

L-1 IDENTITY SOLUTIONS, INC.

Form 10-Q

May 08, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2008.

OR

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

For the Transition Period from to .

Commission File Number 001-33002

L-1 IDENTITY SOLUTIONS, INC.

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(Exact name of registrant as specified in its charter)

Delaware

02-08087887 (State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.) 177 Broad Street, 12th Floor, Stamford, CT 06901 (Address of principal executive offices) (Zip Code) (203) 504-1100

Registrant's telephone number, including area code

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

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

	Class	Outstanding at
May 7, 2008 Common stock, \$.001 par value		77,585,556

L-1 IDENTITY SOLUTIONS, INC.
FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2008

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PART 1 — FINANCIAL INFORMATION

ITEM 1 — UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

L-1 IDENTITY SOLUTIONS, INC.

Condensed Consolidated Balance Sheets

(in thousands)

(Unaudited)

March 31,

2008 December 31,

2007 Assets	Current assets:	Cash and cash equivalents	\$ 8,515	\$ 8,203	Accounts receivable,
net 86,815	Inventory	28,935	21,534	Deferred tax asset	13,253
6,801	3,890	Total current assets	144,319	137,090	Property and equipment, net
23,451	Goodwill	1,084,871	1,054,270	Intangible assets, net	191,139
38,756	37,293	Other assets, net	10,508	9,304	Total assets
Shareholders' Equity	Current liabilities:	Accounts payable and accrued expenses	\$ 81,408	\$ 81,549	Current portion of deferred revenue
81,549	98,958	96,221	Deferred revenue, net of current portion	6,510	4,671
269,000	259,000	Other long-term liabilities	1,580	1,036	Total liabilities
Shareholders' Equity:	Common stock, \$0.001 par value; 125,000,000 shares authorized; 77,400,985 and 75,146,940 shares issued and outstanding at March 31, 2008 and December 31, 2007, respectively	78	76	Additional paid-in capital	1,257,972
75,146,940	1,217,840	Prepaid forward contract	(69,808)	(69,808)	Treasury stock
(6,161)	—	Accumulated deficit	(71,683)	(69,798)	Accumulated other comprehensive income
7,700	6,407	Total shareholders' equity	1,118,098	1,084,717	Total liabilities and shareholders' equity
1,494,146	\$ 1,445,645				\$ 1,494,146

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

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L-1 IDENTITY SOLUTIONS, INC.
 Condensed Consolidated Statements of Operations
 (in thousands, except per share data)
 (Unaudited)

Three months ended March 31,
 2008 March 31,

2007 Revenues	\$ 115,996	\$ 70,007	Cost of revenues:	Cost of revenues	78,741	46,177
Amortization of acquired intangible assets	5,901	6,474	Total cost of revenues	84,642	52,651	Gross profit
31,354	17,356	Operating expenses:	Sales and marketing	7,485	5,461	Research and development
5,333	4,661	General and administrative	16,789	12,817	Amortization of acquired intangible assets	826
826	431	Total operating expenses	30,433	23,370	Operating income (loss)	921
(6,014)	Interest income	71	67	Interest expense	(3,332)	(1,771)
(6,014)	Other expense, net	(1,008)	(25)	Loss before income taxes	(3,348)	(7,743)
(6,014)	Benefit (Provision) for income taxes	1,463	(1,088)	Net loss	\$ (1,885)	\$ (8,831)
(6,014)	Basic and diluted net loss per share	\$ (0.03)	\$ (0.12)	Weighted average basic and dilutive common shares outstanding	72,171	72,540

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

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L-1 IDENTITY SOLUTIONS, INC.
 Condensed Consolidated Statements of Cash Flows
 (in thousands)
 (Unaudited)

