Cogent, Inc.
Form 10-Q
May 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**
Commission file number 000-50947

COGENT, INC.

(Exact name of registrant as specified in its charter)

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

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

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

None

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

Common Stock

(Title of Class)

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

Indicate by check mark whether the registrant is a larger 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 x Accelerated filer ¨ Non-accelerated filer ¨

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

As of May 1, 2006, there were 94,214,485 shares of the registrant s common stock outstanding.

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COGENT, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

COGENT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands, except share data)

	December 31, 2005 (audited)	March 31, 2006 (unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,805	$ 18,373
Investments in marketable securities	281,394	336,479
Billed accounts receivable, net of allowance for doubtful accounts of $429 at December 31, 2005 and $630 at March 31, 2006	42,804	19,108
Unbilled accounts receivable	3,257	2,775
Inventory and contract related costs	16,443	17,772
Prepaid expenses and other current assets	6,285	6,909
Deferred income taxes	33,140	33,123
Total current assets	403,128	434,539
Investments in marketable securities	49,401	29,708
Inventory and contract related costs	3,779	1,239
Property and equipment, net	33,136	33,005
Restricted cash	487	496
Deferred income taxes	22,106	18,400
Intangible and other assets	1,228	1,180
Total assets	$ 513,265	$ 518,567
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,873	$ 3,655
Accrued expenses	4,958	4,409
Income taxes payable	534	707
Deferred revenues	34,573	35,868
Total current liabilities	43,938	44,639
Long-term liabilities		
Deferred revenues	10,585	6,493
Other liabilities	130	130
Total liabilities	54,653	51,262
Commitments and contingencies (note 11)		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2005 and March 31, 2006, respectively		

Common stock, $0.001 par value; 245,000,000 shares authorized; 93,192,192 and 94,012,444 shares issued and outstanding at December 31, 2005 and March 31, 2006, respectively	120	120
Additional paid-in capital	418,031	415,966
Deferred stock-based compensation	(3,980)	
Retained earnings	45,291	52,038
Accumulated other comprehensive loss	(850)	(819)
Total stockholders equity	458,612	467,305
Total liabilities and stockholders equity	$ 513,265	$ 518,567

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share data)

(unaudited)

	For the three months ended March 31, 2005	2006
Revenues:		
Product revenues	$ 31,780	$ 16,868
Maintenance and services revenues	4,061	5,863
Total revenues	35,841	22,731
Cost of revenues:		
Cost of product revenues (1)	13,904	7,082
Cost of maintenance and services revenues (1)	1,218	1,649
Total cost of revenues	15,122	8,731
Gross profit	20,719	14,000
Operating expenses:		
Research and development (1)	2,442	2,267
Selling and marketing (1)	1,956	1,839
General and administrative (1)	2,391	2,693
Total operating expenses	6,789	6,799
Operating income	13,930	7,201
Other income:		
Interest income	1,388	3,489
Other, net	284	4
Total other income	1,672	3,493
Income before income taxes	15,602	10,694
Income tax provision	5,537	3,947
Net income	$ 10,065	$ 6,747
Basic net income per share	$ 0.12	$ 0.07
Diluted net income per share	$ 0.11	$ 0.07
Shares used in computing basic net income per share	82,008	93,685
Shares used in computing diluted net income per share	91,845	96,123

(1) Includes stock-based compensation expense as follows (Notes 1 and 3):

Cost of product revenues	$ 66	$ 86
Cost of maintenance and services revenues	129	171
Research and development expenses	529	231
Selling and marketing expenses	430	403
General and administrative expenses	664	494
	$ 1,818	$ 1,385

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Months Ended, March 31, 2005	Three Months Ended, March 31, 2006
Cash Flows from operating activities:		
Net income	$ 10,065	$ 6,747
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Tax benefit from stock option transactions	5,531	
Depreciation and amortization	446	464
Allowance for doubtful accounts	62	196
Stock-based compensation expense	1,818	1,385
Amortization of premium (discount) on available for sale securities	46	(287)
Deferred income taxes		3,707
Changes in assets and liabilities:		
Billed accounts receivable	(8,103)	23,501
Unbilled accounts receivable	213	482
Inventory and contract related costs	12,347	1,231
Prepaid expenses and other current assets	(806)	(623)
Other assets	(245)	12
Accounts payable	(602)	(245)
Accrued expenses	2,092	(551)
Income taxes payable	(5,676)	173
Deferred revenues	(19,931)	(2,797)
Net cash (used in) provided by operating activities	(2,743)	33,395
Cash Flows from investing activities:		
Proceeds from sale of available-for-sale securities	249,713	247,186
Purchase of available-for-sale securities	(251,009)	(282,252)
Purchase of property and equipment	(121)	(295)
Net cash used in investing activities	(1,417)	(35,361)
Cash Flows from financing activities:		
Proceeds from the exercise of stock options	807	511
Net cash provided by financing activities	807	511
Effect of exchange rate changes on cash	(140)	23
Net decrease in cash and cash equivalents	(3,493)	(1,432)
Cash and cash equivalents, beginning of period	27,004	19,805
Cash and cash equivalents, end of period	$ 23,511	$ 18,373
Supplemental disclosures of cash flow information:		

Cash received (paid) during the period for:				
Interest income	$	921	$	3,398
Income taxes	$	(6,251)	$	(1)
Non-cash financing activities				
Capitalized stock-based compensation expense (inventory and contract related costs)	$	10	$	18

See accompanying notes to unaudited condensed consolidated financial statements.

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COGENT, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. General

Company Background

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

Basis of Presentation

The accompanying condensed consolidated balance sheet as of March 31, 2006 and the condensed consolidated statements of operations and cash flows for the three months ended March 31, 2005 and 2006 are unaudited. These statements should be read in conjunction with the audited consolidated financial statements and related notes, together with management s discussion and analysis of financial position and results of operations, contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on March 15, 2006.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or (GAAP). In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2005 and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of March 31, 2006, and its results of operations and cash flows for the three months ended March 31, 2005 and 2006. The condensed consolidated balance sheet as of December 31, 2005 has been derived from the December 31, 2005 audited financial statements. The interim financial information contained in this quarterly report is not necessarily indicative of the results to be expected for any other interim period or for the entire year.

Concentration

The Company derives a significant portion of its revenues from a limited number of customers. Customers A and B collectively accounted for 70% of revenues, or 26% and 44%, respectively, during the three months ended March 31, 2005. Customers A, B and C collectively accounted for 54% of revenues or 32%, 12% and 10% of revenues, respectively, during the three months ended March 31, 2006.

