L-1 IDENTITY SOLUTIONS, INC.
Form 10-Q
May 09, 2007

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended March 31, 2007.**

**OR**

o **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 001-21559**

**L-1 IDENTITY SOLUTIONS, INC.**

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware**<br>**(State or other jurisdiction of incorporation or organization)** | **04-3320515**<br>**(I.R.S. Employer Identification No.)** |
| **177 Broad Street, 12th Floor, Stamford, CT**<br>**(Address of principal executive offices)** | **06901**<br>**(Zip Code)** |

**(203) 504-1100**
**Registrant s telephone number, including area code**

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

Indicate by a check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o

Indicate by a check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) o 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 May 8, 2007 |
|---|---|

| | |
|---|---|
| Common stock, $.001 par value | 72,841,528 |

**L-1 IDENTITY SOLUTIONS, INC.**

FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2007

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PART 1 FINANCIAL INFORMATION

**ITEM 1 UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**L-1 IDENTITY SOLUTIONS, INC.**

**Condensed Consolidated Balance Sheets**

**(in thousands)**

**(Unaudited)**

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 4,077 | $ 4,993 |
| Accounts receivable, net | 54,094 | 61,513 |
| Inventory | 14,078 | 10,967 |
| Other current assets | 4,135 | 4,529 |
| Total current assets | 76,384 | 82,002 |
| Property and equipment, net | 20,025 | 19,928 |
| Goodwill | 972,455 | 951,443 |
| Intangible assets, net | 168,046 | 170,098 |
| Other assets, net | 4,714 | 3,754 |
| Total assets | $ 1,241,624 | $ 1,227,225 |
| **Liabilities and Shareholders Equity** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ 53,958 | $ 54,807 |
| Current portion of deferred revenue | 11,732 | 10,331 |
| Other current liabilities | 4,918 | 5,206 |
| Total current liabilities | 70,608 | 70,344 |
| Deferred tax liability | 5,435 | 4,394 |
| Deferred revenue, net of current portion | 3,977 | 3,734 |
| Long-term debt | 98,000 | 80,000 |
| Other long-term liabilities | 966 | 1,668 |
| Total liabilities | 178,986 | 160,140 |
| Shareholders equity | 1,062,638 | 1,067,085 |
| Total liabilities and shareholders equity | $ 1,241,624 | $ 1,227,225 |

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

**L-1 IDENTITY SOLUTIONS, INC.**

**Condensed Consolidated Statements of Operations**

**(in thousands, except per share data)**

**(Unaudited)**

| | Three Months Ended | |
|---|---|---|
| | **March 31, 2007** | **March 31, 2006** |
| **Revenues** | $ 70,007 | $ 23,438 |
| **Cost of revenues:** | | |
| Cost of revenues | 46,177 | 15,171 |
| Amortization of purchased intangible assets | 6,474 | 1,868 |
| Total cost of revenues | 52,651 | 17,039 |
| **Gross Profit** | 17,356 | 6,399 |
| **Operating expenses:** | | |
| Sales and marketing | 5,461 | 2,369 |
| Research and development | 4,661 | 1,611 |
| General and administrative | 12,817 | 4,577 |
| Amortization of purchased intangible assets | 431 | 117 |
| Total operating expenses | 23,370 | 8,674 |
| **Operating Loss** | (6,014) | (2,275) |
| Interest income | 67 | 671 |
| Interest expense | (1,771) | (6) |
| Other (expense) income, net | (25) | 17 |
| **Loss before income taxes** | (7,743) | (1,593) |
| Provision for income taxes | (1,088) | (565) |
| **Net Loss** | $ (8,831) | $ (2,158) |
| **Basic and diluted net loss per share** | $ (0.12) | $ (0.07) |
| **Weighted average basic and diluted common shares outstanding** | 72,540 | 29,008 |

