VIISAGE TECHNOLOGY INC
Form 10-Q
November 10, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended October 2, 2005.

OR

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

For the Transition Period from __________ to __________.

Commission File Number 000-21559

VIISAGE TECHNOLOGY, INC.

(Exact name of registrant as specified in its charter)

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

(978) 932-2200

Registrant s telephone number, including area code

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

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

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

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

Class	**Outstanding at November 8, 2005**
Common stock, $.001 par value	48,147,492

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VIISAGE TECHNOLOGY, INC.

FORM 10-Q FOR THE QUARTER ENDED OCTOBER 2, 2005

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PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

VIISAGE TECHNOLOGY, INC.

Condensed Consolidated Balance Sheets

(in thousands)

(Unaudited)

	October 2, 2005	December 31, 2004 *
Assets		
Current assets:		
Cash	$ 12,675	$ 11,309
Accounts receivable	12,366	17,075
Inventories and other costs and estimated earnings in excess of billings	5,532	3,382
Other current assets	762	1,213
Total current assets	31,335	32,979
Property and equipment, net	18,384	19,917
Goodwill	92,621	93,507
Intangible assets, net	21,248	26,046
Other assets	3,151	3,180
	$ 166,739	$ 175,629
Liabilities & Shareholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 10,273	$ 15,279
Current portion of long term debt	141	281
Current deferred revenue	3,063	1,992
Other current liabilities	304	194
Total current liabilities	13,781	17,746
Long term debt	219	149
Deferred tax liability	1,637	859
Deferred revenue	1,234	1,717
Other liabilities	200	368
Total Liabilities	17,071	20,839
Shareholders equity	149,668	154,790

	$ 166,739	$ 175,629

* Derived from audited financial statements.

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

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VIISAGE TECHNOLOGY, INC.

Condensed Consolidated Statements of Operations

(in thousands, except per share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 2, 2005	**September 26, 2004**	**October 2, 2005**	**September 26, 2004**
Revenues:				
Services revenue	$ 9,833	$ 11,818	$ 30,811	$ 34,157
Product revenue	4,473	8,089	20,454	14,285
Total revenue	14,306	19,907	51,265	48,442
Cost of revenues:				
Services cost of revenue	6,677	7,097	21,333	22,327
Product cost of revenue	2,617	6,541	10,965	10,378
Amortization of purchased intangible assets	784	762	2,360	1,908
Total cost of revenue	10,078	14,400	34,658	34,613
Gross Profit:	4,228	5,507	16,607	13,829
Operating expenses:				
Sales and marketing (1)	1,732	1,588	5,873	4,659
Research and development (1)	1,086	781	3,439	2,510
General and administrative (1)	2,936	2,362	9,358	6,717
Amortization of purchased intangible assets	527	115	1,581	287
Total operating expenses	6,281	4,846	20,251	14,173
Income (loss) from operations:	(2,053)	661	(3,644)	(344)
Interest income	75	67	143	108
Interest expense	31	478	85	1,488
Other income (expense), net	210	(27)	294	48
Income (loss) before income taxes:				
Income (loss) before income taxes	(1,799)	223	(3,292)	(1,676)
Provision for income taxes	309	25	963	75
Net income (loss)	$ (2,108)	$ 198	$ (4,255)	$ (1,751)
Net income (loss) per share:				
Net income (loss) per basic share	(0.04)	0.00	(0.09)	(0.05)

Net income (loss) per diluted share	(0.04)	0.00	(0.09)	(0.05)
Weighted average basic shares	48,114	40,072	48,021	35,783
Weighted average diluted shares	48,114	41,090	48,021	35,783

(1) Excludes amortization expense for purchased intangible assets as follows:

Cost of Revenue	$ 784	$ 762	$ 2,360	$ 1,908
Sales and marketing	107		321	
Research and development	359	115	1,077	287
General and administrative	61		183	
Total amortization expense for purchased intangible assets	$ 1,311	$ 877	$ 3,941	$ 2,195

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

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VIISAGE TECHNOLOGY, INC.

Condensed Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Nine Months Ended	
	October 2, 2005	September 26, 2004
Cash Flows from Operating Activities:		
Net loss	$ (4,255)	$ (1,751)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	5,002	5,496
Amortization	4,080	2,381
Expenses paid in common stock	205	333
Deferred tax liability	778	
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	4,709	(7,831)
Inventories and costs and estimated earnings in excess of billings	(2,150)	1,081
Other assets	451	(299)
Deferred revenue	588	
Accounts payable and accrued expenses	(5,597)	2,299
Net cash provided by operating activities	3,810	1,709
Cash Flows from Investing Activities:		
Restricted cash		3,311
Cash paid for acquisitions		(6,227)
Net additions to property and equipment	(3,005)	(1,680)
Proceeds from sale of equipment	500	
(Increase) decrease in other assets		(1,524)
Net cash used for investing activities	(2,505)	(6,120)
Cash Flows from Financing Activities:		
Net proceeds from project financing	199	4,273
Principal payments on long term debt	(269)	(13,150)
Net proceeds from issuance of common stock	169	40,985
Net cash provided by financing activities	99	32,108
Effect of exchange rate changes on cash	(38)	
Net increase in cash and cash equivalents	1,366	27,697
Cash and cash equivalents, beginning of period	11,309	6,666
Cash and cash equivalents, end of period	$ 12,675	$ 34,363

Supplemental Cash Flow Information:				
Cash paid for interest	$	58	$	333
Non-cash Transactions:				
Directors fees paid in common stock	$	250	$	260
Acquisitions paid in common stock	$		$	57,486
Acquisitions paid in related party financing	$		$	15,300
Asset purchased with extended payment terms	$		$	800
Services paid in common stock	$	135	$	14

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

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VIISAGE TECHNOLOGY, INC.

Notes to Condensed Consolidated Financial Statements

1. DESCRIPTION OF BUSINESS

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

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

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

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared by Viisage and reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a fair presentation of the results and financial position for the interim periods. The unaudited consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC), and omit or condense certain information and footnote disclosures pursuant to existing SEC rules and regulations. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the entire fiscal year. These statements should be read in conjunction with the consolidated financial statements and related notes included in Viisage s Annual Report on Form 10-K/A for the year ended December 31, 2004.

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

Certain reclassifications have been made to the condensed consolidated financial statements for the year ended December 31, 2004 in order to conform to the October 2, 2005 balance sheet presentation. Certain reclassifications were made to the statement of operations for the three- and nine-month periods ended September 26, 2004 in order to conform to the presentations for the three- and nine-month periods ended October 2, 2005.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and judgments relied upon in preparing financial statements include revenue recognition for multiple element arrangements, allowances for doubtful accounts, estimated fair value of investments, inventory reserves, expected future cash flows used to evaluate the recoverability of long-lived assets, restructuring and other related charges, contingencies and cost estimates associated with revenue contracts, contingent liabilities, future taxable income in jurisdictions in which Viisage operates, and recoverability of Viisage s net deferred tax assets and related valuation allowance. Although Viisage regularly assesses these estimates, actual results could differ materially from these estimates. Changes in estimates are recorded in the period in which they become known. Viisage bases its estimates on historical

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experience and various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from Viisage s estimates if past experience or other assumptions do not turn out to be substantially accurate.

Stock-Based Compensation

Viisage accounts for its stock-based compensation plans using the intrinsic value method, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and complies with the disclosure provisions of Statements of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*.

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

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Net income (loss) as reported	$ (2,108)	$ 198	$ (4,255)	$ (1,751)
Add: stock based employee compensation expense included in reported net income (loss), net of tax			34	
Deduct: total stock based employee compensation determined under fair value based method for all awards, net of tax	(818)	(814)	(1,932)	(2,625)
Pro forma net loss	$ (2,926)	$ (616)	$ (6,153)	$ (4,376)
Earnings per share:				
Basic net income (loss) per share, as reported	$ (0.04)	$ 0.00	$ (0.09)	$ (0.05)
Basic net loss per share, pro forma	$ (0.06)	$ (0.02)	$ (0.13)	$ (0.12)
Diluted net income (loss) per share, as reported	$ (0.04)	$ 0.00	$ (0.09)	$ (0.05)
Diluted net loss per share, pro forma	$ (0.06)	$ (0.02)	$ (0.13)	$ (0.12)

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

	October 2, 2005	September 26, 2004
Risk free interest rate	4.26%	4.0%-5.0%
Expected dividend yield		
Expected lives	3-10 years	3-10 years
Expected volatility	85%	80%

Computation of Net Loss per Share

The basic net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. The impact of approximately 6,037,000 common equivalent shares consisting of all outstanding options and warrants were not reflected in the three- and nine-month periods ended October 2, 2005 dilutive net loss per share calculations as their effect would be anti-dilutive. The diluted net income per share calculation during the three-month period ended September 26, 2004, as reported, included dilutive share equivalents of 1,017,713 consisting of certain outstanding stock options and stock warrants, using the treasury stock method. The impact of approximately 4,377,000 and 5,395,000 common equivalent shares consisting of certain outstanding options and stock warrants were not reflected in the pro forma net loss per share calculations for the three- and nine-month periods in the prior year as their effect would be anti-dilutive, respectively.