Reclassifications

As discussed in Note 3, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R (SFAS 123R), Share-Based Payment, on January 1, 2006 using the modified prospective transition method. Accordingly, prior period amounts have not been restated. Prior to the adoption of FAS 123R, the Company accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees and related interpretations. Under APB 25, the Company recorded compensation cost equal to the excess of the fair value of its common stock over the option exercise price on the date of grant over the respective vesting period. Prior to the adoption of FAS 123R, stock-based compensation costs were reported in a separate line item. However, since the adoption of FAS 123R, and in accordance with Staff Accounting Bulletin (SAB) 107, the Company has presented the expense related to stock based compensation in the same line items as cash compensation paid to employees. Under SAB 107, the Company is precluded from displaying stock-based compensation as a single line item in the income statement and the Company has reclassified the stock based compensation expense amounts for the three months ended March 31, 2005 to conform to the current period presentation.

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The reclassification of stock compensation expense for the three months ended March 31, 2005 is further explained as follows:

	As Previously Reported	Reclassification	As Currently Reported
Cost of product revenues	$ 13,838	$ 66	$ 13,904
Cost of maintenance and services revenues	1,089	129	1,218
Amortization of stock based compensation	195	(195)	
Total cost of revenues	$ 15,122	$	$ 15,122
Research and development	$ 1,913	$ 529	$ 2,442
Selling and marketing	1,526	430	1,956
General and administrative	1,727	664	2,391
Amortization of stock based compensation	1,623	(1,623)	
Operating expenses	$ 6,789	$	$ 6,789

Note 2 Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140, to simplify and make more consistent the accounting for certain financial instruments. Specifically, SFAS No. 155 amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities , to permit fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation, provided that the whole instrument is accounted for on a fair value basis. SFAS No. 155 amends SFAS No. 140, Accounting for the Impairment or Disposal of Long-Lived Assets , to allow a qualifying special-purpose entity to hold a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 applies to all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006, with earlier application allowed. The Company does not expect the adoption of SFAS No. 155 to have a significant impact on the consolidated results of operations or the financial position of the Company.

Note 3 Stock-Based Compensation

The Company has two stock option plans, the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, which authorize the issuance of stock options, restricted stock and other stock-based incentives to employees. The plans are described in more detail in Note 10 to the consolidated financial statements of the Company s Annual Report on Form 10-K for the period ended December 31, 2005. Prior to January 1, 2006, the Company accounted for these plans under the recognition and measurement principles of APB 25 and adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of FASB Statement No. 123.

Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective transition method. Accordingly, prior period amounts have not been restated. Under this transition method, compensation cost in 2006 includes the portion related to options vesting in the period for (1) all share-based payments granted prior to, but not vested as of January 1, 2006, based on the grant date fair value of the option estimated in accordance with the original provisions of SFAS No. 123 and (2) all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R.

Certain options issued during the years ended December 31, 2003 and 2004 were considered compensatory because, on the date of grant, the option exercise price was less than the deemed fair value of the underlying common stock. Under APB 25, stock-based compensation expense was calculated as the difference, on the date of grant, between the fair value of the underlying common stock and the exercise price of the option. As of December 31, 2005, the Company had an aggregate of $4.0 million of deferred stock-based compensation remaining to be amortized. Upon

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the adoption of SFAS 123R, the balance of deferred stock-based compensation was eliminated against additional paid-in capital.

The following table summarizes the incremental effect of the adoption of SFAS 123R based on the calculation of stock-based compensation expense for stock options under the modified prospective transition method, over the stock-based compensation expense under the intrinsic value method of APB 25 for the three months ended March 31, 2006.

	Three Months Ended March 31, 2006 (in thousands, except per share amounts)
Reduction of operating income and income before income taxes	$ 425
Income tax benefit	(157)
Reduction of net income from continuing operations	$ 268
Reduction of net income per share from continuing operations:	
Basic	$ 0.00
Diluted	$ 0.00

Prior to the adoption of SFAS 123R, the Company presented all tax benefits for deductions resulting from the exercise of stock options as operating cash flows on its statement of cash flows. SFAS 123R requires the cash flows resulting from the tax benefits for tax deductions in excess of the compensation expense recorded for those options (excess tax benefits) to be classified as financing cash flows. In accordance with SFAS 123R, the Company did not record tax benefits from stock options in excess of previously recognized compensation, due to previously recognized deferred tax assets as a result of net operating losses generated for tax purposes. Accordingly, a tax benefit of $2.1 million was not recognized in cash flows from operations during the three months ended March 31, 2006.

The fair values of each award granted under the Company s stock option plans during the three months ended March 31, 2005 and 2006 were estimated at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

	Three months ended March 31, 2005	2006
Volatility	85%	46%
Risk-free interest rate	3.85%	4.54%
Dividend yield	0.00%	0.00%
Expected life (years)	4.0	6.1

In March 2005, the SEC issued SAB 107 which provides guidance on the implementation of SFAS 123R. The Company applied the principles of SAB 107 in conjunction with its adoption of SFAS 123R. The volatility of the Company s common stock is estimated at the date of grant based on the implied volatility of publicly traded 30-day to 270-day options on the Company s common stock, consistent with SFAS 123R and SAB 107. The use of implied volatility was based upon the availability of actively traded options on its common stock and management s assessment that implied volatility is more representative of future stock price trends than historical volatility. The risk-free interest rate that was used in the Black-Scholes option valuation model is based on the implied yield in effect at the time of each option grant, based on U.S. Treasury zero-coupon issues with equivalent remaining terms. Management uses an expected dividend yield of zero in the Black-Scholes option valuation model, as it has no intention to pay any cash dividends on its common stock in the foreseeable future. SFAS 123R requires management to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. Management uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest. SFAS 123R also requires the Company to estimate forfeitures in calculating the stock-based compensation expense relating to options granted prior to the January 1, 2006 adoption date, as opposed to recognizing these forfeitures and the corresponding reduction in expense as they occur. No adjustment was recorded as the cumulative effect of the adjustment to account for such forfeitures, net of tax, was not material to the consolidated statement of income. For options granted prior to January 1, 2006, the Company amortizes the fair value on an accelerated multiple option approach in accordance with the provisions of FASB Interpretation No. 28 Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans . For options granted on or after January 1, 2006, the Company amortizes the fair value on a

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straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods. The expected term of stock option awards granted was calculated using the simplified method in accordance with SAB 107. The weighted average estimated grant date fair value for options granted under the Company s stock option plan during the three months ended March 31, 2005 was $16.67 per share. The weighted average estimated grant date fair value for options granted under the Company s stock option plan during the three months ended March 31, 2006 was $11.06 per share.

As of March 31, 2006, there was $5.6 million of total unrecognized compensation cost related to nonvested stock-based compensation that is expected to be recognized over a weighted-average period of 1.8 years. Based on currently outstanding options, total stock-based compensation expense for fiscal year 2006 is expected to be approximately $4.5 million.