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

**L-1 IDENTITY SOLUTIONS, INC.**

**Condensed Consolidated Statements of Changes in Shareholders Equity and Comprehensive Loss**

**(In thousands)**

**(Unaudited)**

| | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Loss | Total | Comprehensive Loss |
|---|---|---|---|---|---|---|
| Balance, January 1, 2006 | $ 29 | $ 333,456 | $ (56,427) | $ (2,398) | $ 274,660 | |
| Exercise of employee stock options | 1 | 7,180 | | | 7,181 | |
| Common stock issued for directors fees | | 288 | | | 288 | |
| Common stock issued under employee stock purchase plan | | 53 | | | 53 | |
| Common stock issued for acquisition, net of issuing costs | 43 | 769,931 | | | 769,974 | |
| Fair value of vested stock options and warrants assumed for acquisition | | 35,103 | | | 35,103 | |
| Retirement plan contributions paid in common stock | | 288 | | | 288 | |
| Stock-based compensation expense | | 7,492 | | | 7,492 | |
| Comprehensive loss: | | | | | | |
| Foreign currency translation adjustment | | | | 3,083 | 3,083 | $ 3,083 |
| Net loss | | | (31,037) | | (31,037) | (31,037) |
| Comprehensive loss | | | | | | $ (27,954) |
| Balance, December 31, 2006 | 73 | 1,153,791 | (87,464) | 685 | 1,067,085 | |
| Exercise of employee stock options | | 1,706 | | | 1,706 | |
| Common stock issued for directors fees | | 136 | | | 136 | |
| Common stock issued under employee stock purchase plan | | 511 | | | 511 | |
| Retirement plan contributions paid in common stock | | 148 | | | 148 | |
| Stock-based compensation expense | | 1,781 | | | 1,781 | |
| Comprehensive loss: | | | | | | |
| Foreign currency translation adjustment | | | | 102 | 102 | $ 102 |
| Net loss | | | (8,831) | | (8,831) | (8,831) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Comprehensive loss | | | | | | $ (8,729) |
| Balance, March 31, 2007 | $ 73 | $ 1,158,073 | $ (96,295) | $ 787 | $ 1,062,638 | |

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

**L-1 IDENTITY SOLUTIONS, INC.**

**Condensed Consolidated Statements of Cash Flows**

**(in thousands)**

**(Unaudited)**

| | Three Months Ended | |
|---|---|---|
| | March 31, 2007 | March 31, 2006 |
| **Cash Flow from Operating Activities:** | | |
| Net loss | $ (8,831) | $ (2,158) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 9,060 | 4,094 |
| Stock-based compensation expense | 2,579 | 659 |
| Retirement plan contributions paid in common stock | 148 | |
| Deferred income taxes | 1,041 | 508 |
| Amortization of deferred financing costs | 134 | |
| Changes in operating assets and liabilities, net of effects of acquisitions: | | |
| Accounts receivable | 10,244 | (373) |
| Inventory | (1,800) | (862) |
| Other assets | (172) | (969) |
| Accounts payable and accrued expenses | (10,174) | 1,877 |
| Deferred revenue | (836) | 925 |
| Net cash provided by operating activities | 1,393 | 3,701 |
| **Cash Flow from Investing Activities:** | | |
| Cash paid for acquisitions, net of cash acquired | (20,441) | (29,362) |
| Capital expenditures | (1,817) | (1,311) |
| Other assets | (65) | |
| Net cash used in investing activities | (22,323) | (30,673) |
| **Cash Flow from Financing Activities** | | |
| Borrowings under revolving credit agreement, net | 18,000 | |
| Principal payments on long-term debt | (59) | (131) |
| Financing costs | (106) | |
| Proceeds of issuance of common stock and warrants | 2,105 | 1,159 |
| Net cash provided by financing activities | 19,940 | 1,028 |
| Effect of exchange rate changes on cash and cash equivalents | 74 | (13) |
| Net decrease in cash and cash equivalents | (916) | (25,957) |
| Cash and cash equivalents, beginning of period | 4,993 | 72,385 |

| | | |
|---|---|---|
| Cash and cash equivalents, end of period | $ 4,077 | $ 46,428 |
| **Supplemental Cash Flow Information:** | | |
| Cash paid for interest | $ 1,511 | $ 7 |
| Cash paid for income taxes | $ 790 | $ 317 |

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



**L-1 IDENTITY SOLUTIONS, INC.**
**Notes to Condensed Consolidated Financial Statements**
**(Unaudited)**

1. DESCRIPTION OF BUSINESS

L-1 Identity Solutions, Inc. and its subsidiaries ( L-1 or the Company ) provide a full range of identity protection and security solutions that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy. L-1 s identity solutions are specifically designed for the identification of people and include secure credentialing, biometrics, automated document authentication, real-time identity databases, automated testing of identity and identity information, and biometrically-enabled background checks, as well as systems design, development, integration and support services. These identity solutions enable L-1 s customers to manage the entire life cycle of an individual s identity for a variety of applications including civil identification, criminal identification and border management and security. L-1 also provides comprehensive security solutions to the U.S. Government.

