economic forces have had, or are likely in the foreseeable future to have, a material impact on our results of operations.

At September 30, 2005, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose, or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have material relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties.

Recent Accounting Pronouncements

In July 2004, the Emerging Issues Task Force (EITF) published its consensus on Issue No. 03-01, The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments. EITF Issue No. 03-01 addresses the meaning of other-than-temporary impairment and its application to debt and equity securities within the scope of Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities certain debt and equity securities within the scope of SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting. However, implementation guidance related to this consensus was requested. In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 115-1 and 124-1 which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005. The Company continues to assess the potential impact that the adoption of this FSP could have on its financial statements.

In December 2004, the FASB issued SFAS 123 (Revised 2004)-Share Based Payment (SFAS 123R). SFAS 123R requires that the Company record stock option expense in its financial statements based on a fair value methodology. In March 2005 the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107. SAB 107 expresses views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules. In April 2005, the SEC adopted a rule that delayed the compliance dates for adoption of SFAS 123R. The SEC s rule allows companies to implement SFAS 123R at the beginning of the next fiscal year after September 15, 2005, which is January 1, 2006 for the Company. The Company is evaluating the impact of the new standard and the method and timing of adoption. Although the Company has not completed its analysis, it is anticipated that the expense related to stock options will increase under the new pronouncement, however, it cannot be quantified at this time.

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In November 2004, the FASB issued SFAS No. 151 Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe SFAS No. 151 will have a significant impact on the Company s consolidated results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 replaces Accounting Principles Board (APB) Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Company is required to adopt SFAS No. 154 for accounting changes and error corrections at the beginning of the next fiscal year after December 15, 2005, which is January 1, 2006 for the Company. The Company s results of operations and financial condition will only be impacted by SFAS No. 154 if it implements changes in accounting principles that are addressed by the standard or corrects accounting errors in future periods.

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RISK FACTORS

You should consider each of the following factors as well as the other information in this Quarterly Report in evaluating our business and our prospects. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impair our business operations. If any of the following risks actually occur, our business and financial results could be harmed. In that case, the trading price of our common stock could decline. You should also refer to the other information set forth in this Quarterly Report, including our financial statements and the related notes.

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

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

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

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

In 2004 and for the nine months ended September 30, 2005, we derived 71% and 76%, respectively, of our revenues from a limited number of customers.

In each fiscal period we have derived, and we believe that in each future fiscal period we will continue to derive, a significant portion of our revenues from a limited number of customers. We had three customers that collectively accounted for 71% of revenues in 2004, including the DHS and the CNE, which accounted for 25% and 38% of revenues, respectively. In the nine months ended September 30, 2005, the DHS and the CNE collectively accounted for 76% of revenues for that period, or 38% and 38%, respectively. The success of our business is substantially dependent on the continuation of our relationships with, and additional sales to, these significant customers. In addition, our business is dependent upon entering into relationships with additional significant customers. To the extent that any significant customer reduces or delays its purchases from us or terminates its relationship with us, our revenues would decline significantly and our financial condition and results of operations would suffer substantially. None of our customers are obligated to purchase additional solutions from us. As a result, the amount of revenue that we derive from a specific customer may vary from period to period, and a significant customer in one period may not be a significant customer in any subsequent period.

In 2004 and for the nine months ended September 30, 2005, we derived 44% and 54%, respectively, of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

Our performance in any one reporting period is not necessarily indicative of future operating performance because of our reliance on a small number of customers, the majority of which are government entities. Government contracts

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frequently include provisions that are not standard in private commercial transactions. For example, government contracts may include bonding requirements and provisions permitting the purchasing agency to cancel or delay the contract without penalty in certain circumstances. Many of our government customer contracts have these provisions.

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

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

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

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

- the cost, performance and reliability of our solutions and the products and services offered by our competitors;
- customers perceptions regarding the benefits of biometrics solutions;
- the development and growth of demand for biometric solutions in markets outside of government and law enforcement;
- public perceptions regarding the intrusiveness of these solutions and the manner in which organizations use the biometric information collected;
- public perceptions regarding the confidentiality of private information;
- proposed or enacted legislation related to privacy of information;
- customers satisfaction with biometrics solutions; and
- marketing efforts and publicity regarding biometrics solutions.