Inventory and Suppliers

Viisage obtains certain hardware components and complete products from a limited group of suppliers, which involves significant risks, including reduced control over quality and delivery schedules. Any financial instability of these manufacturers or contractors could result in Viisage having to find new suppliers. As a result, Viisage may be required to

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incur additional development, manufacturing and other costs to establish alternative sources of supply. Furthermore, Viisage does not carry significant inventories of the products Viisage purchases, and Viisage has no guaranteed supply arrangements with its vendors. A loss of a significant vendor could delay sales and increase costs.

Comprehensive Income (Loss)

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, the Company reports accumulated other comprehensive income (loss) in its Condensed Consolidated Balance Sheets. Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss), which includes current period foreign currency translation adjustments. Assets and liabilities of Viisage s operations in Germany are denominated in Euros and are translated into U.S. dollars at exchange rates as of each balance sheet date. Income and expense accounts are translated into U.S. dollars at the average rates of exchange prevailing during the periods presented. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are included in other comprehensive loss with the accumulated other comprehensive loss included as a separate component in shareholders equity in accordance with SFAS No. 130. The accumulated other comprehensive income (loss) consists of unrealized translation gains in accordance with SFAS No. 52, *Foreign Currency Translation* of approximately $308,000 for the three months ended October 2, 2005 and unrealized translation losses of approximately $1.4 million for the nine months ended October 2, 2005. For the three and nine-months ended October 2, 2004, unrealized translation gains were approximately $1,000 and $15,000, respectively. The Company had approximately $1.7 million and $322,000 of accumulated other comprehensive loss as of October 2, 2005 and December 31, 2004, respectively.

Foreign Currency Transactions

Foreign currency transaction for Japanese Yen are included in other income for the three- and nine-month periods ended October 2, 2005 of $163,000 and $219,000, respectively, which was the result of realized and unrealized transaction gains and losses related to foreign currency fluctuations on purchases that Viisage made in Japanese Yen in 2005. For the three- and nine-month periods ended September 26, 2004, realized gains related to foreign currency fluctuations were $168,000 and $243,000, respectively.

Recent Accounting Pronouncements

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

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

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

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* (SFAS 151), an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing* . SFAS 151 amends previous guidance regarding treatment of abnormal amounts of idle facility expense, freight, handling costs, and spoilage. This statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal which was the criterion specified in ARB No. 43. In addition, this Statement requires that allocation of fixed production overheads to the cost of the production be based on normal capacity of the production facilities. This pronouncement is effective for Viisage for fiscal periods beginning October 3, 2005. Viisage is currently evaluating the effect that the adoption of SFAS 151 will have on its consolidated results of operations and financial condition, but does not expect it will have any impact to its cash flows or overall financial condition.

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

3. INCOME TAXES

The deferred income tax provision for the three- and nine-month periods ended October 2, 2005 includes $260,000 and $780,000, respectively, to record the deferred tax liability related to tax deductible amortization of certain goodwill. This deferred tax liability is created by taxable temporary differences related to this goodwill for which the period the difference will reverse is indefinite. Following the adoption of SFAS 142, taxable temporary differences creating deferred tax liabilities as a result of different treatment of goodwill for book and tax purposes cannot offset deductible temporary differences that create deferred tax assets in determining the valuation allowance. In the fourth quarter of 2004, Viisage made an election under Internal Revenue Tax Code Section 338(h)(10) to treat the acquisition of Trans Digital Technologies as an asset transaction for tax purposes. This election resulted in future tax deductible amortization expense related to this goodwill for tax purposes. As a result, a deferred tax provision was required to record the deferred tax liability of tax deductible goodwill amortization. There was no current provision for federal income taxes for the three- and nine-month periods ended October 2, 2005 or September 26, 2004 due to the net pre-tax losses during those periods. The provision for state income taxes for the three months ended October 2, 2005 and September 26, 2004 was approximately $49,000 and $25,000, respectively. The provision for state income taxes for the nine months ended October 2, 2005 and September 26, 2004 was $183,000 and $75,000, respectively.

4. RELATED PARTY TRANSACTIONS AND SHAREHOLDERS EQUITY

Lau Technologies, or Lau, and Mr. Buddy Beck beneficially own approximately 11.3%, and 11.9%, respectively, of Viisage s outstanding common stock. Readers are referred to the Notes to Consolidated Financial Statements section of Viisage s 2004 Annual Report on Form 10-K/A for further discussion.

5. BUSINESS SEGMENTS, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK

Viisage reports results in accordance with SFAS No. 131 *Disclosures about Segments of a Business Enterprise and Related Information* , which establishes standards for reporting information about operating segments. Operating segments are defined as components of a company which the chief operating decision maker evaluates regularly in determining how to allocate resources and assess performance. At October 2, 2005, Viisage operated in one business segment, the advanced technology identity solutions segment. Viisage s advanced technology identity solutions segment enables governments, law enforcement agencies and businesses to enhance security, reduce identity theft, and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.

During 2004, Viisage completed three acquisitions which contributed intellectual property that changed Viisage s product mix and service offerings. Beginning in 2004, Viisage had proprietary products and service capability to deliver fully integrated identity solutions projects across its entire customer base. During the fourth quarter of 2004, Viisage realigned its product and service offerings into the three main categories

identified by the markets which they serve: *State and Local, Federal, and Commercial/Emerging Markets.* Viisage s Chief Executive Officer is the chief operating decision maker who evaluates performance based on revenues and total consolidated operating expenses of identity solutions products and services across all markets and geographic regions. This change in the structure of Viisage s internal organization resulted in a consolidation of Viisage s reportable segments into one reportable segment as of December 31, 2004. For comparative purposes, Viisage has reclassified the segment disclosure for the three and nine months ended September 26, 2004 to conform to the segment reporting for the three and nine months ended October 2, 2005.

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Net revenues by market for the three and nine months ended October 2, 2005 and September 26, 2004 were (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
State and Local	$ 8,291	$ 9,882	$ 26,238	$ 29,181
Federal	5,658	9,839	22,287	18,657
Commercial/Emerging Markets	357	186	2,740	604
	$ 14,306	$ 19,907	$ 51,265	$ 48,442

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

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Revenue				
United States	$ 13,446	$ 19,560	$ 46,221	$ 46,858
Rest of World	860	347	5,044	1,584
	$ 14,306	$ 19,907	$ 51,265	$ 48,442

Of the total revenue for the three- and nine-months ended October 2, 2005, approximately $860,000 and $5.0 million was earned from export sales, respectively. Of the total revenue for the three and nine months ended September 26, 2004, approximately $347,000 and $1.6 million was earned from export sales, respectively. The Company did not have significant international sales to individual countries for the periods presented.

For the three- and nine-month periods ended October 2, 2005, one customer, the Department of State, accounted for 20.5% and 26.5% of Viisage s revenue, respectively. As of October 2, 2005, the accounts receivable balance from this customer was approximately $3.0 million. As of December 31, 2004, the accounts receivable balance from this customer was approximately $2.6 million. For the three- and nine-month periods ended September 26, 2004, two customers, the Department of State and Telos (Department of Defense) accounted for 38.6% and 29.6% of Viisage s revenue, respectively.

6. ACQUISITIONS

On January 23, 2004 Viisage acquired all outstanding shares of ZN Vision Technologies AG (ZN) in exchange for an aggregate of 5,221,454 newly issued shares of Viisage common stock and $493 in cash. ZN is a leading German provider of face recognition and computer vision products and services. ZN, now known as Viisage Technology AG, serves as the base of Viisage s European operations. In addition, Viisage agreed to assume ZN s employee share option plan, and accordingly reserved 1,138,546 shares of Viisage common stock as of the acquisition date for issuance to the plan participants. The options under this plan were fully vested prior to the close of the transaction and accordingly were included in the purchase price at their fair value which equaled the intrinsic value as of the closing date. The purchase price for the acquisition was $31.6 million, based on the per share price of Viisage common stock of $4.32, the average trading price of Viisage common stock for the five trading days immediately preceding and the two trading days immediately following March 28, 2003, the date on which the purchase agreement was signed and the acquisition was announced. The operations of ZN are included in the financial statements since the effective date, the close of business on January 23, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. Viisage engaged an independent appraiser to perform a review of the acquired assets and allocated the purchase price based on the results of the independent appraiser s report. For the three and nine months ended October 2, 2005, amortization expense related to this acquisition was approximately $158,000 and $474,000. For the three and nine months ended September 26, 2004 amortization expense related to this acquisition was approximately $115,000 and $287,000, respectively. For the period from the closing date to October 2, 2005 and September 26, 2004 the accumulated amortization related to the identified intangible from the transaction was $919,000 and $287,000, respectively.