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

The Company has developed and acquired complimentary technologies and businesses that allow it to offer a full range of secure credentialing and biometric solutions, including facial, fingerprint and iris recognition solutions and technologies to customers, as well as provide security solutions to the U.S. Government.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis of Presentation and Principles of Consolidation*

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a fair presentation of the financial statements for the interim periods. The unaudited condensed consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission ( SEC ) for interim financial statements, and in accordance with SEC rules, omit or condense certain information and footnote disclosures. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

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

*Use of Estimates*

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

*Revenue Recognition*

The Company derives its revenue from solutions that include products and services, as well as sales of stand alone services, hardware, components, consumables and software. Identity Solutions revenue includes revenues from maintenance, consulting and training services related to sales of hardware and software solutions. Services revenue includes fingerprinting services and security consulting services. A customer, depending on its needs, may order hardware, equipment, consumables or software products or services or combine hardware products, consumables, equipment, software products and services to create a multiple element arrangement. The Company s revenue recognition policies are described in the notes to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

*Stock Based Compensation*

On January 1, 2006, L-1 adopted Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-Based Payment*, which requires share-based payment transactions to be accounted for using a fair value-based method and the recognition of the related expense in the results of operations. L-1 uses the Black-Scholes valuation method to estimate the fair value of option awards. The compensation expense related to share based payments is recognized over the vesting period for awards granted after January 1, 2006 and over the remaining service period for the unvested portion of awards granted prior to January 1, 2006.

Determining the appropriate valuation method and related assumptions requires judgment, including estimating common stock price volatility, forfeiture rates and expected terms. The following weighted average assumptions were utilized in the valuation of stock option awards for the three months ended March 31, 2007 and 2006:

| | Three Months Ended | |
|---|---|---|
| | March 31, 2007 | March 31, 2006 |
| Expected common stock price volatility | 91.3% | 110.0% |
| Risk free interest rate | 4.3% | 4.4% |
| Expected life of options | 6.3 Years | 6.3 Years |
| Expected annual dividends | | |

The expected volatility rate is based on the historical volatility of the Company s common stock. The expected life of options is based on the average life of 6.3 years pursuant to the guidance from Staff Accounting Bulletin No. 107. The Company estimated forfeitures when recognizing compensation expense based on historical rates. The risk free interest rate is based on the 7 year treasury security as it approximates the 6.3 expected life of the options. The Company updates these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are warranted.

Stock-based compensation expense was $2.7 million and $0.7 million for the three months ended March 31, 2007 and 2006, respectively, and includes $0.1 million related to restricted stock for both periods and for the 2007 period, approximately $0.1 million of retirement contributions paid in common stock. The Company recognized the full cost impact of the awards issued under its equity incentive plans in the condensed consolidated statements of operations for the three months ended March 31, 2007 and 2006 and did not capitalize any such costs. The following tables presents stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2007 | March 31, 2006 |
| Cost of revenues | $ 143 | $ 85 |
| Research and development | 225 | 97 |
| Sales and marketing | 405 | 171 |
| General and administrative | 1,954 | 306 |
| Stock-based compensation expense | $ 2,727 | $ 659 |

*Computation of Net Loss per Share*

The basic and diluted net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. The impact of approximately 4,646,000 and 4,407,000 common equivalent shares for three-month periods ended March 31, 2007 and March 31, 2006, respectively, consisting of all outstanding options and warrants were not reflected in the dilutive net loss per share calculations as their effect would be anti-dilutive.

*Recent Accounting Pronouncements*

In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109* , which is effective for fiscal years beginning after December 15, 2006. The interpretation provides that a tax position is recognized if the enterprise determines that it is more likely than not that a tax position will be sustained based on the technical merits of the position, on the presumption that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods and transition. The adoption of Interpretation No. 48 on January 1, 2007 did not have a material impact on the consolidated financial statements.

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Options for the Financial Assets and Financial Liabilities*, which permits entities to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 is effective for years beginning after November 15, 2007. The Company has not determined whether it will adopt the fair value option method permitted by SFAS No. 159.