Three Months Ended March 31,
 2008 March 31,

2007 Cash Flows from Operating Activities:	Net loss	\$ (1,885)	\$ (8,831)	Adjustments to reconcile		
net loss to net cash provided by operating activities:	Depreciation and amortization	9,672	9,060			
Stock-based compensation expense	2,894	2,579	Gain from disposal of equipment	(15)	—	(Benefit)
provision for non-cash income taxes	(1,463)	1,041	Retirement plan contributions paid in common stock			
167	148	Amortization of deferred financing costs	447	134	Changes in operating assets and liabilities, net	
of effects of acquisitions:	Accounts receivable	5,923	10,244	Inventory	(5,533)	(1,800)
assets	(1,380)	(172)	Accounts payable, accrued expenses and other liabilities	(9,542)	(10,174)	Other
Deferred revenue	2,753	(836)	Net cash provided by operating activities	2,038	1,393	Cash Flows from
Investing Activities:	Increase in restricted cash	(28)	—	Acquisitions, net of cash acquired	(1,072)	
(20,441)	Capital expenditures	(3,030)	(1,817)	Additions to intangible assets	(2,138)	—
—	(65)	Net cash used in investing activities	(6,268)	(22,323)	Cash Flows from Financing Activities:	
Net borrowings under revolving credit agreement	10,097	18,000	Financing costs	(2)	(106)	
Principal payments of other debt	(139)	(59)	Repurchase of common stock	(6,161)	—	Proceeds from
issuance of common stock	878	2,105	Net cash provided by financing activities	4,673	19,940	Effect of
exchange rate changes on cash and cash equivalents	(131)	74	Net increase (decrease) in cash and cash			
equivalents	312	(916)	Cash and cash equivalents, beginning of period	8,203	4,993	Cash and cash
equivalents, end of period	\$ 8,515	\$ 4,077	Supplemental Cash Flow Information:			
interest	\$ 1,251	\$ 1,511	Cash paid for			
Cash paid for income taxes	\$ 334	\$ 790	Non-Cash Transactions:			
Common stock issued and options assumed in connection with Bioscrypt acquisition	\$ 35,750	\$ —				

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

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

1. DESCRIPTION OF BUSINESS

L-1 Identity Solutions, Inc. and its subsidiaries (“L-1” or the “Company”) provide identity solutions and services that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy. L-1’s identity solutions are specifically designed for the identification of people and include secure credentialing, biometrics capture and access devices, automated document authentication, automated biometric identification systems, and biometrically-enabled background checks, as well as systems design, development, integration and support services. These identity solutions enable L-1’s customers to manage the entire life cycle of an individual’s identity for a variety of applications including civil identification, criminal identification, commercial, border management, military, antiterrorism and national security. L-1 also provides comprehensive consulting, training, security, technology development, and information technology solutions to the U.S. intelligence community.

The Company’s identity solutions combine products and related services, consisting of hardware, components, consumables and software, as well as maintenance, consulting and training services integral to sales of hardware and software. The Company also provides fingerprinting enrollment services and government consulting, training, security, technology development and information technology services. A customer, depending on its needs, may order solutions that include hardware, equipment, consumables, software products or services or combine hardware products, consumables, equipment, software products and services to create a multiple element arrangement.

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

Reorganization

On May 16, 2007, the Company adopted a new holding company organizational structure in accordance with Section 251(g) of the Delaware General Corporation Law (the “DGCL”) in order to facilitate its convertible senior notes (the “Convertible Notes” or “Notes”) offering and the structuring of acquisitions. Pursuant to the reorganization, L-1 Identity Solutions, Inc. became the sole shareholder of its predecessor, L-1 Identity Solutions Operating Company (“L-1 Operating Company”, previously known as L-1 Identity Solutions, Inc.). The reorganization has been accounted for as a reorganization of entities under common control and the historical consolidated financial statements of the predecessor entity represent the consolidated financial statements of the Company. The reorganization did not impact the historical carrying amounts of the assets and liabilities of the Company or its historical results of operations and cash flows.

The Company has no operations other than those carried through its investment in L-1 Operating Company, other than the financing operations related to the issuance of the Convertible Notes, and its assets consist of its investment in L-1 Operating Company of \$1,290.5 million and deferred financing costs of \$5.1 million. Its liabilities consist of Convertible Notes of \$175.0 million and accrued interest of \$2.5 million.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a

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fair presentation of the financial statements for the interim periods. The unaudited condensed consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (“SEC”) for interim financial statements, and in accordance with SEC rules, omit or condense certain information and footnote disclosures. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2007.

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

Use of Estimates

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

Revenue Recognition

The Company derives its revenue from solutions that include products and services, as well as sales of stand alone services, hardware, components, consumables and software. Solutions revenue includes revenues from maintenance, consulting and training services related to sales of hardware and software solutions. Services revenue includes fingerprinting enrollment services and government consulting, security and information technologies services. A customer, depending on its needs, may order hardware, equipment, consumables, software products or services or combine hardware products, consumables, equipment, software products and services to create a multiple element arrangement. The Company’s revenue recognition policies are described in the notes to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2007.