On February 14, 2004 Viisage acquired all outstanding shares of Trans Digital Technologies Corporation (TDT) for $56.6 million. TDT is the sole source provider of high security technology and services to the U.S. Department of State for the production of U.S. passports. The purchase price consisted of 5,850,000 newly issued shares of Viisage common stock, which were valued at $5.13 per share, the average price of Viisage common stock for the five trading days immediately preceding and the two trading days immediately following February 14, 2004, the date on which the purchase agreement was signed and the acquisition was announced, plus $15.3 million in notes and $5.0 million in cash. The operations of TDT are

included in the financial statements since the effective date, the close of business on February 14, 2004. The purchase price has been allocated to net assets acquired based on their estimated fair values. Viisage engaged an independent appraiser to perform a review of the acquired assets and have allocated the purchase price based on the results of the independent appraiser s report. For the three and nine months ended October 2, 2005, amortization expense related to this acquisition was approximately $747,000 and $2.2 million. For the three and nine months ended September 26, 2004 amortization expense related to this acquisition was approximately $762,000 and $1.9 million, respectively. For the period from the closing date to October 2, 2005 and September 26, 2004, the accumulated amortization related to the identified intangible from the transaction was $4.9 million and $1.9 million, respectively

In connection with the acquisition of TDT, Viisage agreed to pay the former sole shareholder of TDT an additional cash payment of up to $2.6 million if the U.S. Department of Defense (DoD) placed orders with an aggregate value of at least $4.0 million prior to June 30, 2004 for the production of smart cards as part of DoD s Common Access Card (CAC) program. The terms for this additional cash payment were met, which Viisage recorded as additional goodwill. This additional goodwill was reduced by approximately $754,000 related to purchase price adjustments as defined in the stock purchase agreement.

On October 5, 2004, Viisage acquired all outstanding shares of Imaging Automation, Inc. for $40.1 million. Imaging Automation is the industry and market leader in automated identity document authentication technologies. The purchase price consisted of 3,908,387 newly issued shares of Viisage s common stock which were valued at $6.27, the average price of Viisage common stock over the five trading days immediately preceding and the two trading days immediately following October 5, 2004, the date on which the purchase agreement was signed and the acquisition was announced, $5.0 million in cash and the assumption of $2.9 million in debt, which has subsequently been repaid in full. Viisage issued fully vested stock options at of the close of the transaction to assume the options outstanding under the Imaging Automation stock option plans. Viisage reserved approximately 565,270 shares of Viisage common stock for these options and recorded their fair value which equaled the intrinsic value of approximately $3.7 million as part of the purchase price. The operations of Imaging Automation are included in the financial statements from the effective date of the transaction, October 5, 2004. Viisage engaged an independent appraiser to perform a review of the acquired assets and allocated the purchase price based on the results of the independent appraiser s report. For the three and nine months ended October 2, 2005, amortization expense related to this acquisition was approximately $406,000 and $1.2 million, respectively. There was no amortization expense related to identified intangible assets for this acquisition during the three- and nine-month periods ended September 26, 2004. For the period from the closing date to October 2, 2005, the accumulated amortization related to the identified intangible from the transaction was $1.6 million.

The allocation of the purchase price for ZN, TDT and Imaging Automation is as follows (in thousands):

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

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

	October 2, 2005	Estimated Useful Life
Gross carrying amounts:		
Completed Technology	$ 9,575	5 years
Customer lists	130	10 years
Acquired contracts	16,200	5 years
Non-competition agreements	490	2 years
Tradename and trademarks	150	3 years
Total intangible assets	26,545	
Accumulated amortization:		
Completed Technology	(2,103)	
Customer lists	(32)	
Acquired contracts	(5,033)	
Non-competition agreements	(242)	
Tradename and trademarks	(44)	
Translation adjustments	8	
Total accumulated amortization	(7,446)	
Intangible assets, net	$ 19,099	

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

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

The unaudited pro forma and combined selected operating data below present the acquisitions of ZN, TDT and Imaging Automation as if the acquisitions had occurred on January 1, 2004. The unaudited pro forma data is for informational purposes only and may not necessarily reflect future results of operations or what the results of operations would have been had Viisage, ZN, TDT and iA been operating as a combined entity for the periods presented. The unaudited pro forma revenue, loss and loss per share information for the three and nine months ended October 2, 2005 and September 26, 2004 are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Revenue	$ 14,306	$ 20,379	$ 51,265	$ 53,147
Net loss	($2,108)	($1,648)	($4,255)	($5,674)
Basic and diluted net loss per share	($0.04)	($0.04)	($0.09)	($0.12)

7. FOREIGN CURRENCY HEDGES

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

In 2005, Viisage began to utilize foreign currency forward contracts. All gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts was terminated prior to settlement. As of October 2, 2005, Viisage had committed to three foreign currency forward contracts to purchase approximately 91,351,000 Japanese Yen for $827,000. The fair value of these contracts at October 2, 2005 was a liability of approximately $18,000. All of these contracts will be settled before December 31, 2005.

8. LEGAL PROCEEDINGS

In March and April 2005, eight putative class action lawsuits were filed in the United States District Court for the District of Massachusetts against Viisage, Bernard C. Bailey, William K. Aulet and Denis K. Berube and other members of Viisage s Board of Directors. A motion has been filed by the so-called Turnberry Group to consolidate these lawsuits into one action under the case name: *Darquea v. Viisage Technology, Inc. et al.*, Civil Action No. 05-10438-MLW. This motion also seeks to have the Turnberry Group designated as lead plaintiff and its counsel designated as lead counsel. The suits allege violations

of the federal securities laws by Viisage and certain of its officers and directors arising out of purported misrepresentations in the guidance that Viisage provided on its anticipated financial results for fiscal 2004 following the release of its 2004 second and third quarter results, which allegedly artificially inflated the price of Viisage s stock during the period May 3, 2004 through March 2, 2005. Viisage is not able to estimate the amount of the loss allegedly suffered by members of the putative class or the amount of legal costs and internal efforts associated with defending itself and its officers and directors. Viisage believes that the allegations and claims made in these lawsuits are wholly without merit and intends to defend the actions vigorously. If Viisage is unsuccessful in defending itself in this litigation, these lawsuits could adversely affect its business, financial condition, results of operations and cash flows as a result of the damages that it could be required to pay. It is possible that Viisage s insurance policies either may not cover potential claims of this type or may not be adequate to indemnify Viisage for all liability that may be imposed. In April 2005, two purported shareholder derivative actions also were filed against Viisage s directors, naming Viisage as a nominal defendant. The suits claim that these directors breached their fiduciary duties to Viisage s shareholders and to Viisage generally in connection with the same set of circumstances alleged in the class action lawsuits. The complaints are derivative in nature and do not seek relief from Viisage. One of these actions was filed in Massachusetts Superior Court and the other was filed in the United States District Court for the District of Massachusetts. In July 2005, the state court action was dismissed with prejudice at the plaintiff s request. Viisage s response to the federal court action is not yet due. Viisage believes that the allegations and claims made in the remaining derivative lawsuit are likewise wholly without merit and intends to defend this action vigorously.

In December 2004, the superior court for Fulton County, Georgia granted summary judgment in favor of Georgia s Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by Digimarc ID Systems, LLC in March 2003 alleging that DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. In July 2003, the court had issued a preliminary injunction prohibiting DMVS from continuing to work with Viisage to install the State s new drivers license system. In July 2004, Viisage reached a settlement agreement with the State pursuant to which DMVS terminated the contract for convenience and agreed to pay Viisage $2.0 million in cash and the State agreed to purchase certain equipment from Viisage for $500,000. In its December 2004 ruling, the Georgia court authorized DMVS to issue a new request for proposals for a digital drivers license system, but disallowed the $2.0 million cash payment described above. Without this payment, Viisage believes either that the settlement agreement with DMVS is not effective and that its contract with DMVS remains in place, or that Viisage s initial claim for an $8.2 million settlement payment is revived. The State has paid Viisage $500,000 for the equipment and Viisage appealed the disallowance of the $2.0 million settlement payment. In May 2005, the Georgia Supreme Court voted in a 4-3 decision not to hear Viisage s appeal based on procedural grounds. Due to the uncertainty of the cash settlement as a result of the judge s ruling and the uncertainty of future cash flows from this contract to support the book value of certain system assets installed, Viisage has identified $2.2 million of assets deployed within the state that it has deemed to have no alternative use. Viisage reduced the recorded value of these assets from approximately $2.2 million to their estimated fair value of approximately $200,000 based on its estimate of realizable value from liquidation of these assets, which resulted in a $2.0 million charge in the fourth quarter of 2004. In addition, Viisage has removed the contract from its backlog, and it will lose up to $19.7 million in revenue that it expected to recognize over the next five and one-half years, unless the contract remains in place or Viisage is able to win the new contract for the digital drivers license system and the revenues from such new contract are substantially similar to the prior contract. There are approximately $2.9 million of system assets remaining on Viisage s balance sheet from the Georgia contract. These consist of approximately $1.1 million of assets that Viisage anticipates using in Georgia if it wins the contract based on the new request for proposals, approximately $150,000 of assets that Viisage anticipates could either be used in Georgia under a new contract or used in other projects, and approximately $1.6 million of assets constituting Viisage s central production facility in Georgia. Viisage has evaluated these assets for impairment and, based upon its current probability-weighted estimate of cash flows, it has determined that these assets are not currently impaired. While Viisage believes it can utilize these assets either in Georgia, if it wins the new contract, or on alternative projects, to the extent that it is unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, Viisage would be required to take a further charge to earnings. (See Note 9)