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

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

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

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

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

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

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

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

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

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

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

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

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

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. Prior to commencement of our preparations for our initial public offering, we operated primarily on a cash accounting basis consistent with our status as a privately held S Corporation, and did not maintain a system of internal controls that was adequate for a public company. As a result, we have in the past discovered, and may in the future discover, areas in our internal controls that need improvement. For example, in connection with the audit of our financial statements for the three years ended December 31, 2003, in May 2004 our independent registered public accounting firm (independent auditors) reported to our audit committee several matters that were reportable conditions and material weaknesses in our internal controls as defined in standards established by the American Institute of Certified Public Accountants. In addition, in connection with the preparation of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, we discovered a deficiency in our internal controls used in calculating amortization of deferred stock compensation. In general, reportable conditions are significant deficiencies in our internal controls that could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. A material weakness is a reportable condition in which our internal controls do not reduce to a low level the risk that undetected misstatements caused by error or fraud may occur in amounts that are material to our audited financial statements.

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

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

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

Among the most significant regulations affecting our business are:

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

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

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

- the Foreign Corrupt Practices Act; and

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

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

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

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

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

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

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

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

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

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

Deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the projects and deploy appropriate resources, including our own project managers and third party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in reputational damage or even claims for substantial monetary damages against us. In addition, we sometimes guarantee customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit from a particular project. Moreover, 79% of our revenues in 2004 and 46% of our revenues for the nine months ended September 30, 2005 were derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing solutions in order to address the changing and sophisticated needs of the marketplace.

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

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

Our success depends largely upon the continued services of our executive officers and other key personnel, particularly Ming Hsieh, our founder and Chief Executive Officer. The relationships that our key managers have cultivated with our customers makes us particularly dependent upon their continued employment with us. We are also substantially dependent on the continued services of our existing engineering and project management personnel because of the highly technical nature of our solutions. We do not have employment agreements with any of our executive officers or key personnel obligating them to provide us with continued services and therefore, they could terminate their employment with us at any time without penalty. We do not maintain key person life insurance policies on any of our employees. The loss of one or more members of our management team could seriously harm our business.

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

Historically, our business and products have been focused on the government and law enforcement markets. In 2004 and for the nine months ended September 30, 2005, sales to customers in these markets accounted for 99% of our revenues. A key component of our strategy is to develop and grow our sales of other fingerprint biometrics solutions. The market for these solutions is at an early stage of development compared to the market for law enforcement and other government sector biometrics products. We cannot assure you that other fingerprint biometrics products and solutions will gain wide market acceptance, that this market will develop and grow as we expect, that we will successfully develop products for this market or that we will have the same success in this market as we have had in the government and law enforcement markets. In addition, we cannot assure you that our strategy of expanding our business to cover biometric solutions and products based on biometrics other than fingerprints will be successful.

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

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

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

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

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

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

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

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

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

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

As the size of our market increases, the likelihood of an intellectual property claim against us increases. Our technologies may not be able to withstand third-party claims against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to litigate or settle, and could divert management attention away from the execution of our business plan. In addition, we may be required to indemnify our customers for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also prevent us from offering our solutions to others.

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

Ming Hsieh, our Chief Executive Officer, controlled approximately 56% of our outstanding common stock as of September 30, 2005. As a result, he is able to exercise control over matters requiring stockholder approval, such as the election of directors and the approval of significant corporate transactions. These types of transactions include transactions involving an actual or potential change of control of our company or other transactions that the non-controlling stockholders may deem to be in their best interests and in which such stockholders could receive a premium for their shares. We are a controlled company under the Nasdaq corporate governance rules, and therefore we are entitled to exemptions from certain of the Nasdaq corporate governance rules. These requirements are generally intended to increase the likelihood that boards will make decisions in the best interests of stockholders. Specifically, we are not required to have a majority of our directors be independent or to have compensation, nominating and corporate governance committees comprised solely of independent directors. We do not intend to avail ourselves of the controlled company exemptions, but our intentions may change and in such event, if our stockholders interests differed from those of Mr. Hsieh, our stockholders would not be afforded the protections of these Nasdaq corporate governance requirements.

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

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

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

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

In 2004 and for the nine months ended September 30, 2005, revenues outside of the Americas accounted for approximately 15% and 7%, respectively, of our total revenues. We also currently have international operations, including offices in Austria, China and Taiwan. Our international revenues and operations are subject to a number of material risks, including, but not limited to:

- difficulties in building and managing foreign operations;
- regulatory uncertainties in foreign countries;
- difficulties in enforcing agreements and collecting receivables through foreign legal systems and other relevant legal issues;

- longer payment cycles;
- foreign and U.S. taxation issues;
- potential weaknesses in foreign economies;
- fluctuations in the value of foreign currencies;
- general economic and political conditions in the markets in which we operate; and
- unexpected domestic and international regulatory, economic or political changes.

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

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

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

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

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

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

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

- difficulties in integrating operations, technologies, accounting and personnel;
- difficulties in supporting and transitioning customers of our acquired companies;
- diversion of financial and management resources from existing operations;
- risks of entering new markets;
- potential loss of key employees; and

inability to generate sufficient revenues to offset acquisition costs.