Stock-Based Compensation

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

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Determining the appropriate valuation method and related assumptions requires judgment, including estimating common stock price volatility, forfeiture rates and expected terms. The following weighted average assumptions were utilized in the valuation of stock options in 2008 (excluding the Bioscript assumed stock options) and 2007:

	Three Months Ended			
March 31, 2008	March 31, 2007			
Expected common stock price volatility	52.2 %	91.3 %	Risk free interest rate	4.3 % 4.3 %
Expected life of options	5.3 Years	6.3 Years	Expected annual dividends	— —

The expected volatility rate is based on the historical volatility of the Company's common stock. In the second quarter of 2007, the Company reviewed the historical volatility of its common stock and began using a weighted average method that more accurately reflects volatility. The expected life of options are calculated pursuant to the guidance from Staff Accounting Bulletin No. 107. The Company estimated forfeitures when recognizing compensation expense based on historical rates. The risk free interest rate is based on the applicable treasury security whose term approximates the expected life of the options. The Company updates these assumptions on at least an annual basis and on an interim basis if significant changes to the assumptions are warranted.

Stock-based compensation expense was \$3.1 million and \$2.7 million for the three months ended March 31, 2008 and 2007, respectively, and includes \$0.1 million related to restricted stock for both periods, and for the first quarter 2008 and 2007 period, approximately \$0.2 million and \$0.1 million, respectively, of retirement contributions paid in common stock. The Company recognized the full cost impact of the awards issued under its equity incentive plans in the condensed consolidated statements of operations for the three months ended March 31, 2008 and 2007 and did not capitalize any such costs. The following tables presents stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

	Three Months Ended			
March 31, 2008	March 31, 2007			
Cost of revenues	\$ 266	\$ 143	Research and development	463 225
General and administrative	1,866	1,954		Sales and marketing 466
Computation of Net Income (Loss) per Share			\$ 3,061	\$ 2,727

The Company computes basic and diluted net income (loss) per share in accordance with SFAS No. 128, "Earnings per Share." Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is based upon the weighted average number of dilutive common and common equivalent shares outstanding during the period.

The basic and diluted net loss per share calculation is computed based on the weighted average number of shares of common stock outstanding during the period. The impact of approximately 4.2 million common equivalent shares for the three months period ended March 31, 2008 and the impact of approximately 4.6 million for the three months period ended March 31, 2007, were not reflected in the net loss per share calculations as their effect would be anti-dilutive.

The Company calculates the effect of the Convertible Notes for the three month period ended March 31, 2008 on diluted earnings per share utilizing the “if converted” method. For the three month period ended March 31, 2008, the effect was antidilutive. Accordingly, approximately 5.5 million shares

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of weighted average common stock issuable at conversion have been excluded from the determination of weighted average diluted shares outstanding.

In connection with the issuance of the Convertible Notes, the Company entered into a pre-paid forward contract with Bear Stearns for a payment of \$69.8 million to purchase 3,490,400 shares of the Company's common stock at a price of \$20.00 per share. Pursuant to SFAS No. 150, the number of shares to be delivered under the contract is used to reduce weighted average basic and diluted shares outstanding for earnings (loss) per share purposes.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157, as amended, defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States of America, and expands disclosures about fair value measurements. With respect to financial assets and liabilities, SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. However, in February 2008, the FASB determined that an entity need not apply this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis until 2009. Accordingly, the Company's adoption of this standard on January 1, 2008, is limited to financial assets and liabilities and did not have a material effect on the Company's financial condition or results of operations. The Company's still in the process of evaluating the impact of this standard with respect to its effect on nonfinancial assets and liabilities and has not yet determined the impact that it will have on the consolidated financial statements upon full adoption.