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9. PROPERTY AND EQUIPMENT

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

	October 2, 2005	December 31, 2004
System assets held under capital leases	$ 449	$ 250
System assets	54,019	51,216
Computer and office equipment	5,269	3,269
Leasehold Improvements	242	147
	59,979	54,882
Less accumulated depreciation	41,595	34,965
	$ 18,384	$ 19,917

Included in system assets at December 31, 2004 are $500,000 of assets held for sale to Georgia related to the state s agreement to purchase certain assets pursuant to a portion of the settlement agreement between Viisage and the state which was upheld by the Georgia court in its summary judgment ruling. In the first quarter of 2005 Viisage received full payment from the state for these assets. Also included in system assets for both periods presented is approximately $2.9 million of system assets remaining from the Georgia contract. (See Note 8)

10. SUBSEQUENT EVENTS

On October 5, 2005, Viisage entered into a definitive investment agreement with L-1 Investment Partners LLC (L-1) providing for the issuance and sale to L-1 of 19,047,619 shares of Viisage common stock at $5.25 per share and the issuance of warrants to purchase an aggregate of 4,000,000 shares of Viisage common stock at an exercise price of $5.50 per share. The sale of the shares to L-1 will result in gross proceeds to Viisage of $100 million. The L-1 Investment Agreement stipulates that $85 million of the proceeds will be used to finance acquisitions subject to approval by Viisage s board of directors.

The closing of the transaction is subject to the approval of Viisage s stockholders and the satisfaction of customary closing conditions. In addition, the stockholders of Viisage will be asked to approve a one-for-two and a half reverse stock split of the issued and outstanding common stock of Viisage. Viisage has filed a preliminary proxy statement with the Securities and Exchange Commission to solicit stockholder approval of the transaction with L-1 and the reverse stock split.

The warrants have a term of three years from the closing date, and vest as follows: (1) warrants to purchase 3,200,000 shares of Viisage common stock vest on a pro rata basis proportionate to acquisitions involving the aggregate consideration of $125 million; (2) warrants to purchase 533,333 shares of Viisage common stock vest upon Viisage reporting gross revenues for any four-quarter period equal to or greater than $200 million; and (3) warrants to purchase 266,667 shares of Viisage common stock vest upon Viisage reporting gross revenues for any four-quarter period equal to or greater than $300 million.

The Investment Agreement provides that if either Viisage or L-1 breaches or fails to perform in any material respect any of its representations or obligations under the Investment Agreement and the breach or failure is not cured within ten days after notice from the other party, the breaching party will be required to pay the other party $4,000,000 as a termination fee plus up to $1,000,000 of actual out-of-pocket expenses incurred by the other party. Viisage also shall be required to pay the termination fee and up to $1,000,000 of L-1 s actual out-of-pocket expenses if the Viisage board fails to make or withdraws its recommendation to the stockholders that they approve the investment or if Viisage materially breaches its obligations relating to the non-solicitation of competing transactions.

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VIISAGE TECHNOLOGY, INC.

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

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

COMPANY BACKGROUND

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

- *assurance* that an identification document is authentic and has been issued to the correct person;
- *confidence* that the person holding the identification is uniquely tied to and authorized to use the document; and
- *verification* of the privileges the individual is entitled to at a particular point in time.

We generate revenue through the sale and license of products and services for verifying and managing identities. Our revenues decreased to approximately $14.3 million for the three months ended October 2, 2005 from $19.9 million for the three months ended September 26, 2004. Our revenues for the nine months ended October 2, 2005 increased to approximately $51.3 million from $48.4 million in the first nine months of 2004. Our net loss for the three months ended October 2, 2005 increased to $2.1 million from net income of $198,000 for the three months ended September 26, 2004. Our net loss for the nine months ended October 2, 2005 increased to $4.3 million from $1.8 million in the first nine months of 2004.

STRATEGIC INITIATIVE

On October 5, 2005, we entered into an investment agreement with L-1 Investment Partners LLC (L-1) providing for the issuance and sale to L-1 of 19,047,619 shares of our common stock at $5.25 per share and the issuance of warrants to purchase an aggregate of 4,000,000 shares of our common stock at an exercise price of $5.50 per share. The sale of the shares to L-1 will result in gross proceeds to us of $100 million. The L-1 Investment Agreement stipulates that $85 million of the proceeds will be used to finance acquisitions subject to approval by our board of directors. The closing of the transaction is subject to the approval of our stockholders and the satisfaction of customary closing conditions. In addition, our stockholders will be asked to approve a one-for-two and a half reverse stock split of our issued and outstanding common stock. We have filed a preliminary proxy statement with the Securities and Exchange Commission to solicit stockholder approval of the transaction with

L-1 and the reverse stock split.

SEGMENTS AND GEOGRAPHIC INFORMATION

At October 2, 2005, we operated in one business segment, the advanced technology identity solutions segment. Our advanced technology identity solutions segment enables governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases.

During the fourth quarter of 2004, we categorized our net product and services revenues into three primary markets: *State and Local, Federal,* and *Commercial/Emerging Markets*. Our Chief Executive Officer is the chief operating decision maker who evaluates performance based on total consolidated revenues, gross margin, and operating expenses of identity solutions products and services across all markets and geographic regions.

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Revenues by market for the three and nine months ended October 2, 2005 and September 26, 2004 are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
State and Local	$ 8,291	$ 9,882	$ 26,238	$ 29,181
Federal	5,658	9,839	22,287	18,657
Emerging Markets	357	186	2,740	604
	$ 14,306	$ 19,907	$ 51,265	$ 48,442

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

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Revenue				
United States	$ 13,446	$ 19,560	$ 46,221	$ 46,858
Rest of World	860	347	5,044	1,584
	$ 14,306	$ 19,907	$ 51,265	$ 48,442

Of the total revenue for the three- and nine-months ended October 2, 2005, approximately $860,000 and $5.0 million was earned from export sales, respectively. Of the total revenue for the three and nine months ended September 26, 2004, approximately $347,000 and $1.6 million was earned from export sales, respectively. The Company did not have significant international sales to individual countries for the periods presented.

DEPENDENCE ON SIGNIFICANT CUSTOMERS

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

for the three-month and nine-month periods ended October 2, 2005, one customer accounted for an aggregate of 20.5% and 26.5%, respectively; and

for the three-month and nine-month periods ended September 26, 2004, two customers accounted for an aggregate of 38.6% and 29.6%, respectively.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES

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

Valuation of Goodwill and Other Long-Lived and Intangible Assets

Our long-lived assets include property, plant and equipment, other intangible assets and goodwill. As of October 2, 2005, the balances of property, plant and equipment, other intangible assets and goodwill, net of accumulated depreciation and amortization, were $18.4 million, $92.6 million, and $21.2 million, respectively.

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

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

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

We have evaluated the assumptions used in our assessment of goodwill impairment as of December 31, 2004 and have determined that the estimates used in the independent valuation of goodwill at that date have not materially changed after considering the above triggering events for an impairment review during the three months ended October 2, 2005. If actual results differ significantly from these estimates, there could be a material effect on our financial statements.