3. STOCK OPTIONS

*Stock Options*

The following table summarizes the stock option activity from January 1, 2007 through March 31, 2007:

| | Stock Options | Weighted Average Exercise Price | Weighted Average Remaining Life (Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2007 | 6,370,051 | $ 12.96 | | |
| Granted | 131,000 | 15.78 | | |
| Exercised | (210,701) | 8.96 | | |
| Canceled/expired/forfeited | (50,505) | 15.93 | | |
| Outstanding at March 31, 2007 | 6,239,845 | 13.36 | 6.82 | $ 24,702,094 |
| Vested or expected to vest at March 31, 2007 (1) | 4,717,323 | $ 10.10 | 6.82 | $ 18,674,783 |
| Exercisable at March 31, 2007 | 3,771,429 | $ 12.31 | 5.28 | $ 20,433,087 |

(1) Options expected to vest are determined by applying the pre-vesting forfeiture rate assumptions to total outstanding options.

The aggregate unearned compensation cost of unvested options outstanding as March 31, 2007 was $20.5 million and will be amortized over a weighted average period of 3.2 years. The total intrinsic value of options exercised during the three months ended March 31, 2007 was $1.5 million. The intrinsic value is calculated as the difference between the market value of the Company s common stock and the exercise price of options.

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

4. INCOME TAXES

The income tax provision for the three month periods ended March 31, 2007 and 2006 includes approximately $1.1 million and $0.5 million, which represent the aggregate increase of a deferred tax asset resulting from losses incurred during the periods, a full valuation allowance against such deferred tax asset, and, pursuant to SFAS No. 109, an additional provision related to the amortization of tax deductible goodwill for which the period of reversal of the related temporary difference is indefinite. This related deferred tax liability cannot be used to offset the deferred tax asset in determining the valuation allowance. The income tax provision also includes state income tax expense for the three month period ended March 31, 2007 of $0.1 million and $0.1million for the three months ended March 31, 2006.

The Company is subject to income tax examinations by U.S. Federal and other jurisdictions for tax years ended, subsequent to December 31, 2002. The condensed financial statements do not include any provision for interest or penalties. In the event interest and penalties are incurred, the Company may make an election to account for interest expense and penalties related for income tax issues as income tax expense.

5. RELATED PARTY TRANSACTIONS

Aston Capital Partners, L.P. ( Aston ), an affiliate of L-1 Investment Partners LLC, Lau Technologies ( Lau ), an affiliate of Mr. Denis K. Berube, a member of the board of directors of the Company, and Mr. Buddy Beck, also a member of the board of directors of the Company beneficially own approximately 10.5%, 3.0%, and 3.0%, respectively, of L-1 s outstanding common stock. Mr. Robert V. LaPenta, Mr. James DePalma, Mr. Joseph Paresi and Ms. Doni Fordyce, each executive officers of the Company, directly and indirectly hold all the beneficial ownership in L-1 Investment Partners LLC and Aston Capital Partners GP LLC, the investment manager and general partner of Aston Capital Partners, L.P., respectively. Mr. LaPenta is also the Chairman of the Board of Directors, Chief Executive Officer and President of the Company. Mr. DePalma is also the Chief Financial Officer and Treasurer of the Company.

The Company has consulting agreements with Mr. Berube and his spouse, Ms. Joanna Lau, under which each receives annual compensation of $0.1 million. Each agreement terminates on the earlier of July 10, 2012 or commencement of full time employment elsewhere. During the three months ended March 31, 2007, $0.04 million, and for the three months ended March 31, 2006, $0.04 million was paid in the aggregate to Mr. Berube and Ms. Lau for these services.

Under the terms of a 2002 acquisition agreement of Lau Security Systems, the Company is obligated to pay Lau a royalty of 3.1% on certain of its face recognition revenues through June 30, 2014, up to maximum royalties of $27.5 million. Royalty expense included in cost of revenues was approximately $0.01 million and $0.01 million for the three months ended March 31, 2007 and 2006, respectively.

In connection with a consulting agreement which terminated in April 2006, Mr. Beck received annual compensation of $0.3 million. For the three months ended March 31, 2006, Mr. Beck was paid $0.1 million for these services. At March 31, 2007 there was no outstanding balance owed to Mr. Beck.

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

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

In connection with the relocation of the corporate headquarters of L-1 in the third quarter of 2006 to the offices of L-1 Investment Partners LLC in Stamford, Connecticut, L-1 entered into a sublease with L-1 Investment Partners LLC under which L-1 will reimburse L-1 Investment Partners LLC for the rent and other costs payable by L-1, which is estimated at $0.7 million annually. For the three months ended March 31, 2007, L-1 incurred costs of $0.2 million and at March 31, 2007 the Company was obliged to pay the landlord $0.1 million.