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

The FASB has proposed a FASB Staff Position ("FSP") that would significantly impact the accounting for the Company's Convertible Notes. The proposed FSP, if adopted in its current form, would require cash settled convertible debt to be separated into debt and equity components at issuance. The value assigned to the Convertible Notes would be the estimated fair value, as of the issuance date, of a similar bond without the conversion feature. The difference between the Convertible Notes cash proceeds and its assigned value would be recorded as a debt discount and amortized to interest expense over the life of the Convertible Notes. Although the proposed FSP would have no impact on the actual past or future cash flows from the Convertible Notes, it would result in recording a significant amount of non-cash interest expense as the debt discount is amortized. The FSP, if adopted, would require retrospective application.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements—on Amendment of ARB No. 51. SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim statements within those fiscal years. Among other things, SFAS No. 160 requires noncontrolling interest to be included as a component of shareholders' equity. The Company does not currently have any material noncontrolling interests.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations. SFAS No. 141(R) establishes standards for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS No. 141(R) also provides

guidance for recognizing and measuring the goodwill acquired in the business combination and for information to disclose. Among other things, SFAS No. 141(R) requires that securities issued to be valued as of the acquisition date, transaction costs incurred in connection with an acquisition be expensed, except acquiree costs that meet the criteria of SFAS No. 146, contingent consideration be recognized at fair value as of the date of acquisition with subsequent changes reflected in income, and in process research and development be capitalized as an

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intangible asset. The provisions of SFAS No. 141(R) are applicable to business combinations consummated on or after December 15, 2008. Early application is prohibited. The provision of SFAS No. 141(R) will have a significant impact in the accounting for future business combinations.

On March 19, 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. SFAS No. 161 provides guidance about the location and amounts of derivative instruments disclosed in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133, Derivatives Implementation; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. SFAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure features that are credit risk-related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. SFAS No. 161 is effective for financial statements issued after November 15, 2008. The Company is evaluating the impact of this standard on its consolidated financial statements.

3. STOCK OPTIONS

Stock Options

The following table summarizes the stock option activity from January 1, 2008 through March 31, 2008:

Stock Options	Weighted							
Average Exercise Price	Weighted							
Average Remaining Life (Years)	Aggregate							
Intrinsic Value Outstanding at January 1, 2008	7,528,106	\$ 15.02	Granted	149,955	12.98			
Assumed Stock Options – Bioscript	256,228	31.25	Exercised	(60,437)	7.86			
Canceled/expired/forfeited	(149,049)	19.14	Outstanding at March 31, 2008	7,724,803	\$ 15.47			
6.94 \$ 9,968,805 Vested or expected to vest at March 31, 2008(1)	5,839,951	\$ 15.47	6.94	\$				
7,536,417 Exercisable at March 31, 2008	3,982,521	\$ 13.90	5.21	\$ 9,691,467				

(1)

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

The aggregate unearned compensation cost of unvested options outstanding as of March 31, 2008 was \$29.9 million and will be amortized over a weighted average period of 2.8 years. The total intrinsic value of options exercised during the three ended March 31, 2008 was \$0.2 million. The intrinsic value is calculated as the difference between the market value of the Company's common stock and the exercise price of options.

On May 7, 2008, the Company's shareholders approved the L-1 Identity Solutions, Inc. 2008 Long-Term Incentive Plan, under which 2 million shares will be available for awards to employees, consultants and directors. Shares remaining available for issuance under the Company's 2005 Long-Term Incentive Plan will be carried over to, and available for future awards under, the Company's 2008 Long-Term Incentive Plan.

4. INCOME TAXES

The provision for income taxes for 2008 is based on the consolidated annual estimated effective tax rate for 2008 of 43.7%. The income tax provision for the three months ended March 31, 2007 includes approximately \$1.1 million which represent the aggregate increase in the deferred tax asset

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resulting from losses incurred for income tax purposes and a full valuation allowance against such deferred tax asset. Pursuant to SFAS No. 109, such provision was recorded for the amortization of tax deductible goodwill, for which the period of reversal of the related temporary difference is indefinite; the related deferred tax liability cannot be used to offset the deferred tax asset in determining the valuation allowance. The remaining income tax provision in 2007 comprises foreign and state income tax expense.

5. RELATED PARTY TRANSACTIONS

Aston Capital Partners, L.P. (“Aston”), an affiliate of L-1 Investment Partners LLC and Lau Technologies (“Lau”), an affiliate of Mr. Denis K. Berube, a member of the board of directors of the Company, own approximately 9.8%, and 2.7%, respectively, of L-1’s outstanding common stock. Mr. Robert LaPenta, Mr. James DePalma, Mr. Joseph Paresi and Ms. Doni Fordyce, each executive officers of the Company, directly and indirectly hold all the beneficial ownership in L-1 Investment Partners LLC and Aston Capital Partners GP LLC, the investment manager and general partner of Aston. Mr. LaPenta is also the Chairman of the Board of Directors and Chief Executive Officer and President of the Company. Mr. DePalma is also the Chief Financial Officer and Treasurer of the Company.