The options outstanding as of March 31, 2006 have generally been granted with a 10-year term, vest 25% at the completion of the first year and vest quarterly thereafter over the remaining three-year period. A summary of option activity under the plans for the three months ended March 31, 2006 is as follows:

	Number of options	Weighted Average Exercise Price
Outstanding, December 31, 2005	3,718,748	$ 2.88
Granted	35,000	21.78
Exercised	(820,252)	0.62
Canceled or forfeited		
Outstanding March 31, 2006	2,933,496	$ 3.74
Exercisable at March 31, 2006	1,079,831	$ 1.52

A summary of the status of the Company s nonvested shares as of March 31, 2006, and changes during the three months ended March 31, 2006 is presented below:

	Three Months Ended March 31, 2006	Weighted Average Grant-Date Fair Value
Nonvested options as of December 31, 2005	2,063,234	$ 7.58
Granted	35,000	11.06
Vested	(244,569)	6.06
Forfeited		
Nonvested options as of March 31, 2006	1,853,665	7.85

A total of 3,832,612 options remain available for grant under the Company s share-based compensation plans at March 31, 2006.

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The following tables further describe stock options outstanding at March 31, 2006.

Range of Exercise Prices		Options Outstanding Number Outstanding at March 31, 2006	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Exercisable Options Number Exercisable at March 31, 2006	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$ 0.30	$ 0.60	381,300	4.5	$ 0.33	$ 6,868	373,175	4.5	$ 0.32	$ 6,724
0.75	0.75	660,425	7.0	0.75	11,617	221,175	6.9	0.75	3,891
1.00	1.00	1,078,552	7.8	1.00	18,702	304,679	7.8	1.00	5,283
4.50	11.00	550,394	8.2	5.07	7,304	174,081	8.2	4.97	2,327
18.01	34.43	262,825	9.4	24.64	1	6,721	8.8	28.04	
0.30	34.43	2,933,496	7.4	3.74	$ 44,492	1,079,831	6.6	1.52	$ 18,225

The Company defines in-the-money options at March 31, 2006 as options that had exercise prices that were lower than the $18.34 fair market value of its common stock at that date. The aggregate intrinsic value of options outstanding at March 31, 2006 is calculated as the difference between the exercise price of the underlying options and the fair market value of the Company s common stock for the 2.7 million shares that were in-the-money at that date. There were 1.1 million in-the-money options exercisable at March 31, 2006. The total intrinsic value of options exercised during the three months ended March 31, 2005 and 2006 was $67.7 million and $18.1 million, respectively, determined as of the date of exercise.

The following table details the effect on net income and earnings per share had compensation expense for the employee stock-based awards been recorded in the first quarter of 2005, based on the fair value method under FAS 123.

	Three Months Ended March 31, 2005 (in thousands, except per share data)
Net income as reported	$ 10,065
Add: Total stock-based employee compensation expense included in reported net income net of related tax effects	1,687
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards net of the related tax effects	(1,782)
Pro forma net income	$ 9,970
Net Income per share	
Basic as reported	$ 0.12
Basic pro forma	$ 0.12
Diluted as reported	$ 0.11
Diluted pro forma	$ 0.11

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Note 4. Fair Value of Investments in Marketable Securities

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

	December 31, 2005	March 31, 2006
	(in thousands)	
Type of Security:		
Short-term instruments	$ 81,696	$ 109,317
Corporate debt securities with maturities of less than one year	98,472	113,578
Municipal securities with maturities of less than one year	58,270	58,117
U.S. government securities with maturities of less than one year	42,956	55,467
Total short-term investments	281,394	336,479
Corporate debt securities with maturities between one and three years	26,979	18,875
U.S. government securities with maturities between one and three years	22,422	10,833
Total long-term investments	49,401	29,708
	$ 330,795	$ 366,187

The Company s short-term instruments consist primarily of money market funds, certificates of deposit and commercial paper. These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of stockholders equity. The accumulated unrealized loss on available for sale securities totaled $1.4 million at December 31, 2005 and March 31, 2006, respectively. The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses are reported in other income and expense and were zero for the three months ended March 31, 2005 and 2006, respectively.

Note 5. Inventory and Contract Related Costs

Inventory and contract related costs consist of the following:

	December 31, 2005	March 31, 2006
	(in thousands)	
Materials and components	$ 1,671	$ 1,573
Inventory and costs related to long-term contracts	323	158
Deferred costs of revenue	18,228	17,280
	$ 20,222	$ 19,011

Materials and components are stated at the lower of cost or market determined using the first-in, first-out method. Inventoried costs relating to long-term contracts are stated at actual production costs incurred to date reduced by amounts identified with revenue recognized on progress completed. Deferred costs of revenue relate to contracts for which revenue has been deferred, and such costs are stated at actual production costs incurred to date, which primarily include materials, labor and subcontract costs which are directly related to the contract. Deferred costs of revenue are amortized to costs of revenue at the time revenues are recognized. The long-term component of inventory and contract related costs of $3,779,000 and $1,239,000 at December 31, 2005 and March 31, 2006, respectively, consists of deferred costs relating to contracts where revenue recognition is deferred beyond one year (see Note 9).

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Note 6. Net Income Per Share

Basic net income per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share reflects the effects of potentially dilutive securities, which consist of stock options. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share follows:

	Three Months Ended March 31, 2005	2006
	(in thousands, except per share data)	
Numerator:		
Net income available to common stockholders	$ 10,065	$ 6,747
Denominator:		
Denominator for basic net income per share weighted average shares	82,008	93,685
Dilutive potential common stock		
Stock options	9,837	2,438
Denominator for diluted net income per share adjusted weighted average shares	91,845	96,123
Basic net income per share	$ 0.12	$ 0.07
Diluted net income per share	$ 0.11	$ 0.07

During the three months ended March 31, 2005 and 2006, options to purchase 22,000 and 209,000 shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options exercise price was greater than the average market price of the common shares for each of these respective periods.

Note 7. Comprehensive Income

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

	Three Months Ended March 31, 2005	2006
	(In thousands)	
Net income	$ 10,065	6,747
Other comprehensive income:		
Change in unrealized loss, net of tax	(503)	23
Change in foreign currency translation adjustment	(46)	8
Total comprehensive income	$ 9,516	6,778

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Note 8. Income Taxes

During the three months ended March 31, 2005 and 2006, the Company experienced disqualifying dispositions of incentive stock options. Disqualifying dispositions result in a tax deduction on the Company s corporate tax return equal to the intrinsic value of the option at exercise. To the extent the Company recorded stock-based compensation expense related to disqualifying dispositions of incentive stock options, the Company recorded the benefit from the disqualifying disposition of incentive stock options as a reduction to the Company s provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the financial statements is credited to additional paid-in capital.