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

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

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

In December 2005, Aston completed at $100.0 million investment in and became the beneficial owner of more than 5% of L-1 s outstanding common stock. In accordance with the terms of the investment agreement, L-1 issued to Aston warrants to purchase an aggregate of 1,600,000 shares of L-1 s common stock at an exercise price of $13.75 per share.

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

On April 23, 2007 the Company entered into an employee arrangement with Mr. Robert LaPenta, Jr., the son of the Company's Chief Executive Officer.

6. REPORTABLE SEGMENTS, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK

SFAS No. 131, *Disclosures about Segments of a Business Enterprise and Related Information*, establishes standards for reporting information regarding reportable and operating segments. Operating segments are defined as components of a company which the chief operating decision maker evaluates regularly in deciding how to allocate resources and assess performance. The Company s chief operating decision maker is its Chief Executive Officer. Effective with the acquisition of IBT in December 2005, the Company operates in two operating segments, the Identity Solutions segment and the Services segment. The Identity Solutions segment provides solutions that 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. The Services segment provides fingerprinting services to government, civil, and commercial customers, as well as security consulting services to U.S. Government agencies.

The Company measures segment performance primarily based on revenues and operating income (loss) and Adjusted EBITDA. Operating results by segment for the three months ended March 31, 2007 and March 31, 2006 were as follows (in thousands):

| | Three months ended March 31, 2007 | Three months ended March 31, 2006 | As of March 31, 2007 |
|---|---|---|---|

| | Three months ended March 31, 2007 | | Three months ended March 31, 2006 | | As of March 31, 2007 | |
|---|---|---|---|---|---|---|
| | Revenues | Operating Loss | Revenues | Operating Loss | Total Assets | Goodwill |
| Identity Solutions | $ 36,303 | $ (7,017) | $ 17,850 | $ (2,241) | $ 1,025,913 | $ 820,056 |
| Services | 33,704 | 1,003 | 5,888 | (34) | 209,516 | 152,399 |
| Corporate | | | | | 6,195 | |
| | $ 70,007 | $ (6,014) | $ 23,438 | $ (2,275) | $ 1,241,624 | $ 972,455 |

Corporate assets consist mainly of cash and cash equivalents and deferred financing costs. Effective January 1, 2007, the Company began allocating corporate costs using a three factor formula based on sales, payroll and capital assets. Prior to the merger with Identix, all corporate costs were allocated to the Identity Solutions segment.

Revenues by market are as follows for the three months ended March 31, 2007 and 2006 (in thousands):

| | Three months ended | |
|---|---|---|
| | March 31, 2007 | March 31, 2006 |
| State and local | $ 28,557 | $ 17,561 |
| Federal | 40,305 | 5,670 |
| Commercial | 1,145 | 207 |
| | $ 70,007 | $ 23,438 |

The Company s operations outside the United States include a wholly owned subsidiary in Bochum, Germany and ConnetiX, which has operations in Ontario, Canada. Revenues are attributed to each region based on the location of the customer. The following is a summary of revenues and total assets by geographic region (in thousands):

| | Three months ended | | Total assets as of | |
|---|---|---|---|---|
| | March 31, 2007 | March 31, 2006 | March 31, 2007 | March 31, 2006 |
| United States | $ 61,476 | $ 21,259 | $ 1,189,273 | $ 275,475 |
| Rest of the World | 8,531 | 2,179 | 52,351 | 26,188 |
| | $ 70,007 | $ 23,438 | $ 1,241,624 | $ 301,663 |

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

For the three month period ended March 31, 2007, one Federal government agency accounted for 26% of the Company s consolidated revenues. For the three month period ended March 31, 2006, two Federal government agencies accounted for 37% of the Company s consolidated revenues. As of March 31, 2007, the Company had an accounts receivable balance of approximately $13.4 million from one Federal government agency which was the only customer that had a balance of greater than 10% of consolidated accounts receivable. As of March 31, 2006, one Federal government agency was the only customer that had a balance of greater than 10% of consolidated accounts receivable, which was approximately $2.9 million.