The Company has consulting agreements with Mr. Berube and his spouse, Ms. Joanna Lau, under which each receives annual compensation of \$0.1 million. Each agreement terminates on the earlier of January 10, 2012 or commencement of full time employment elsewhere. During the three months ended March 31, 2008 and 2007, \$0.1 million and \$0.1million, respectively, was paid in the aggregate to Mr. Berube and Ms. Lau in connection with the agreements.

Under the terms of a 2002 acquisition agreement of Lau Security Systems, the Company is obligated to pay Lau a royalty of 3.1% on certain of its face recognition revenues through June 30, 2014, up to a maximum of \$27.5 million. Royalty expense included in cost of revenues was approximately \$34,000 and \$12,000 for the three months ended March 31, 2008 and 2007 respectively.

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

In connection with the relocation of the corporate headquarters of the Company in the third quarter of 2006 to the offices of L-1 Investment Partners LLC in Stamford, Connecticut, the Company entered into a sublease with L-1 Investment Partners LLC under which the Company will reimburse L-1 Investment Partners LLC for the rent and other costs payable by the Company, which is estimated at \$0.7 million annually. For the three months ended March 31, 2008 and 2007, the Company incurred costs of \$0.2 million and \$0.2 million, respectively.

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

Bear Stearns is party to the revolving credit agreement under which it was paid \$0.3 million and \$0.4 million in interest for the three months ended March 31, 2008 and 2007, respectively. Bear Stearns share of borrowings outstanding at March 31, 2008 approximated \$21.9 million. In

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addition, Bear Stearns was an initial purchaser of the Convertible Notes issued on May 17, 2007 for which it received an aggregate discount of \$4.8 million. Also on May 17, 2007, the Company entered in a pre-paid forward contract with Bear Stearns to purchase approximately 3.5 million shares of the Company's common stock for \$69.8 million to be delivered in May 2012. Bear Stearns acted as the broker for the purchase of 362,000 shares of the Company's stock in January 2008 and received a commission of 2 cents per share.

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

As a condition to the closing of the Identix merger, the Company and L-1 Investment Partners LLC entered into a Termination and Noncompete Agreement which, among other things, (1) terminated all arrangements whereby L-1 Investment Partners LLC and its affiliates provided financial, advisory, administrative or other services to the Company or its affiliates, and (2) prohibits L-1 Investment Partners LLC and its affiliates from engaging or assisting any person that competes directly or indirectly with the Company in the business of biometric, credentialing and ID management business anywhere in the United States or anywhere else in the world where the Company does business, or plans to do business or is actively evaluating doing business during the restricted period; provided however that the foregoing does not restrict L-1 Investment Partners LLC and its affiliates from retaining its investment in and advising AFIX Technologies, Inc. The restricted period runs co-terminously with the term of Mr. LaPenta's employment agreement with the Company, dated as of August 29, 2006, and for a twelve month period following the expiration of the term of Mr. LaPenta's employment agreement. On April 23, 2007, the Company entered into an employee arrangement with Mr. Robert LaPenta, Jr., the son of the Company's Chief Executive Officer, to serve as Vice President, M&A/Corporate Development.

In connection with the acquisition of Integrated Biometric Technology, Inc. ("IBT") in December 2005, the Company issued warrants to purchase 440,000 shares of common stock with an exercise price of \$13.75 per share to L-1 Investment Partners LLC, of which 280,000 are currently exercisable and 160,000 will become exercisable upon IBT meeting a specified level of operating performance.

In December 2005, Aston, completed a \$100 million investment in and became the beneficial owner of more than 5% of L-1's outstanding common stock. In accordance with the terms of the investment agreement, L-1 issued to Aston warrants to purchase an aggregate of 1,600,000 shares of L-1's common stock at an exercise price of \$13.75 per share, which are fully exercisable and expire in December 2008.

6.