During the three months ended March 31, 2005 and 2006, a total of 2,492,500 and 820,252 stock options were exercised resulting in net proceeds to the Company of $807,000 and $511,000, respectively. As a result of the disqualifying dispositions of incentive stock options during the three months ended March 31, 2005, the Company recorded tax benefits from stock option transactions which totaled approximately $5.5 million. In accordance with SFAS 123R, the Company did not record a credit to additional paid in capital during the three months ended March 31, 2006 due to previously recognized deferred tax assets recorded as a result of net operating losses generated for tax purposes. A credit of approximately $2.1 million will be recorded when the tax benefit is realizable by the Company, in a future period.

Note 9. Deferred Revenues and Deferred Costs

In the second quarter of 2005, the Company entered into contracts with a total value of approximately $31.8 million with the National Electoral Council (CNE) of Venezuela. The contracts required the Company to provide a full identification solution to the CNE including licensed software, hardware, installation, maintenance and service. The contracts also provided for the short-term lease of equipment to be used by the CNE in connection with the August 7, 2005 Venezuela local elections. The estimated relative fair value of the lease component of approximately $3.0 million, which was based upon an independent valuation, was recognized as revenue in the third quarter of 2005. Because vendor-specific objective evidence, or VSOE, of the maintenance element of this contract does not exist, all revenue in excess of the fair value of the lease component will be amortized over the life of the contract once the customer has accepted all software. As of March 31, 2006, the Company has not completed all its deliverables under the contract with the CNE; therefore, no revenue was recognized during the three months ended March 31, 2006. As of December 31, 2005 and March 31, 2006, deferred revenue related to this contract totaled approximately $28.7 million. Deferred costs related to this contract are included in inventory and contract related costs and will be recognized as cost of product revenues ratably over the contractual maintenance period.

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Note 10. Segment Information

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

	Three months ended March 31, 2006				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 13,801	$ 1,895	$ 1,170	$ 2	$ 16,868
Maintenance and services revenues	4,960	502	199	202	5,863
Total	$ 18,761	$ 2,397	$ 1,369	$ 204	$ 22,731

	Three months ended March 31, 2005				
	Americas	Europe	Asia	Other	Total
Revenues:					
Product revenues	$ 28,412	$ 63	$ 1,434	$ 1,871	$ 31,780
Maintenance and services revenues	3,570	351	140		4,061
Total	$ 31,982	$ 414	$ 1,574	$ 1,871	$ 35,841

At December 31, 2005 and March 31, 2006, the Company s property and equipment, net of accumulated depreciation and amortization in the United States was approximately $31,392,000 and $31,507,000, respectively. At December 31, 2005 and March 31, 2006, the Company s property and equipment, net of accumulated depreciation and amortization in foreign countries was approximately $1,744,000 and $1,498,000, respectively. At December 31, 2005 and March 31, 2006, the Company s intangible assets in the United States, net of accumulated amortization, were approximately $650,000 and $613,000, respectively.

Note 11. Commitments and Contingencies

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

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

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

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

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

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, in Item 1A of Part II of this Quarterly Report under the caption Risk Factors, and the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission.

Risk factors that could cause actual results to differ from those contained in the forward-looking statements including but are not limited to: changes in government policies; uncertain political conditions in international markets; deriving a significant portion of revenues from a limited number of customers; deriving a significant portion of revenues from the sale of solutions pursuant to government contracts; failure of the biometrics market to experience significant growth; failure of our products to achieve broad acceptance; potential fluctuations in quarterly and annual results; changes in our effective tax rate; failure to successfully compete; failure to comply with government regulations; failure to accurately predict financial results due to long sales cycles; negative publicity and/or loss of clients due to security breaches resulting in the disclosure of confidential information; loss of export licenses or changes in export laws; failure to manage projects; rapid technology change in the biometrics market; loss of a key member of management team; termination of backlog orders; loss of limited source suppliers; negative audits by government agencies; failure to protect intellectual property; and exposure to intellectual property and product liability claims.

Overview

We are a leading provider of advanced Automated Fingerprint Identification Systems, or AFIS, and other fingerprint biometrics solutions to governments, law enforcement agencies and other organizations worldwide. We were incorporated and commenced operations in 1990. We have been researching, designing, developing and marketing AFIS and other fingerprint biometrics solutions since inception. During most of our operating history, we have achieved positive income and cash flows from operations. From the fourth quarter of 2003 through the year ended December 31, 2005, we experienced significant increases in our revenues and net income as the market for our AFIS solutions expanded primarily due to increased demand by the Department of Homeland Security, or DHS, as well as the National Electoral Council of Venezuela, or CNE. We experienced a decline in revenues in the first quarter of 2006 due to the completion of a number of significant contracts and the timing of revenue recognition related to contracts entered into in previous periods. While we believe that the prospects for growth in the biometrics market are good and that we are well positioned in this market, a number of very large AFIS awards are currently pending and will be decided in the remainder of 2006 or 2007, any of which could have a material impact on our revenues. If we are unable to secure some or all of these pending awards, then our revenues will likely be lower in 2006 than they were in 2005.

Sources of Revenue

We generate product revenues principally from sales of our AFIS solutions, which typically consist of our Programmable Matching Accelerator, or PMA, servers and other AFIS equipment, including workstations and live-scans, bundled with our proprietary software. Also included in product revenues are fees generated from design and deployment of our AFIS solutions. We generate maintenance revenues from maintenance contracts that are typically included with the sale of our AFIS solutions. Maintenance contracts for technical support and software updates generally cover a period of one year, and after contract expiration, our customers have the right to purchase maintenance contract renewals, which generally cover a period of one year. Revenues from maintenance contracts are deferred and amortized on a straight-line basis over the life of the maintenance obligation. We generate services revenues from engineering services and AFIS system operation services that are not an element of an arrangement for the sale of products. These services are typically performed under fixed-price and time-and-material agreements.

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

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

We also expect to experience increased demand from a number of other governments as they deploy AFIS solutions in elections, at points of entry and exit, including borders, seaports and airports, and in connection with national identification programs. For example, in Canada, we have made significant progress in working with the RCMP s Real Time Identification Initiative, and in Europe, we have partnered with Siemens in bidding for the EU VIS program, which is expected to be awarded this summer with an initial system deployment by the end of this calendar year. While we believe our technology and proven experience in running similar programs will be a factor in the decision, the award of this contract is highly competitive, and we can provide no assurance that we will win. In conjunction with the EU VIS program, we also have opportunities with the individual EU countries that are required to install AFIS systems that are interoperable with the EU VIS program. Notwithstanding our expectations regarding demand for these solutions and timing of the awards, the quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations. Government contracts for security solutions in elections, at points of entry and exit and in connection with national identification programs are typically awarded in open competitive bidding processes. Therefore, our future level of sales of AFIS solutions for deployments in elections and at points of entry and exit may vary substantially, and will depend on our ability to successfully compete for this business.