In the fourth quarter of 2004, we recorded an impairment charge of $2.0 million related to a write-down of certain system assets associated with our contract to produce drivers licenses in the state of Georgia. This impairment was the result of a Georgia court s grant of summary judgment, during that quarter, in favor of Georgia s Department of Motor Vehicle Safety, or DMVS, in connection with litigation brought by one of our competitors in March 2003 alleging that the DMVS did not comply with its own bid process when it selected Viisage as the vendor for its new digital drivers license program. The summary judgment negated a prior settlement between us and the state that would have provided us with a payment of $2.0 million upon the cancellation of its contract. Due to the uncertainty of the cash settlement as a result of the judge s ruling and the uncertainty of future cash flows from this contract to support the book value of the system assets installed, we identified $2.2 million of assets deployed within the state that we deemed to have no alternative use. We reduced the recorded value of these assets from approximately $2.2 million to their estimated fair value of approximately $200,000 based on our estimate of realizable value from liquidation of these assets, which resulted in a $2.0 million charge in the fourth quarter of 2004. We also have evaluated for impairment the remaining $2.9 million in assets being retained by us from the Georgia contract. These consist of approximately $1.1 million of assets that we anticipate using in Georgia if we win the

contract based on the new request for proposals, approximately $150,000 of assets that we anticipate could either be used in Georgia under a new contract or used in other projects, and approximately $1.6 million of assets constituting our central production facility in Georgia. Based upon our current probability-weighted estimate of cash flows, we have determined that these assets are not currently impaired. While we believe we can utilize these assets either in Georgia, if we win the new contract, or on alternative projects, to the extent that we are unable to utilize these assets or realize value through a sale of these assets or reach a new settlement with DMVS regarding these assets, we would be required to take a further charge to earnings.

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

- future expected cash flows from product sales, customer contracts and acquired developed technologies and patents;

expected costs to complete any in-process research and development projects and commercialize viable products and estimated cash flows from sales of such products;

the acquired companies brand awareness and market position;

assumptions about the period of time over which we will continue to use the acquired brand; and

discount rates.

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

As of October 2, 2005, we have recorded goodwill of $92.6 million. We perform impairment reviews on the carrying values of goodwill arising from the aforementioned acquisitions at least annually. Future cash flows and operating results used in the impairment review are based on management s projections and assumptions. Actual results could differ from such projections used to originally value the acquisitions, which could result in significant impairment charges in the future.

Revenue and Cost Recognition

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

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

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

We have contracts, generally with state governments for the production of drivers licenses and other identification credentials, where we have determined that we have multiple elements and where the title to equipment installed to produce these credentials does not pass to the customer.

Under these contracts, the first element consists of hardware, system design, implementation, training, consumables management, maintenance and support which is accounted for as equipment and related executory services under lease in accordance with SFAS No. 13. The second element consists of customized software which is accounted for as a long term contract in accordance with AICPA Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2, and Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, or SOP 81-1, on a units of delivery method of measurement.

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

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system design and installation phase of our contracts, including customized software and equipment, and recognize revenue as credentials are produced.

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

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

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

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

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

- a high level of certainty exists regarding expected cash flows from these contracts; and

- a reliable basis exists for determining the percentage of the contract that will be completed at the end of the accounting period.

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

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

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

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the sales price is fixed and determinable;
- collection is probable; and

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there are no post delivery obligations.

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

Derivative Instruments and Hedging Activities

In 2005, Viisage began to utilize foreign currency forward contracts. All gains and losses resulting from the change in fair value of the derivatives are recorded in earnings. None of the contracts was terminated prior to settlement. As of October 2, 2005, Viisage had committed to seven foreign currency forward contracts to purchase approximately 91,351,000 Japanese Yen for $827,000. The fair value of these contracts at October 2, 2005 was a liability of approximately $18,000. All of these contracts will be settled before December 31, 2005.

RESULTS OF OPERATIONS

Revenue

	Three Months Ended			Nine Months Ended		
	October 2, 2005	Percent Change	September 26, 2004	October 2, 2005	Percent Change	September 26, 2004
Services revenue	$ 9,833	-16.8%	$ 11,818	$ 30,811	-9.8%	$ 34,157
Product revenue	4,473	-44.7%	8,089	20,454	43.2%	14,285
Total revenue	$ 14,306	-28.1%	$ 19,907	$ 51,265	5.8%	$ 48,442

Services revenues include multi-year service contracts for systems implementation, maintenance, credential production and other related services. During the three-month period ending October 2, 2005, service revenue decreased by $2.0 million. In the state and local market, service revenue decreased by $1.6 million from approximately $9.9 million in the third quarter of 2004 to $8.3 million. This decrease was primarily due to state contracts for Ohio and New York ending in the first quarter of 2005 which generated service revenue of $1.1 million in the third quarter of 2004 and no revenue in the third quarter of 2005. In addition, we delivered on a face recognition contract for North Carolina in the third quarter of 2004 which contributed $584,000 in that period. The remaining decrease in service revenue of $454,000 was attributable to Federal solutions services decrease from the prior period last year. During the nine-month period ending October 2, 2005, service revenue decreased by $3.3 million. In the state and local market, service revenue decreased by $3.9 million from approximately $29.2 million in the third quarter of 2004 to $25.3 million. This decrease was primarily due to state contracts for Ohio and New York ending in the first quarter of 2005 which generated service revenue of $3.0 million in the nine months ended September 26, 2004 compared to approximately $186,000 for the first nine months of 2005. In addition our state contract for Florida ended in the third quarter of 2005 which resulted in decreased revenue of $903,000 from the prior period last year. The remaining decrease in service revenue of $662,000 was attributable to a decrease in the run-rate of

Federal solutions services and parts decrease from the prior period last year. This decrease was offset by Imaging Automation maintenance contracts and international sales of which contributed service revenue of $1.3 million in 2005.

Product revenues include sale of our document authentication systems, printers, and other consumables to the federal market. Product revenues in the three-month period ended October 2, 2005 decreased by $3.6 million, relative to the comparable period in the prior year. Revenue for products in the third quarter of 2004 included $5.4 million of non-recurring revenue associated with printer sales and approximately $600,000 of consumables to the Department of Defense accounted for the decrease in 2005 third quarter product revenue. In the third quarter 2005 we delivered consumables to the Department of State for approximately $2.0 million and sales of document authentication systems from the acquisition of Imaging Automation in the fourth quarter of 2004, as well as additional sales to emerging markets totaling approximately $400,000. Product revenues for the nine-month period ended October 2, 2005 increased by $6.2 million relative to comparable periods in the prior year. Revenue from products for the nine-month period ended September 26, 2004 included $6.2 million of non-recurring revenue associated with printer sales to the Department of Defense. This decrease was offset by additional consumables delivered to the Department of State and Department of Defense for approximately $6.3 million and $2.4 million of revenue, respectively, during the first nine months of 2005. This decrease also was offset by $3.7 million of document authentication system sales as well as additional sales to emerging markets during the first nine months of 2005.

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Cost of revenue

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Services cost of revenue	$ 6,677	$ 7,097	$ 21,333	$ 22,327
Product cost of revenue	2,617	6,541	10,965	10,378
Amortization expense	784	762	2,360	1,908
	$ 10,078	$ 14,400	$ 34,658	$ 34,613
As a percentage of net revenues	70.4%	72.3%	67.6%	71.5%

The increases in our gross margin for the quarter was the result of a change to a higher margin mix of products and solutions that we delivered to our customers, partially offset by fixed service costs related to a lower revenue base. Our state and local market margins were affected by two state contracts that ended in the first quarter of 2005 and the phase out of a third state contract which reduced the overall margin in the state and local market by approximately 4%. This decrease was offset by a 6% increase in gross margins in our Federal solutions business as a result of sales of higher margin products relative to the comparable prior year period. The increases in our gross margin for the first nine months was a result of a change to a higher margin mix of products and solutions that we delivered to our customers. Our state and local market margins were impacted by two state contracts that ended in the first quarter of 2005 and the phase out of a third state contract which reduced the overall margin in this market by approximately 4%. This decrease in gross margin was offset by higher margin product sales from the Imaging Automation acquisition in the fourth quarter 2004.

Sales and Marketing Expenses

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Sales and Marketing Expenses	$ 1,732	$ 1,588	$ 5,873	$ 4,659
As a percentage of net revenues	12.1%	8.0%	11.5%	9.6%

Sales and marketing expense consists primarily of salaries and related personnel costs, commissions, travel and entertainment expenses, promotions, and other marketing and sales support expenses. The net increase for the three months ended October 2, 2005 compared to the prior year period is $144,000, and this increase was the result of $191,000 of expense for additional headcount primarily from the Imaging Automation acquisition and $126,000 of incremental corporate communications expenses which was reallocated from general and administrative expenses. These increases were partially offset by a reduction of approximately $175,000 of expense reduction in other employee related costs during the quarter. The increase of $1.2 million for the nine months ended October 2, 2005 compared to first nine months ended September 26, 2004 are primarily due to additional headcount from the Imaging Automation acquisition which contributed additional expense of approximately $881,000, as well as approximately $300,000 expended to increase the visibility of our product and services offerings in the state and local and federal marketplaces. We expect to continue to invest in our sales and marketing organization for fiscal 2005.