7. ACQUISITIONS

On February 21, 2007, the Company acquired ComnetiX, Inc. ( ComnetiX ) which provides biometric identification and authentication technologies to private and public sector companies in Canada and the United States. The Company acquired ComnetiX because of its significant presence in the fingerprint services segment of the Canadian market and complimentary base of customers, particularly within the law enforcement community. ComnetiX is included in the Services reporting segment. The results of operations of ComnetiX have been included in the condensed consolidated statement of operations from the date of acquisition.

The aggregate purchase price of ComnetiX was approximately $18.6 million, including $0.8 million in transaction costs, all of which was funded by borrowings under the revolving credit facility. Preliminarily, the purchase price has been allocated as follows:

| | | |
|---|---|---|
| Current assets | $ | 4,566 |
| Other assets | | 491 |
| Current liabilities | | (5,732) |
| Note payable - long- term | | (50) |
| Intangible assets | | 4,899 |
| Goodwill | | 14,391 |
| | $ | 18,565 |

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

The following gives effect to the acquisition of ComnetiX as if it had occurred at the beginning of each period presented (in thousands except per share amounts):

| | Three months ended | | | |
|---|---|---|---|---|
| | March 31, 2007 | | March 31, 2006 | |
| Revenues | $ | 71,533 | $ | 25,979 |
| Net loss | | (10,488) | | (4,051) |
| Basic and dilutive loss per share | | (0.14) | | (0.14) |

The pro-forma data is presented for informational purposes only and may not necessarily be indicative of future results of operations or what the results of operations would have been had the Company acquired ComnetiX on the date indicated.

8. ADDITIONAL FINANCIAL INFORMATION

**Inventory** (in thousands):

| | March 31, 2007 | | December 31, 2006 | |
|---|---|---|---|---|
| Purchased parts and materials | $ | 8,337 | $ | 8,482 |
| Work in progress | | 572 | | 209 |
| Finished goods | | 5,169 | | 2,276 |
| Total Inventory | $ | 14,078 | $ | 10,967 |

Approximately $2.2 million and $3.2 million of inventory was maintained at customer sites at March 31, 2007 and December 31, 2006, respectively.

**Property and equipment** (in thousands):

| | March 31, 2007 | | December 31, 2006 | |
|---|---|---|---|---|
| System assets | $ | 48,900 | $ | 48,437 |
| Computer office equipment and software | | 3,935 | | 4,377 |
| Software | | 2,175 | | 1,944 |
| Machinery and equipment | | 1,166 | | 3,273 |
| Leasehold improvements | | 1,087 | | 423 |
| Other- including tooling and demo equipment | | 3,360 | | 2,595 |

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| | 60,816 | 58,504 |
| Less accumulated depreciation and amortization | 40,792 | 38,576 |
| Property and equipment, net | $ 20,025 | $ 19,928 |

For the three months ended March 31, 2007and 2006, depreciation and amortization expense of property and equipment was $2.2 million and $1.9 million, respectively.

**Goodwill** (in thousands):

The following summarizes the activity in goodwill for the three months ended March 31, 2007 (in thousands):

| | Identity Solutions | Services | Total |
|---|---|---|---|
| Balance beginning of period | $ 813,435 | $ 138,008 | $ 951,443 |
| ComnetiX acquisition | | 14,391 | 14,391 |
| Iridian acquisition purchase price allocation adjustment | 6,000 | | 6,000 |
| Other adjustments | 621 | | 621 |
| | $ 820,056 | $ 152,399 | $ 972,455 |

**Intangible Assets** (in thousands):

| | March 31, 2007 | | December 31, 2006 | |
|---|---|---|---|---|
| | Cost | Accumulated Amortization | Cost | Accumulated Amortization |
| Completed technology | $ 124,452 | $ (12,473) | $ 124,452 | $ (7,462) |
| Core technology | 6,020 | (1,119) | 5,500 | (785) |
| Trade names and trademarks | 27,778 | (919) | 25,600 | (557) |
| Customer contracts and relationships | 34,092 | (11,048) | 31,692 | (9,785) |
| Other | 2,103 | (840) | 2,103 | (660) |
| | $ 194,445 | $ (26,399) | $ 189,347 | $ (19,249) |

Amortization of intangible assets was $7.2 million and $2.0 million for the three months ended March 31, 2007 and March 31, 2006, respectively. Amortization for the current and subsequent five years and thereafter is as follows: $21.9 million, $26.9 million, $22.3 million, $20.5 million, $19.2 million, $19.2 million and $37.8 million.