Cost of Revenue and Operating Expenses

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

Research and Development. Research and development expenses consist primarily of salaries and related expenses for engineering personnel, fees paid to consultants and outside service providers, depreciation of development and test equipment, prototyping expenses related to the design, development, testing and enhancements of our products, and the cost of computer support services. We expense all research and development costs as incurred. Under our customer contracts, we typically obtain the rights to use any improvements to our technology developed on a particular customer deployment on other customer deployments. As a result, we have historically been able to moderate our research and development expenses by leveraging the improvements developed by our personnel working on customer engagements. Research and development expenses also include stock-based compensation allocable to personnel performing services related to research and development.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses also include stock-based compensation allocable to personnel performing services related to sales and marketing.

General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses also include stock-based compensation allocable to personnel performing general and administrative services.

Application of Critical Accounting Estimates

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

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

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

Revenue Recognition. Because our proprietary software is essential to the functionality of our AFIS solutions and other biometrics products, we apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. For arrangements that require significant production, modification, or customization of software, we apply the provisions of Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Production Type Contracts. To the extent an element within our software arrangements falls within a level of accounting literature that is higher than SOP 97-2, we record revenue on such element in accordance with the relevant authoritative literature. For arrangements that contain the lease of equipment, we account for the lease element in accordance with SFAS No. 13 Accounting for Leases and account for the remaining elements in the arrangement in accordance with SOP 97-2. For arrangements that contain a non-software deliverable such as hardware, the Company applies the provisions of EITF 03-05 Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software and recognizes revenue when all other revenue recognition criteria are met. The application of the appropriate accounting principle to our revenue is dependent upon the specific transaction and whether the sale includes systems, software and services or a combination of these items. As our business evolves, the mix of products and services sold will impact the timing of when revenue and related costs are recognized. Additionally, revenue recognition involves judgments, including estimates of costs to complete contracts accounted for using the percentage of completion method of accounting and assessments of the likelihood of nonpayment. We analyze various factors, including a review of specific transactions, the credit-worthiness of our customers, our historical experience and market and economic conditions. Changes in judgments on these factors could materially impact the timing and amount of revenue and costs recognized.

Product Revenues

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

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

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

Revenue associated with the sale of our ASIC applications, stand-alone live-scans and other biometric products, excluding maintenance when applicable, is recognized upon shipment to the customer provided (i) persuasive evidence of an arrangement exists, (ii) title and risk of ownership has passed to the buyer, (iii) the fee is fixed or determinable and (iv) collection is deemed probable. We recognize revenue in this manner upon shipment of our BioGate and MobileIdent products.

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

Revenue associated with contracts where sufficient VSOE cannot be established for the allocation of revenue to the various elements of the arrangement is deferred until the earlier of the point at which (i) such sufficient VSOE does exist or (ii) all elements of the arrangement have been delivered.

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

Maintenance Revenue

Maintenance revenue consists of fees for providing technical support and software updates on a when-and-if available basis. We recognize all maintenance revenue ratably over the applicable maintenance period. We determine the amount of maintenance revenue to be deferred through reference to substantive maintenance renewal provisions

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contained in a particular arrangement or, in the absence of such renewal provisions, through reference to VSOE of maintenance renewal rates. We consider substantive maintenance provisions to be provisions where the stated maintenance renewal as a percentage of the product fee is comparable to our normal pricing for maintenance only renewals. In the event that maintenance included in an AFIS solutions contract does not have VSOE, the entire arrangement fee, including the contractual amount of the maintenance obligation, is included in product revenues and recognized ratably over the term of the maintenance period.

Services Revenue

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

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

Revenue Recognition Criteria

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

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

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

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

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

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

Commitments and Contingencies . We periodically evaluate all pending or threatened contingencies and commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position.

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

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

Accounting for Taxes. In preparing our consolidated financial statements, we estimate our income tax liability in each of the jurisdictions in which we operate by estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. As of March 31, 2006, our net deferred tax assets were approximately $51.5 million. Management judgment is required in assessing the realizability of our deferred tax assets. In performing this assessment, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from our estimates or we adjust our estimates in future periods, we may need to make or adjust valuation allowances with respect to our deferred tax assets, which could materially impact our financial position and results of operations. Our income tax provision is based on calculations and assumptions that may be subject to examination by the Internal Revenue Service and other tax authorities. Should the actual results differ from our estimates, we would have to adjust the income tax provision in the period in which the facts that give rise to the revision become known. Tax law and rate changes are reflected in the income tax provision in the period in which such changes are enacted.

Our effective tax rate for the quarter ended March 31, 2006 was, and we expect our tax rate to continue to be, impacted as a result of the disqualifying disposition of incentive stock options and research and development tax credits. Our effective tax rate may continue to fluctuate from quarter to quarter primarily as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place thus impacting the effective tax rate on a quarterly basis. The benefit resulting from disqualifying dispositions results in a tax deduction on our corporate tax return with no expense recorded in our consolidated financial statements. To the extent we have previously recorded stock-based compensation expense related to incentive stock options in our consolidated financial statements, we record the benefit from the disqualifying disposition of incentive stock options as a reduction to our provision for income taxes. A tax benefit resulting from an amount of compensation expense allowable for income tax purposes that is greater than the expense recorded in the consolidated financial statements is credited to additional paid-in capital.

Accounting for Stock-Based Compensation. Prior to January 1, 2006, we accounted for stock option awards granted in accordance with the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations, and complied with the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. Under APB Opinion No. 25, compensation cost, if any, was recognized over the respective vesting period based on the difference between the deemed fair value of our common stock and the exercise price on the date of grant. Prior to January 1, 2006, we recorded compensation expense for issuances of stock awards where the exercise price was less than the deemed fair value of the underlying stock for financial accounting purposes. Effective January 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment,* (SFAS 123R) using the modified prospective transition method. Under this transition method, compensation expense recognized during the three months ended March 31, 2006 included: (a) compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based awards granted subsequent to January 1,

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2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified-prospective-transition method, results for prior periods have not been restated. The adoption of SFAS 123R resulted in a charge to net earnings of approximately $1.4 million or $0.01 per diluted share for the three months ended March 31, 2006.

The calculation of share-based employee compensation expense involves estimates that require management s judgment. These estimates include the fair value of each of our stock option awards, which is estimated on the date of grant using a Black-Scholes option-pricing model as discussed in Note 3 of our condensed consolidated financial statements. The fair value of our stock option awards is expensed on a straight-line basis over the vesting life of the options. We estimate the volatility of our common stock at the date of grant based on the implied volatility of publicly traded 30-day to 270-day options on our common stock, consistent with SFAS 123R and Securities and Exchange Commission Staff Accounting Bulletin No. 107. Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our belief that implied volatility is more representative of future stock price trends than historical volatility. We base the risk-free interest rate that we use in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms. We do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. SFAS 123R requires us to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. For options granted before January 1, 2006, we amortize the fair value on an accelerated basis. For options granted on or after January 1, 2006, we amortize the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods. We may elect to use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income or loss and net income or loss per share.