Research and Development Expenses

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Research and Development Expenses	$ 1,086	$ 781	$ 3,439	$ 2,510
As a percentage of net revenues	7.6%	3.9%	6.7%	5.2%

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Research and development expense consists primarily of salaries and related personnel costs and prototype costs related to the design, development, testing and enhancement of our products. The increase for the third quarter of 2005 relative to the comparable period for the prior year is a result of the inclusion of the Imaging Automation acquisition from October 2004 of approximately $300,000 of additional expense. The remaining increase in R&D expense is the result of additional investment in product development in the federal and emerging markets. For the nine-month period ended October 2, 2005, research and development expenses increased $929,000. This increase was due to the acquisitions we made in 2004 and related to higher employee related costs. We expect to continue to invest in biometric technologies and new product development to broaden our product offerings of advanced technology identity solutions for fiscal 2005 and 2006.

General and Administrative Expenses

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
General and Administrative Expenses	$ 2,936	$ 2,362	$ 9,358	$ 6,717
As a percentage of net revenues	20.5%	11.9%	18.3%	13.9%

General and administrative expenses consist primarily of salaries and related personnel costs for executive and administrative personnel, recruiting expenses, and professional fees. For the three-month period ending October 2, 2005 the increase in general and administrative expenses was $574,000 relative to comparable prior year period. The increase in general and administrative expenses for the three-month period ended October 2, 2005 compared to the comparable prior year period was the result of enhancements to our employee benefit plans that resulted in $226,000 of additional expense, higher corporate insurance costs totaling approximately $146,000, and an increase of employee related expenses of $202,000, from headcount additions primarily in accounting and information technology functions. For the nine-month period ended October 2, 2005 the increase in general and administrative expenses was $2.6 million relative to the comparable prior year period. This was the result of higher corporate insurance expense of $615,000, an increase of employee related expenses of $757,000, an increase in legal and audit fees of $932,000, and other general and administrative of costs of approximately $297,000. We will continue to invest in our infrastructure for fiscal 2005, particularly as it relates to addressing our material weaknesses in internal controls.

Interest Income and Expense

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Interest income	$ 75	$ 67	$ 143	$ 108
Interest expense	31	478	85	1,488
Net interest income and (expense)	$ 44	$ (411)	$ 58	$ (1,380)

The increase in interest income are related to a higher average cash balance during the third quarter and first nine months of 2005 compared to the comparable periods in 2004. Interest expense for the third quarter 2005 decreased by approximately $447,000 compared to the prior year

periods. Interest expense for the nine-months ended October 2, 2005 decreased by approximately $1.4 million compared to the prior year period. These decreases in interest expense are related to our repayment during 2004 of approximately $16.7 million of debt that was on our balance sheet as of September 26, 2004.

Other Income (Expense)

	Three Months Ended		Nine Months Ended	
	October 2, 2005	**September 26, 2004**	**October 2, 2005**	**September 26, 2004**
Other Income (Expense)	$ 210	$ (27)	$ 294	$ 48

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The increase in other income are the result of mark to market adjustments related to forward contracts purchased to hedge our foreign currency exposure to Japanese Yen-denominated supply contracts entered in the third quarter and first nine months of 2005.

Income Taxes

	Three Months Ended		Nine Months Ended	
	October 2, 2005	September 26, 2004	October 2, 2005	September 26, 2004
Income Taxes	$ 309	$ 25	$ 963	$ 75

The income tax provision is primarily a result of taxable temporary differences related to certain goodwill for which the period the difference will reverse is indefinite. In the fourth quarter of 2004, Viisage made an election under Internal Revenue Tax Code Section 338(h)(10) to treat its acquisition of TDT as an asset transaction for tax purposes which resulted in future tax deductible amortization expense for tax purposes. As a result, a deferred federal income tax provision is required beginning in the fourth quarter of 2004. No current provision for federal income taxes was made for the three- and nine-month periods ended October 2, 2005 and September 26, 2004. Included in the income tax expense is state income tax expense of approximately $49,000 for the three-month period ending October 2, 2005 and was approximately $25,000 in the prior year period. For the nine-month period ending October 2, 2005 the state income tax expense was approximately $183,000 and approximately $75,000 for the prior year period.

LIQUIDITY AND CAPITAL RESOURCES

	Nine Months Ended		Year Ended
	October 2, 2005	September 26, 2004	December 31, 2004
Consolidated Cash Flow Data:			
Net cash provided by (used in):			
Operating activities	$ 3,810	$ 1,709	$ 4,135
Investing activities	(2,505)	(6,120)	(12,992)
Financing activities	99	32,108	13,504
Effect of exchange rates on cash and cash equivalents	(38)		(4)
Net increase in cash and cash equivalents	$ 1,366	$ 27,697	$ 4,643

In the nine-month period ended October 2, 2005, cash provided by operating activities was approximately $3.8 million, which resulted from our net loss of approximately $4.3 million, offset by non-cash charges for depreciation and amortization of approximately $9.1 million, $205,000 for expenses paid in common stock and deferred tax liability of $778,000. The net changes in operating assets and liabilities resulted in a use of approximately $2.0 million of cash.

Accounts receivable decreased from $17.1 million at December 31, 2004 to $12.4 million at October 2, 2005, primarily due to collections and a lower revenue base.

Inventories and other costs and estimated earnings in excess of billings increased approximately 63.6% from $3.4 million at December 31, 2004 to $5.5 million at October 2, 2005. This increase of approximately $2.1 million was primarily due to additional inventory of document authentication products for delivery on expected future contracts.

Accounts payable and accrued expenses decreased from $15.3 million at December 31, 2004 to $10.3 million at October 2, 2005 primarily due to payments made and a lower volume of business activity, as well as payments made prior to the end of the third quarter of 2005 for professional services fees.

On December 14, 2004, we entered into a Loan and Security Agreement with Citizens Bank of Massachusetts. The Loan and Security Agreement permits us to borrow up to $25,000,000, subject to certain financial covenants which may restrict the amounts borrowed. As of October 2, 2005, we estimate that the amount available to us under the Loan and Security Agreement was approximately $7.4 million based on the financial covenants. Any amounts borrowed under the Loan and Security Agreement bear interest at the rate of Citizens prime rate minus 0.25% or the London Interbank Offered Rate (LIBOR) plus 2.5%, at our option, and must be repaid on or before May 30, 2007. In March and October 2005, we entered into amendments to the Loan and Security Agreement to modify the financial covenants and make certain other changes. The October 2005 amendment requires that we maintain cash and cash equivalents of at least $7.5 million. We are in compliance with the amended financial covenants for the quarter ended October 2, 2005. If we do not remain in compliance with the

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applicable covenants, Citizens could refuse to lend funds to us and could require repayment of any amounts outstanding at the time that we are not in compliance with such covenants. Currently, there are no borrowings outstanding under the Loan and Security Agreement other than a commitment of $2.3 million in letters of credit issued by Citizens to certain of our customers

In April 2003, we entered into an arrangement for approximately $1.5 million of equipment financing with three of our suppliers. These project lease arrangements are accounted for as capital leases. There are no financial covenants associated with these leasing arrangements. As of October 2, 2005, we had outstanding approximately $142,000 under these arrangements. The interest rates on these capital leases are between 6% and 8% and are fixed. The terms of these leases range from 12 months to 60 months. In August 2003, we entered into an arrangement for financing of database licenses with another vendor. As of October 2, 2005, we had outstanding approximately $27,000 under this arrangement.

In September 2005, we entered into a three-year capital lease with payments due quarterly for approximately $199,000 for software licenses. As of October 2, 2005, $191,000 is included in current and long term debt. There are no financial covenants associated with this leasing arrangement. The total remaining installment payments due are $207,000.

In the first quarter of 2004, we purchased an asset totaling $800,000 which is payable in installments over four years. As of October 2, 2005, $384,000 is included in other liabilities which represent the unpaid principal balance, net of imputed interest. Total remaining installment payments due are $400,000.

On October 5, 2005, we entered into a definitive investment agreement with L-1 Investment Partners LLC (L-1) providing for the issuance and sale to L-1 of 19,047,619 shares of Viisage common stock at $5.25 per share and warrants to purchase an aggregate of 4,000,000 shares of Viisage common stock at an exercise price of $5.50 per share. The sale of the shares to L-1 will result in gross proceeds to Viisage of $100 million. The L-1 Investment Agreement stipulates that $85 million of the proceeds will be used to finance acquisitions subject to approval by our board of directors. The closing of the transaction is subject to the approval of our stockholders and the satisfaction of customary closing conditions.

The closing of the transaction is subject to the approval of Viisage s stockholders and the satisfaction of customary closing conditions. In addition, the stockholders of Viisage will be asked to approve a one-for-two and a half reverse stock split of the issued and outstanding common stock of Viisage. Viisage has filed a preliminary proxy statement with the Securities and Exchange Commission to solicit stockholder approval of the transaction with L-1 and the reverse stock split.