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

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

Our amended and restated certificate of incorporation and our bylaws, as amended, contain provisions that could delay or prevent a change of control of our company that our stockholders might consider favorable. In addition, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which may discourage, delay or prevent certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our charter documents may make it more difficult for stockholders or potential acquirers to initiate actions that are opposed by the then-current board of directors, including delaying or impeding a merger, tender offer, or proxy contest or other change of control transaction involving our company. Any delay or prevention of a change of control transaction could cause stockholders to lose a substantial premium over the then current market price of their shares.

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The trading price of our common stock is volatile.

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

- variations in our financial results;
- announcements of technological innovations, new solutions, strategic alliances or significant agreements by us or by our competitors;
- recruitment or departure of key personnel;
- changes in the estimates of our financial results or changes in the recommendations of any securities analysts that elect to follow our common stock;
- market conditions in our industry, the industries of our customers and the economy as a whole.

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

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

Ming Hsieh, who was our sole stockholder prior to the sale of the shares in our initial public offering, continues to hold a substantial number of shares of our common stock. Sales by Mr. Hsieh of a substantial number of shares, or the expectation that such sales may occur, could significantly reduce the market price of our common stock. In connection with our June 2005 public offering, Mr. Hsieh entered into a contractual lock-up agreement with respect to sales, offers to sell, and other transfers or transactions relating to our common stock. The term of this lock-up agreement will extend to the end of calendar year 2005. Morgan Stanley & Co. Incorporated and J.P. Morgan Securities Inc. may, in their sole discretion, release Mr. Hsieh from these restrictions prior to the expiration of his lock-up agreement.

Other than the shares subject to the lock-up agreement described above, all of our outstanding shares are eligible for sale in the public market, subject in certain cases to volume limitations under Rule 144 under the Securities Act of 1933, as amended, or Securities Act. Also, shares subject to outstanding options and rights under our 2000 Stock Option Plan and 2004 Equity Incentive Plan are eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements and Rules 144 and 701 under the Securities Act. If these additional shares are sold, or if it is perceived that they will be sold in the public market, the trading price of our common stock could decline.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Although we currently bill for our products and services mostly in U.S. dollars, our financial results could be affected by factors such as changes in foreign currency rates or weak economic conditions in foreign markets. A strengthening of the dollar could make our products and services less competitive in foreign markets and therefore could reduce our revenues. We are billed by and pay substantially all of our vendors in U.S. dollars. In the future, an increased portion of our revenues and costs may be denominated in foreign currencies. To date, exchange rate fluctuations have had little impact on our operating results. We do not enter into derivative instrument transactions for trading or speculative purposes.

Fixed income securities are subject to interest rate risk. The fair value of our investment portfolio would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investment portfolio. The portfolio is diversified and consists primarily of investment grade securities to minimize credit risk.

Item 4. Controls and Procedures

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

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As required by Rule 13a-15(b) under the Exchange Act, we conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon the foregoing evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the quarterly period covered by this report.

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Securities and Exchange Commission declared our registration statement, which we filed on Form S-1 (Registration No. 333-115535) under the Securities Act of 1933 in connection with the initial public offering of our common stock, effective on September 23, 2004. The sale of shares of our common stock, including the sale of 2,700,000 shares pursuant to the exercise of the over-allotment option by the underwriters, resulted in aggregate gross proceeds of approximately $248.4 million, approximately $17.4 million of which we applied to underwriting discounts and commissions and approximately $2.4 million of which we applied to related costs. As a result, we received approximately $228.6 million of the offering proceeds. The underwriting syndicate was managed by Morgan Stanley & Co. Incorporated, J.P. Morgan Securities Inc., Bear, Stearns & Co. Inc., SG Cowen & Co., LLC and Needham & Company, Inc.

As of September 30, 2005, we had used approximately $65.5 million of the net proceeds of the offering to fund the final dividend of our undistributed accumulated S Corporation earnings to our stockholder of report prior to our initial public offering. We had also used approximately $73.1 million to fund operating expenses. The remaining net proceeds of the offering were used to purchase marketable securities.

Item 6. Exhibits

Exhibit Number	Description of Documents
3.2(1)	Amended and Restated Certificate of Incorporation
3.3(2)	Bylaws of the registrant
4.1(3)	Specimen Common Stock Certificate
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Filed with a Current Report on Form 8-K dated November 1, 2004.

(2) Filed with initial Registration Statement on Form S-1 (File No. 333-115535) dated May 14, 2004.

(3) Filed with Amendment No. 4 to the Registration Statement on Form S-1 (File No. 333-115535) dated September 23, 2004.

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SIGNATURE

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

Cogent, Inc.

By: /s/ Paul Kim

Paul Kim
Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: November 14, 2005