Results of Operations

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

	Three Months Ended March 31,	
	2005	**2006**
Consolidated Statements of Operations Data:		
Revenues:		
Product revenues	88.7%	74.2%
Maintenance and services revenues	11.3	25.8
Total revenues	100.0	100.0
Cost of revenues:		
Cost of product revenues	38.8	31.1
Cost of maintenance and services revenues	3.4	7.3
Total cost of revenues	42.2	38.4
Gross profit	57.8	61.6
Operating expenses:		
Research and development	6.8	10.0
Selling and marketing	5.5	8.1
General and administrative	6.7	11.8
Total operating expenses	19.0	29.9
Income from operations	38.8	31.7
Interest income	3.9	15.3
Other , net	1.0	
Income before income taxes	43.5	47.0

Income tax (benefit) provision	15.4	17.4
Net income	28.1%	29.6%

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Comparison of Results for the Three Months Ended March 31, 2005 and 2006

Revenues. Revenues were $22.7 million for the three months ended March 31, 2006 compared to $35.8 million for the three months ended March 31, 2005. Product revenues were $16.9 million for the three months ended March 31, 2006 compared to $31.8 million for the three months ended March 31, 2005. The $14.9 million decrease in product revenues resulted primarily from a $13.1 million decrease in revenues generated from the CNE and a $2.9 million decrease in revenues from the DHS, offset in part by revenues from new customers, including the Royal Canadian Mounted Police. During the three months ended March 31, 2006, we recognized revenue of approximately $2.7 million for AFIS solutions delivered to the CNE compared to $15.8 million for the three months ended March 31, 2005. The decrease in revenue from the CNE is primarily attributed to the completion in fiscal 2005 of certain of the arrangements under which we provided AFIS solutions to the CNE. Maintenance and services revenues increased by 44% to approximately $5.9 million for the three months ended March 31, 2006 from approximately $4.1 million for the three months ended March 31, 2005. The $1.8 million increase was due to an increase in maintenance revenues and engineering services associated with increasing product sales in prior periods, as well as the generally increasing size of the installed base of customers who purchase maintenance.

Gross Profit. Gross profit as a percentage of revenues was 61.6% for the three months ended March 31, 2006 compared to 57.8% for the same period of the prior year. Product gross margins were 58.0% for the three months ended March 31, 2006 compared to 56.2% for the three months ended March 31, 2005. The increase in margins on product revenues was primarily due to a shift in product mix away from CNE, which has higher costs. The solutions developed for the CNE required a significant amount of hardware, which we acquired from third parties and then sold to the CNE. Sales of hardware typically result in lower margins than sales of software licensing and services. The effect of the decrease of the portion of our revenues from sales of equipment in the three months ended March 31, 2006 was partially offset by the allocation of fixed overhead costs over a lower revenue base. Costs of product revenues decreased to approximately $7.1 million for the three months ended March 31, 2006 from approximately $13.9 million for the three months ended March 31, 2005. Maintenance and services gross margins were essentially level at 71.9% for the three months ended March 31, 2006 compared to 70.0% for the three months ended March 31, 2005. Costs of maintenance and service revenues increased to approximately $1.6 million for the three months ended March 31, 2006 from approximately $1.2 million for the three months ended March 31, 2005.

Research and Development. Research and development expenses decreased to approximately $2.3 million, or 10% of revenues, for the three months ended March 31, 2006 compared to approximately $2.4 million, or 6.8% of revenues for the three months ended March 31, 2005. The $175,000 decrease was due to a reduction in total compensation costs of approximately $288,000 during the three months ended March 31, 2006 compared to the same period of the prior year as a result of a $298,000 decrease in stock compensation expense which was partially offset by an increase of $10,000 in other employee compensation related costs, such as payroll and employee benefits. A decrease in outside development fees of approximately $239,000 also contributed to the decrease in research and development expenses. These decreases were partially offset by an increase of $154,000 in development expenses incurred primarily as a result of an increase in headcount and an aggregate increase of approximately $160,000 in supplies, equipment maintenance, consultant fees and travel expenses incurred in the development our products.

Selling and Marketing. Selling and marketing expenses decreased to approximately $1.8 million, or 8.1% of revenues, for the three months ended March 31, 2006 compared to approximately $2.0 million, or 5.5% of revenues, for the three months ended March 31, 2005. The $117,000 decrease was primarily due to a decrease in third party consulting and professional service fees of approximately $259,000, which was partially offset by an increase in compensation costs of approximately $200,000 due to an increase in headcount. A decrease in travel related costs totaling approximately $69,000 also contributed to the decrease in sales and marketing expenses for the three months ended March 31, 2006 compared to the same period in the prior year.

General and Administrative. General and administrative expenses increased to approximately $2.7 million, or 11.8% of revenues, for the three months ended March 31, 2006 compared to approximately $2.4 million or 6.7% of revenues, for the three months ended March 31, 2005. The $302,000 increase was primarily due to a $259,000 increase in accounting and consulting fees due to costs incurred to meet the requirements of the Sarbanes-Oxley Act of 2002. Costs such as directors, officers and business insurance increased approximately $52,000 during the three months ended March 31, 2006 compared to the three months ended March 31, 2005. Compensation costs decreased approximately $111,000 primarily as a result of a $170,000 decrease in stock compensation expense which was partially offset by an increase of $60,000 in other employee compensation related costs, such as payroll and employee benefits, due to an increase in headcount.

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Interest Income. We earned interest income of approximately $3.5 million during the three months ended March 31, 2006 compared to approximately $1.4 million during the three months ended March 31, 2005. The increase in interest income was primarily due to higher cash and investment balances as a result of net proceeds of approximately $96.8 million from our public offering in June 2005 as well as cash generated from operations and higher interest rates.

Income Tax Provision. We recognized an income tax provision of approximately $3.9 million, with an effective tax rate of 36.9%, during the three months ended March 31, 2006 as a result of the net income earned in the period. Our effective tax rate of 36.9% for the three months ended March 31, 2006 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by state research and development credits. We recognized an income tax provision of approximately $5.5 million, with an effective tax rate of 35.5%, during the three months ended March 31, 2005 as a result of the net income incurred in the period. Our effective tax rate of 35.5% for the three months ended March 31, 2005 represents federal, state and foreign taxes on our income reduced primarily as a result of benefits resulting from the disqualifying disposition of incentive stock options and by research and development credits. We expect our effective tax rate may fluctuate from quarter to quarter as a result of disqualifying dispositions that may continue to occur related to incentive stock options currently outstanding and held by Company personnel. The tax benefit resulting from the disqualifying dispositions of incentive stock options is only recognized when the actual disposition takes place.