The warrants have a term of three years from the closing date, and vest as follows: (1) warrants to purchase 3,200,000 shares of Viisage common stock vest on a pro rata basis proportionate to acquisitions involving the aggregate consideration of $125 million; (2) warrants to purchase 533,333 shares of Viisage common stock vest upon Viisage reporting gross revenues for any four-quarter period equal to or greater than $200 million; and (3) warrants to purchase 266,667 shares of Viisage common stock vest upon Viisage reporting gross revenues for any four-quarter period equal to or greater than $300 million.

The Investment Agreement provides that if either Viisage or L-1 breaches or fails to perform in any material respect any of its representations or obligations under the Investment Agreement and the breach or failure is not cured within ten days after notice from the other party, the breaching party will be required to pay the other party $4,000,000 as a termination fee plus up to $1,000,000 of actual out-of-pocket expenses incurred by the other party. Viisage also shall be required to pay the termination fee and up to $1,000,000 of L-1 s actual out-of-pocket expenses if the Viisage board fails to make or withdraws its recommendation to the stockholders that they approve the investment or if Viisage materially breaches its obligations relating to the non-solicitation of competing transactions.

We believe that our existing cash balances, anticipated closing of investment transaction with L-1, and anticipated cash flows from operations will be sufficient to meet our operating and debt service requirements for the next 12 months, as well as fund our acquisition strategy. However, if we cannot achieve our operating goals in 2005 or 2006 or if the L-1 investment described above does not occur or if we win additional drivers license contracts in 2005, we may be required to seek additional financing. There can be no assurance that such financing will be available on commercially reasonable terms, or at all. Our ability to meet our business forecast is dependent on a number of factors, including those described in the section of this report entitled Factors that May Affect Future Results.

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CONTRACTUAL OBLIGATIONS

The following table sets forth our contractual obligations as of October 2, 2005 (in thousands).

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Capital Lease Obligations	$ 360	$ 141	$ 219	$	$
Operating Lease Obligations	$ 3,141	$ 506	$ 1,416	$ 1,104	$ 116

As of October 2, 2005, we had standby letters of credit issued by Citizens Bank for approximately $2.3 million to certain of our customers.

CONTINGENT OBLIGATIONS

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

INFLATION

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

FORWARD-LOOKING STATEMENTS

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

FACTORS THAT MAY AFFECT FUTURE RESULTS

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

We have a history of operating losses.

We have a history of operating losses. Our business operations began in 1993 and, except for fiscal years 1996 and 2000, have resulted in net losses in each fiscal year, including a net loss of $7.0 million in 2004 and $4.3 million for the nine months October 2, 2005. At October 2, 2005, we had an accumulated deficit of approximately $49.1 million. We expect to continue to invest in the development of our secure credential and biometric technologies. Accordingly, we cannot predict when or if we will ever achieve sustained profitability on an annual basis.

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

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

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

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

include provisions that allow the government agency to terminate the contract without penalty under some circumstances;

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- be subject to purchasing decisions of agencies that are subject to political influence;
- contain onerous procurement procedures; and
- be subject to cancellation if government funding becomes unavailable.

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

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

For the three- and nine-month periods ended October 2, 2005, one customer, the U.S. Department of State, accounted for an aggregate of 20.5% and 26.5%, respectively, of our revenue. The loss of any of our significant customers would cause revenue to decline and could have a material adverse effect on our business.

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

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

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

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

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

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

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

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

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

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

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 10-K for the year ended December 31, 2004, we were required to furnish a report by our management on our internal control over financial reporting with each year s Form 10-K. Such report must contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our

internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. Such report must also contain a statement that our auditors have issued an attestation report on management s assessment of such internal controls. Management s report and our auditors attestation report for 2004 were included in our Annual Report on Form 10-K/A for the year ended December 31, 2004 under Item 8.

Our external auditors notified management and the audit committee of our board of directors that they believed there were material weaknesses due to insufficient personnel resources and technical accounting expertise within the accounting function to effect a timely financial close process and to evaluate and resolve non-routine and/or complex accounting transactions, and in the control processes around information technology systems. These material weaknesses could result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Management has determined that it is in agreement with the auditors initial assessment that these control deficiencies constituted a material weakness as of December 31, 2004, and October 2, 2005. Because of these material weaknesses, management has concluded that we did not maintain effective internal control over financial reporting as of December 31, 2004 and October 2, 2005. Our management has identified certain steps designed to address the material weaknesses described above, and has begun to execute remediation plans, as discussed in Item 8 of our Annual Report on Form 10-K/A for the year ended December 31, 2004 and Part I, Item 4 of this Quarterly Report on Form 10-Q.

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

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

Changes in the laws and regulations that have recently been enacted, including regulations under of the Sarbanes-Oxley Act of 2002, are likely to continue to increase our expenses as we devote resources in response to them. Consequently, as we take steps to further improve and strengthen our financial management and controls, we anticipate corresponding increases in our operating expenses that may reduce our profitability in the future.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- liability for damages and litigation costs, including attorneys fees;

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

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

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

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

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

In the fiscal years ended December 31, 2003 and 2004, and nine-month periods ended October 2, 2005 and September 26, 2004, we sold substantially all of our services and licensed substantially all of our products through our direct sales organization. Our future success depends on substantially increasing the size and scope of our direct sales force and partnering arrangements, both domestically and internationally. We will face intense competition for personnel, and we cannot guarantee that we will be able to attract, assimilate or retain additional qualified sales personnel on a timely basis. Moreover, given the large-scale deployment required by some of our customers, we will need to hire and retain a number of highly trained customer service and support personnel. We cannot guarantee that we will be able to increase the size of our customer service and support organization on a timely basis to provide the high quality of support required by our customers. Failure to add additional sales and customer service representatives could result in our inability to increase our sales and support our customers.

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

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

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

In addition, the differences between U.S. and German business cultures and the geographic distance between the companies could present significant obstacles to our timely, cost-effective integration of ZN. Our strategy contemplates acquiring additional businesses, the integration of which may consume significant financial and managerial resources, and could have a severe negative impact on our business, financial condition and results of operations

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

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

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

The transaction costs and expenses attributable to financial advisory, legal and accounting services that we incurred have been capitalized as a component of the purchase price. Goodwill and other intangible assets associated with the acquisitions are required to be tested at least annually for impairment, and we will be required to record a charge to earnings if there is an impairment in the value of such assets.

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

As a result of our acquisitions of ZN, TDT and Imaging Automation, goodwill and other intangible assets have been created. The values recorded at the purchase date for goodwill and other intangible assets represent fair values calculated by independent third-party appraisers at such points in time. Such valuations require significant estimates and assumptions, which are derived from information obtained from the management of the acquired businesses and our business plans for the acquired businesses or intellectual property. If estimates and assumptions used to initially value goodwill and intangible assets prove to be inaccurate, ongoing reviews of the carrying values of such goodwill and intangible assets may indicate impairments which will require us to record a charge in the period in which such an impairment is identified, which could have a severe negative impact on our business, financial condition and results of operations.

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

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

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

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

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

economic conditions in European markets, including fluctuations in the relative values of the U.S. dollar and the Euro;

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- taxes and fees imposed by European governments that may increase the cost of products and services; and
- laws and regulations imposed by individual countries and by the European Union.

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

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

As a result of our acquisitions of ZN, TDT and Imaging Automation, we expect that we will have increased exposure to foreign currency fluctuations. Net revenue and related expenses generated from our operations in Germany are denominated in euros. The results of operations and certain of our inter-company balances associated with this location are exposed to foreign exchange rate fluctuations. As of October 2, 2005 and December 31, 2004, the accumulated other comprehensive income (loss) includes foreign currency translation adjustments was $1.7 million and $322,000, respectively. In addition to our German operation, we have significant Japanese Yen-denominated transactions with Japanese vendors supplying hardware and consumables for the delivery of certain large contracts. Fluctuations in foreign currencies, including our Japanese Yen-denominated transaction, could result in unexpected fluctuations to our results of operations, which could be material and adverse.

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

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

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

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

- the proprietary nature or protection of our methodologies is not recognized in the United States or foreign countries;
- third parties misappropriate our proprietary methodologies and such misappropriation is not detected; and

competitors create applications similar to ours but which do not technically infringe on our legally protected rights.