SEGMENT REPORTING, GEOGRAPHICAL INFORMATION AND CONCENTRATIONS OF RISK

SFAS No. 131, Disclosures about Segments of a Business Enterprise and Related Information, establishes standards for reporting information regarding reportable and operating segments. Operating segments are defined as components of a company which the chief operating decision maker evaluates regularly in deciding how to allocate resources and assess performance. The Company's chief operating decision maker is its Chief Executive Officer. The Company operates in two reportable segments, the Identity Solutions segment and the Services segment. The Identity Solutions segment provides solutions that enable governments, law enforcement agencies, and businesses to enhance security, reduce identity theft, and protect personal privacy utilizing secure credential provisioning and authentication systems, biometric technology and the creation, enhancement and/or utilization of identity databases. The Services segment provides enrollment services to government, civil, and commercial customers, as well as comprehensive government

consulting, training, network security, technology development, and information technology solutions to the U.S. intelligence community.

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

Three months ended	Total assets as of	March 31,					
2008	March 31,	2007					
2007	March 31,	2008					
2008	March 31,	2007					
United States	\$ 107,953	\$ 61,476	\$ 1,445,285	\$ 1,189,273	Rest of the World	8,043	8,531
48,861	52,351	\$ 115,996	\$ 70,007	\$ 1,494,146	\$ 1,241,624		

For the three month period ended March 31, 2008, two Federal government agencies accounted for 29% of consolidated revenues. For the three month period ended March 31, 2007, one Federal government agency accounted for 26% of consolidated revenues. As of March 31, 2008, the Company had an accounts receivable balance of approximately \$13.9 million from one Federal government agency which was the only customer that had a balance of greater than 10% of consolidated accounts receivables. As of March 31, 2007, one Federal government agency was the only customer that had a balance of greater than 10% of consolidated accounts receivable, which was approximately \$13.4 million.

7. ACQUISITIONS

2008 Acquisitions

Digimarc

On March 24, 2008, the Company entered into a definitive agreement to acquire Digimarc Corporation in a stock and cash transaction valued at approximately \$245 million, including cash consideration of approximately \$120 million. The cash portion of the consideration is expected to be funded with borrowings. Digimarc stockholders will also receive shares in a new company bearing the Digimarc name and holding Digimarc's digital watermarking business. The number of L-1 shares to be issued will be based on the average price of the common stock over the 20 consecutive trading days ending five days prior to closing of the transaction, and will be fixed at approximately 10.3 million shares if the average trading price of L-1's common stock is between \$11 and \$14. If the price of L-1 shares exceeds \$14 per share, the number of shares to be issued will be reduced. Under the definitive agreement, the maximum number of L-1 shares that can be issued is 11.3 million. The Company has also agreed to invest \$5 million in the new company that will hold the digital watermarking business of Digimarc following the spin-off. The acquisition has been approved by the respective Board of Directors of each company and is subject to the approval of Digimarc's stockholders, the spin-off of Digimarc's digital watermarking business, antitrust regulatory approvals and other customary closing conditions, and is expected to close in the second half of 2008.

The results of operations of all consummated acquisitions described below have been included in the condensed consolidated financial statements from their respective dates of acquisition.

Bioscrypt

On March 5, 2008, the Company acquired Bioscrypt Inc. (“Bioscrypt”), a provider of enterprise access control solutions headquartered in Markham, Canada. Under the terms of the definitive agreement, the Company issued approximated 2.5 million shares. Certain shareholders of Bioscrypt have exercised their dissenting shareholder rights under Canadian law and will receive cash. In addition the Company assumed all Bioscrypt stock options outstanding at the effective date of the acquisition (approximately 252,656 options). Bioscrypt is included in the Identity Solutions segment.

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The aggregate purchase price of Bioscrypt was approximately \$37.2 million, including an estimated \$1.5 million of liabilities to dissenting shareholders and direct acquisition costs, and stock options valued at \$1.7 million. The Company acquired Bioscrypt for its leadership position in Biometric physical access control, its global customer base, its offerings that complement the Company's existing offerings and expected cost and revenue synergies. Preliminarily, the purchase price has been allocated as follows (in thousands):

	Cash	\$ 1,710	Other current assets	5,013	Other
assets	811	Current liabilities	(8,393)	Deferred revenue	(1,084)
		Other non-current liabilities	(130)		
Intangible assets	12,357	Goodwill	26,933		\$ 37,217

The purchase price allocation of Bioscrypt is preliminary. The final allocation will be based on final analyses of identifiable intangible assets, contingent liabilities and income taxes, among other things, and will be finalized after the data necessary to complete the analyses of fair value of assets and liabilities is obtained and evaluated. Differences between the preliminary and final allocation could have a material impact on the consolidated results of operations. None of the goodwill is deductible for income tax purposes.