Liquidity and Capital Resources

Since inception, we have financed our operations by generating cash from operations. Since September 2004 we have supplemented our cash resources through public offerings of our common stock, raising approximately $228.6 million in our initial public offering in September 2004 and approximately $96.8 million in a subsequent public offering in June 2005. As of March 31, 2006, we had approximately $18.4 million in cash and cash equivalents and approximately $366.2 million in investments in marketable securities.

We derive cash from operations primarily from cash collected on product sales and maintenance contract sales. Net cash provided by (used in) operating activities was approximately $33.4 million and $(2.7) million during the three months ended March 31, 2006 and 2005, respectively. The cash provided by operating activities during the three months ended March 31, 2006 primarily resulted from net income of approximately $6.7 million adjusted for non-cash reconciling items, the most significant of which were deferred income taxes of approximately $3.7 million and stock-based compensation expense of approximately $1.4 million. Cash provided by operating activities during the three months ended March 31, 2006 was also significantly impacted by a $23.5 million decrease in billed accounts receivable and a $1.2 million decrease in inventory and contract related costs partially offset by a $2.8 million decrease in deferred revenues. The decrease in cash provided by operating activities during the three months ended March 31, 2005 resulted from net income of $10.1 million adjusted for non-cash reconciling items, the most significant of which were stock-based compensation expense of $1.8 million, the tax benefit from stock option transactions of $5.5 million, a decrease in inventory and contract related costs of $12.3 million and an increase in accrued expenses of $2.1 million. These items were offset by a decrease in deferred revenues of $19.9 million, an increase in billed accounts receivable of $8.1 million and a decrease in income taxes payable of $5.7 million.

For the three months ended March 31, 2006 and 2005, cash used in investing activities was approximately $35.4 million and $1.4 million, respectively. Investing activities consisted of purchases and sales of available-for-sale securities and capital expenditures, which consisted primarily of computer equipment and software for our engineering, service and information technology departments. Approximately $35.1 million and $1.3 million of cash used during the three months ended March 31, 2006 and 2005, respectively, represented the net increase of investments in marketable securities.

For the three months ended March 31, 2006 and 2005, cash provided by financing activities was approximately $511,000 and $807,000, respectively, which represented proceeds collected from the exercise of stock options.

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

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these external economic forces have had, or are likely in the foreseeable future to have, a material impact on our results of operations.

At March 31, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose, or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have material relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties.

Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140, to simplify and make more consistent the accounting for certain financial instruments. Specifically, SFAS No. 155 amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, to permit fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation, provided that the whole instrument is accounted for on a fair value basis. SFAS No. 155 amends SFAS No. 140, Accounting for the Impairment or Disposal of Long-Lived Assets, to allow a qualifying special-purpose entity (SPE) to hold a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 applies to all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006, with earlier application allowed. We do not expect that the adoption of SFAS No. 155 will have a significant impact on the consolidated results of operations or financial position of the Company.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

Item 4. Controls and Procedures

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

As reported in our 2005 Form 10-K, management concluded that as of December 31, 2005, certain deficiencies in our internal controls surrounding revenue accounting and the development of our statement of cash flows constituted material weaknesses within the meaning of the Public Company Accounting Oversight Board Auditing Standard No. 2. Our efforts to remediate the deficiencies in our internal controls include the augmentation and reallocation of resources within our finance group, the implementation of additional checklists, and more timely review of non-routine transactions.

Management believes that the steps implemented during the three months ended March 31, 2006 have been sufficient to address the internal control deficiency surrounding the statement of cash flows, and we conclude that these controls were operating effectively at March 31, 2006. However, management believes that the new internal controls related to revenue accounting must operate effectively for a sufficient period of time to validate a conclusion that such controls are effective, and as of March 31, 2006, management does not believe this criterion has been satisfied. As a result, management has concluded that, in light of the failure to confirm remediation of the material weakness related to revenue accounting, our disclosure controls and procedures were not effective as of the end of the fiscal period covered by this report.

There were no other changes in our internal controls over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

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

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

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

In 2005 and for the three months ended March 31, 2006, we derived 69% and 54%, respectively, of our revenues from a limited number of customers.

In each fiscal period we have derived, and we believe that in each future fiscal period we will continue to derive, a significant portion of our revenues from a limited number of customers. We had three customers that collectively accounted for 54% of revenues during the three months ended March 31, 2006, including the DHS, the CNE and the Royal Canadian Mounted Police, which accounted for 32%, 12% and 10% of revenues, respectively. In 2005, the DHS and the CNE collectively accounted for 69% of revenues, or 31% and 38%, respectively. The success of our business is substantially dependent on the continuation of our relationships with, and additional sales to, these significant customers. In addition, our business is dependent upon entering into relationships with additional significant customers. To the extent that any significant customer reduces or delays its purchases from us or terminates its relationship with us, our revenues would decline significantly and our financial condition and results of operations would suffer substantially.

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None of our customers are obligated to purchase additional solutions from us. As a result, the amount of revenue that we derive from a specific customer may vary from period to period, and a significant customer in one period may not be a significant customer in any subsequent period.

In 2005 and for the three months ended March 31, 2006, we derived 54.5% and 57.6%, respectively, of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

Our performance in any one reporting period is not necessarily indicative of future operating performance because of our reliance on a small number of customers, the majority of which are government entities. Government contracts frequently include provisions that are not standard in private commercial transactions. For example, government contracts may include bonding requirements and provisions permitting the purchasing agency to cancel or delay the contract without penalty in certain circumstances. Many of our government customer contracts have these provisions.

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

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

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

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

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

marketing efforts and publicity regarding biometrics solutions.

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

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

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

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

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

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

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

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

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

- prime government contractors, such as Northrop Grumman, that develop integrated information technology products and services that include biometrics-related solutions that are frequently delivered in partnership with diversified technology providers and biometrics-focused companies; and companies focused on other fingerprint biometric solutions, such as AuthenTec, BioScrypt, Dermalog and UPEK.

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

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

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. In connection with the audit of our financial statements for the year ended December 31, 2005, we identified material weaknesses in our controls related to the recognition of revenue and the preparation of our statement of cash flows. There can be no assurance that our controls over financial processes and reporting will be effective in the future. For more information, see Item 9A of our Annual Report on Form 10-K for the period ended December 31, 2005.