**Products and Services Revenues**

The following represents details of the products and services for revenues for the three months ended March 31, 2007 and 2006 (in thousands):

| | Three months ended | |
|---|---|---|
| | March 31, 2007 | March 31, 2006 |
| Government consulting services | $ 18,026 | $ |
| Fingerprinting services | 14,084 | 5,588 |
| Drivers licenses | 7,999 | 8,099 |
| Software, hardware, consumables and components | 21,074 | 5,731 |
| Maintenance & other services | 8,824 | 4,020 |
| Total revenues | $ 70,007 | 23,438 |

9. CONTINGENCIES

In March and April 2005, eight putative class action lawsuits were filed in the United States District Court for the District of Massachusetts against L-1, Mr. Bernard C. Bailey, Mr. William K. Aulet (the Company s former Chief Financial Officer) and Mr. Denis K. Berube and other members of the Board of Directors of Viisage Technology, Inc. These lawsuits have been consolidated into one action under one case name: In re: Viisage Technology Securities Litigation, Civil Action No. 05-10438-MLW. The so-called Turnberry Group has been designated as lead plaintiff and its counsel has been designated as lead counsel. The amended consolidated complaint that was filed in February 2006 alleges violations of the federal securities laws by Viisage (now named L-1 Identity Solutions, Inc.) and certain officers and directors arising out of purported misstatements and omissions in Viisage s SEC filings related to certain litigation involving the Georgia drivers' license contract and related to the Viisage s reported material weaknesses in internal controls over financial reporting, which allegedly artificially inflated the price of the Company s stock during the period May 12, 2004 through March 2, 2005. In April 2006, the Company filed a motion to dismiss this case. In February 2007, the judge dismissed all claims related to the Georgia drivers' license contract and permitted the case to proceed on claims associated with purported internal control weaknesses over financial reporting. The Company believes that the plaintiff s remaining claims in this lawsuit are without merit and the Company intends to defend the action vigorously. The Company is not able to estimate the ultimate amount of the loss, if any, allegedly suffered by members of the putative class or the ultimate amount of legal costs and internal efforts associated with defending the company and officers and directors. The Company s insurance carrier is currently paying the defense costs of the Company and the individual defendants. Based on all facts and circumstances, including available insurance policies, management believes that it is unlikely that the eventual resolution of the litigation will have a material adverse effect on the consolidated financial statements.

In April 2005, two purported shareholder derivative actions also were filed against directors, naming Viisage as a nominal defendant. The suits claim that these directors breached their fiduciary duties to its shareholders and to Viisage generally in connection with the same set of circumstances alleged in the class action lawsuit. The complaints are derivative in nature and do not seek relief from the Company. One of these actions was filed in Massachusetts Superior Court and the other was filed in the United States District Court for the District of Massachusetts. In July 2005, the state court action was dismissed with prejudice at the plaintiff s request. An amended complaint in the federal court derivative action was filed in July 2006 in which the plaintiff added allegations regarding disclosures by Viisage s representatives that generally appear to be intended to support her contention that she was excused from making a demand on the board of directors before filing a derivative complaint. Oral arguments have not yet been scheduled by the court. The Company has filed a motion to dismiss the federal court action. The Company believes that the allegations and claims made in the remaining derivative lawsuit are likewise without merit and intends to defend the action vigorously.

In January 2004, LG Electronics USA, Inc. and LG Electronics, Inc. (a Korean corporation.) ( LG ) filed a lawsuit against Iridian Technologies, Inc., a wholly owned subsidiary of the Company, in federal court in New Jersey seeking to cancel Iridian s federal trademark registration for its IrisAccess trademark, and alleging that Iridian had made false statements by announcing that it had discontinued its IrisAccess line of products. At the time LG filed this lawsuit, the parties had been engaged in an ongoing negotiation regarding Iridian s introduction of new standard pricing for its licenses. LG contended that Iridian was not entitled to impose its new standard per user pricing on LG pursuant to the terms of the parties 2000 Amended and Restated Development, Distribution and Supply agreement (the License Agreement ). In August 2004, LG filed a demand for arbitration before the American Arbitration Association, seeking a finding that its fee for using Iridian s iris recognition technology remained at the original per unit pricing structure under the License Agreement. Shortly thereafter, Iridian terminated the License Agreement due to LG s failure to pay royalties as required under Iridian s new standard pricing. In response, LG filed another lawsuit in New Jersey federal court, asking the court to enter a finding that Iridian&