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

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

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

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

Beyond the acquisitions of ZN, TDT and Imaging Automation, our growth strategy includes additional acquisitions of companies or technologies that complement ours. Of the $100 million proceeds we will receive if the L-1 investment is consummated, $85 million are to be used to finance acquisitions, pursuant to the terms of the investment agreement between us and L-1. Future acquisitions could involve risks inherent in acquisitions, such as:

challenges associated with integrating acquired technologies and the business and operations of acquired companies;

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

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

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

We believe that the continued service of our executive officers will be important to our future growth and competitiveness. We have entered into employment agreements with Bernard C. Bailey, our Chief Executive Officer, Bradley T. Miller, our Chief Financial Officer, Iftikhar Ahmad, our Senior Vice President, Worldwide Services, Mohamed Lazzouni, our Chief Technology Officer, and James P. Ebzery, our Senior Vice President, Customer Solutions. These agreements are intended to provide the executives with incentives to remain employed by us. However, we cannot assure you that they will remain employed by us. In addition, we believe that the continued employment of key members of our technical and sales staff is important to us. Most of our employees are entitled to voluntarily terminate their relationship with us, typically without any, or with only minimal, advance notice. The process of finding additional trained personnel to carry out our strategy could be lengthy, costly and disruptive. We may be unable to retain the services of all of our key employees or a sufficient number of them to execute our plans. In addition, we may be unable to attract new employees as required.

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

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

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

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

Lau Technologies, or Lau, and Mr. Buddy Beck, the former sole stockholder of TDT who is now a director and Vice Chairman of our Board of Directors, beneficially own approximately 11.3% and 11.9%, respectively, of our outstanding common stock. As a result, both Lau and Mr. Beck have a strong influence on matters requiring approval by our stockholders, including the election of directors and most corporate actions, including mergers and acquisitions. In addition, we have significant relationships with each of Lau and Mr. Beck, including:

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

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

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

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

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

If the L-1 investment is consummated, L-1 will become our largest shareholder and Mr. Robert LaPenta, the Chief Executive Officer of L-1, will become the Chairman of our Board of Directors. These relationships, and other relationships we may enter into in the future with L-1, will have risks similar to those arising from our relationships with Lau and Mr. Beck.

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

As of November 8, 2005, there were 48,147,492 shares of our common stock outstanding. Lau and Mr. Buddy Beck own approximately 11.3% and 11.9%, respectively, of our common stock. If either of these stockholders sell a significant number of shares of our common stock in the open market, our stock price could decline. If the L-1 investment is consummated, L-1 will become our largest shareholder. If, following the investment, L-1 should sell a significant number of shares of our common stock in the open market, our stock price could decline.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Since our January 2004 acquisition of ZN, our international operating results from transactions by our German operations have been denominated in euros. As of October 2, 2005, the cumulative loss from foreign currency translation adjustments was approximately $1.7 million. Hardware and consumables purchases related to contracts associated with the TDT acquisition are denominated in Japanese Yen. We mitigate exchange rate volatility by utilizing foreign currency forward contracts. Prior to 2005, we did not hedge foreign currencies using derivative instruments. Subsequent to year end, we entered into derivatives contracts as cash flow hedges to mitigate exchange risk associated with our Japanese Yen purchases. For the quarter ended October 2, 2005, we had unrealized losses related to transactions with Japanese vendors of approximately $18,000. Our international operations and transactions are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign currency exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

ITEM 4 CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures*. In connection with the preparation of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of October 2, 2005. We previously reported two material weaknesses in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act), which were described in Item 9A and Management s Report on Internal Control Over Financial Reporting in our Annual Report on Form 10-K/A for the year ended December 31, 2004. As a result of these material weaknesses in our internal control over financial reporting, we have concluded that our disclosure controls and procedures were not effective as of October 2, 2005.

(b) *Changes in internal controls.* In performing its evaluation of our internal controls over financial reporting for the year ended December 31, 2004, management determined that there were two internal controls that had significant deficiencies which constituted material weaknesses in our control processes. The first of these was with regard to insufficient personnel resources and technical accounting expertise within the accounting function to effect a timely financial close process and to effectively evaluate and resolve non-routine and/or complex accounting

transactions. The second was with regard to inadequate or ineffective control processes around information technology systems, including inadequate security, inadequate restricted access to systems, inadequate segregation of duties within systems, lack of appropriate system documentation, ineffective change management processes and insufficient disaster recovery plans. As described in our Annual Report on Form 10-K/A for the year ended December 31, 2004 and our Quarterly Reports on Form 10-Q for the periods ended April 3, 2005 and July 3, 2005, management has taken a number of steps to address these material weaknesses. In addition, during the quarter ended October 2, 2005, management took the following steps they believe necessary to help address the material weaknesses described above.

- Hired an experienced director of internal audit who is a certified public accountant who started in August 2005;

- Hired a Chief Financial Officer with 20 years experience in financial management, public reporting, technical accounting, systems and controls who started in September 2005;

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- Continued to streamline our financial close process through enhanced implementation of our existing financial management and accounting system;

- Hired external advisors with significant expertise assisting companies document, assess, and recommend improvements to their internal control environments, including their information technology environment;

- Implemented new reports to monitor access to our information technology, or IT, systems; and

- Completed policy and procedure documentation related to change control processes for our IT systems and related processes.

We continue to plan and expect to implement additional changes to our infrastructure and related processes that we believe are also reasonably likely to strengthen and materially affect our internal control over financial reporting. These include:

- Hiring additional accounting and finance resources;

- Continuing to expand the implementation of our existing financial management and accounting system;

- Continuing to standardize internal processes; and

- Changing responsibilities to help ensure appropriate access to our IT systems by consultants and authorized personnel.

The changes in our internal control over financial reporting implemented by us to date will not in and of themselves remediate the material weaknesses, and certain of these remedial measures will require some time to be fully implemented or to take full effect. Prior to the remediation of these material weaknesses, there remains risk that the transitional controls, described below, on which we currently rely will fail to be sufficiently effective, which could result in material misstatement of our financial position or results of operations and require a restatement.

We are currently implementing an enhanced controls environment intended to address the material weaknesses in our internal control over financial reporting and to remedy the ineffectiveness of our disclosure controls and procedures. While this implementation phase is underway, we are continuing to rely on extensive manual procedures, While we are undertaking the implementation of this new controls environment, there remains risk that the transitional controls on which we are currently relying will fail to be sufficiently effective. We also note, however, that a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must include an assessment of the costs and related risks associated with the control and the purpose for which it was intended. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues including instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some person, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our control systems, as we develop them, may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected and could be material and require a restatement of our financial statements.

There were no material changes to any reported financial results that have been released by us in this or any other filing as a result of these identified deficiencies. The impact of the above conditions was relevant to the fiscal year ended December 31, 2004 and the nine months ended October 2, 2005 only and did not affect the results of any prior periods.

The certifications of our principal executive officer and principal financial officer required in accordance with Rule 13a-14(a) under the Exchange Act are attached as exhibits to this Quarterly Report on Form 10-Q. The disclosures set forth in this Item 4 contain information concerning the evaluation of our disclosure controls and procedures, and changes in our internal control over financial reporting, referred to in paragraph 4 of those certifications. Those certifications should be read in conjunction with this Item 4 for a more complete understanding of the matters covered by the certifications.

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VIISAGE TECHNOLOGY, INC.

PART II - OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

See Item 1 of Part II of our Quarterly Report on Form 10-Q for the quarter ended July 3, 2005 for a description of certain legal proceedings involving Viisage. There have been no material changes in such proceedings since the date of such Form 10-Q.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On September 30, 2005, we held a special meeting in lieu of our annual shareholders meeting. At that meeting, the following matters were voted on and approved:

(a) Robert Gelbard, Peter Nessen and Thomas J. Reilly were elected as Class III directors to serve three-year terms. The vote was 42,366,183 for and 1,006,405 withheld with respect to Mr. Gelbard; 41,376,177 for and 1,996,411 withheld with respect to Mr. Nessen, and 41,495,204 for and 1,877,284 withheld with respect to Mr. Reilly.

(b) The decision to approve the adoption of the Viisage 2005 Long-Term Incentive Plan was ratified. The vote was 17,108,223 for, 5,436,219 against, 182,353 abstained and 20,646,193 not voted.

(c) The selection of BDO Seidman, LLP as our independent public accountants for the year ending December 31, 2005, was ratified. The vote was 43,190,231 for, 90,022 against and 92,735 abstained.

ITEM 5 OTHER INFORMATION

None.

ITEM 6 EXHIBITS

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

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VIISAGE TECHNOLOGY, INC.

SIGNATURES

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

Date: November 10, 2005	By:	/s/ Bernard C. Bailey **Bernard C. Bailey** **President and Chief Executive Officer** **(Principal Executive Officer)**
Date: November 10, 2005	By:	/s/ Bradley T. Miller **Bradley T. Miller** **Senior Vice President and Chief Financial Officer** **(Principal Financial Officer)**

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EXHIBIT INDEX

Exhibit No.	Note	Description
10.1	(a)	Second Amendment to Loan and Security Agreement dated as of March 16, 2005 by and among Viisage Technology, Inc., Trans Digital Technologies Corporation, Imaging Automation, Inc., Biometrica Systems, Inc. and Citizens Bank of Massachusetts.
31.1	(a)	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	(a)	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	(a)	Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	(a)	Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Note	Description
(a)	Filed herewith.

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