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

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

Among the most significant regulations affecting our business are:

- the Federal Acquisition Regulations, or the FAR, and agency regulations supplemental to the FAR, which comprehensively regulate the formation and administration of, and performance under government contracts;
- the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations;
- the Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under cost-based government contracts;
- the Foreign Corrupt Practices Act; and
- laws, regulations and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

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

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

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

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

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

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

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

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

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

Deployments of our solutions often involve large-scale projects. The quality of our performance on such projects depends in large part upon our ability to manage relationships with our customers and to effectively manage the projects and deploy appropriate resources, including our own project managers and third party subcontractors, in a timely manner. Any defects or errors or failures to meet clients expectations could result in reputational damage or even claims for substantial monetary damages against us. In addition, we sometimes guarantee customers that we will complete a project by a scheduled date or that our solutions will achieve defined performance standards. If our solutions experience a performance problem, we may not be able to recover the additional costs we will incur in our remedial efforts, which could materially impair profit from a particular project. Moreover, 53% of our revenues in 2005 and 37% of our revenues for the three months ended March 31, 2006 were derived from fixed price contracts. Changes in the actual and estimated costs and time to complete fixed-price, time-certain projects may result in revenue adjustments for contracts where revenue is recognized under the percentage of completion method. Finally, if we miscalculate the amount of resources or time we need to complete a project for which we have agreed to capped or fixed fees, our financial results could be adversely affected.

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

Our future success will depend upon our ability to develop and introduce a variety of new capabilities and enhancements to our existing solutions in order to address the changing and sophisticated needs of the marketplace. Frequently, technical development programs in the biometrics industry require assessments to be made of the future direction of technology, which is inherently difficult to predict. Delays in introducing new products and enhancements, the failure to choose correctly among technical alternatives or the failure to offer innovative products or enhancements at competitive prices may cause customers to forego purchases of our solutions and purchase our competitors solutions.

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We may not have adequate resources available to us or may not adequately keep pace with appropriate requirements in order to effectively compete in the marketplace.

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

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

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

Historically, our business and products have been focused on the government and law enforcement markets. In 2005 and for the three months ended March 31, 2006, sales to customers in these markets accounted for 99% and 97% of our revenues, respectively. A key component of our strategy is to develop and grow our sales of other fingerprint biometrics solutions. The market for these solutions is at an early stage of development compared to the market for law enforcement and other government sector biometrics products. We cannot assure you that other fingerprint biometrics products and solutions will gain wide market acceptance, that this market will develop and grow as we expect, that we will successfully develop products for this market or that we will have the same success in this market as we have had in the government and law enforcement markets. In addition, we cannot assure you that our strategy of expanding our business to cover biometric solutions and products based on biometrics other than fingerprints will be successful.

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

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

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

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

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

Government agencies may audit us as part of their routine audits and investigations of government contracts. As part of an audit, these agencies may review our performance on contracts, cost structures and compliance with

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

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

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

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

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

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

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

Ming Hsieh, our Chief Executive Officer, controlled approximately 54% of our outstanding common stock as of March 31, 2006. As a result, he is able to exercise control over matters requiring stockholder approval, such as the election of directors and the approval of significant corporate transactions. These types of transactions include transactions involving an actual or potential change of control of our company or other transactions that the non-controlling stockholders may deem to be in their best interests and in which such stockholders could receive a premium for their shares. We are a controlled company under the Nasdaq corporate governance rules, and therefore we are

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entitled to exemptions from certain of the Nasdaq corporate governance rules. These requirements are generally intended to increase the likelihood that boards will make decisions in the best interests of stockholders. Specifically, we are not required to have a majority of our directors be independent or to have compensation, nominating and corporate governance committees comprised solely of independent directors. We do not intend to avail ourselves of the controlled company exemptions, but our intentions may change and in such event, if our stockholders interests differed from those of Mr. Hsieh, our stockholders would not be afforded the protections of these Nasdaq corporate governance requirements.

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

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

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

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

In 2005 and for the three months ended March 31, 2006, revenues outside of the Americas accounted for approximately 6% and 17%, respectively, of our total revenues. We also currently have international operations, including offices in Austria, China and Taiwan. Our international revenues and operations are subject to a number of material risks, including, but not limited to:

- difficulties in building and managing foreign operations;
- regulatory uncertainties in foreign countries;
- difficulties in enforcing agreements and collecting receivables through foreign legal systems and other relevant legal issues;
- longer payment cycles;
- foreign and U.S. taxation issues;
- potential weaknesses in foreign economies;
- fluctuations in the value of foreign currencies;

- general economic and political conditions in the markets in which we operate; and

- unexpected domestic and international regulatory, economic or political changes.

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

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

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

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

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

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

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

- difficulties in integrating operations, technologies, accounting and personnel;
- difficulties in supporting and transitioning customers of our acquired companies;
- diversion of financial and management resources from existing operations;
- risks of entering new markets;
- potential loss of key employees; and
- inability to generate sufficient revenues to offset acquisition costs.

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

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

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

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The trading price of our common stock is volatile.

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

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

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

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

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

In addition, Ming Hsieh, who was our sole stockholder prior to our initial public offering, continues to hold a substantial number of shares of our common stock. Sales by Mr. Hsieh of a substantial number of shares, or the expectation that such sales may occur, could significantly reduce the market price of our common stock.

The implementation of new accounting rules related to the expensing of stock-based awards affected our reported results of operations for the first quarter of 2006 and will continue to impact our operating results in subsequent periods. Any subsequent changes in accounting rules may also have an adverse effect on our results of operations.

Effective January 1, 2006 we adopted SFAS 123R. SFAS 123R requires all share-based payment awards to employees, including grants of employee stock options, to be recognized in the financial statements based on their grant date fair values and does not allow the previously permitted pro forma disclosure-only method as an alternative to financial statement recognition.

The adoption of SFAS 123R has an adverse impact on our reported results of operations because the stock-based compensation expense is charged directly against our reported earnings. Our net income for the three months ended March 31, 2006 reflected stock-based compensation expense of $1.4 million as a result of our adoption of SFAS 123R. As of March 31, 2006, there was $5.6 million of total unrecognized compensation cost related to nonvested stock options that is expected to be recognized over a weighted-average period of 1.8 years. Based on currently outstanding options, total stock-based compensation expense for fiscal year 2006 is expected to be approximately $4.5 million. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense. Future stock-based compensation expense and unearned stock-based compensation will increase to the extent that we grant additional equity awards to employees or assume unvested equity awards in connection with acquisitions.

Had we adopted SFAS 123R in prior periods, the magnitude of the impact of that standard on our results of operations would have approximated the impact of SFAS 123 assuming the application of the Black-Scholes option

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pricing model as described in the disclosure of pro forma net income (loss) and pro forma net income (loss) per share in Notes 1 and 3 of Notes to Condensed Consolidated Financial Statements (unaudited). SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement may reduce net operating cash flows and increase net financing cash flows in periods after its adoption.

Any other subsequent changes in the accounting rules applicable to us may also have an adverse effect on our results of operations.

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Item 6. Exhibits

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

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

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

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

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SIGNATURE

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

Cogent, Inc.

By: /s/ Paul Kim

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

Date: May 10, 2006