2007 Acquisitions

McClendon

On July 13, 2007, the Company acquired McClendon Corporation ("McClendon"). The Company purchased all of the issued and outstanding shares of common stock of McClendon from a newly-formed holding company for a purchase price of \$33.0 million in cash and \$33.0 million (approximately 1.6 million shares) of the Company's common stock for a total consideration of \$66.0 million, subject to an adjustment based on McClendon's closing working capital, as defined. The number of shares issued were determined based on an average for a specified period prior to closing. The Company acquired McClendon for the suite of technical and professional services it provides to the intelligence and military communities and a customer base which complements the Company's portfolio. McClendon is included in the Services segment.

The aggregate purchase price of McClendon was approximately \$68.7 million, including a working capital adjustment of \$1.0 million and \$1.7 million of direct acquisition costs. Substantially all of the cash portion of the purchase price was funded by borrowings under the revolving credit facility. Preliminarily, the purchase price has been allocated as follows (in thousands):

	Cash	\$ 607	Other current assets	7,399	Other
assets	421	Current liabilities	(4,045)	Note payable – long-term	(67)
		Deferred tax liability	(8,222)		
Intangible assets	17,900	Goodwill	54,723		\$ 68,716

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

ACI

On July 27, 2007, the Company acquired Advanced Concepts, Inc., (“ACI”), pursuant to which the Company acquired all of the issued and outstanding shares of common stock of ACI from a newly-formed holding company for a purchase price of \$71.5 million in cash, subject to an adjustment based on ACI’s closing working capital, as defined. In addition, pursuant to the Stock Purchase Agreement, if ACI achieves certain financial targets in 2008, the Company will make additional payments of a maximum amount of \$3.0 million. The Company acquired ACI for its access to a customer base within the U.S. government and its complementary service offerings, consisting of information and network security solutions and system engineering and development capabilities to the U.S. intelligence and military communities. ACI is included in the Services segment.

The aggregate purchase price of ACI was approximately \$73.3 million, including a working capital adjustment of \$0.5 million and \$1.3 million of direct acquisition costs, substantially all of which was funded by borrowings under the Company’s revolving credit facility. Preliminarily, the purchase price has been allocated as follows (in thousands):

	Cash	\$ 2,259	Other current assets	9,488	Other		
assets	137	Current liabilities	(6,204)	Long-term liabilities	(165)	Intangible assets	18,000
49,761		\$ 73,276				Goodwill	

The purchase price allocation of ACI is preliminary. The final allocation will be based on final analyses of identifiable intangible assets, contingent liabilities and income taxes, among other things, and will be finalized after the data necessary to compare the analyses of fair value of assets and liabilities is obtained and analyzed. Differences between preliminary and final allocations are not expected to have a material impact on the consolidated results of operations. Additional payments that may be made if certain financial targets are achieved will be accounted for as additional purchase price. The goodwill is deductible for income tax purposes.

Comnetix

On February 22, 2007, the Company consummated the acquisition of Comnetix Inc. (“Comnetix”), for approximately \$17.8 million in cash. Comnetix offers biometric identification solutions for use in areas such as applicant screening, financial services, health care, transportation, airlines and airports, casinos and gaming, and energy and utilities. Comnetix is also a leading applicant fingerprinting services company in Canada, with a chain of ten offices. In addition, Comnetix has established more than 40 applicant fingerprinting services locations throughout the United States. The fingerprinting services business has been integrated with our IBT business and is included in the Services segment. The biometric identification solutions business is included in the Identity Solutions segment.

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Property and equipment (in thousands):

	2008		December 31,		March 31,	
2007 System assets	\$ 54,151	\$ 52,101	Computer and office equipment	7,510	9,213	Machinery and equipment
5,553	2,467	Leasehold improvements	1,926	1,693	Other – including tooling and demo equipment	
3,933	3,991	73,073	69,465	Less accumulated depreciation and amortization	48,520	
46,014	Property and equipment, net	\$ 24,553	\$ 23,451			

For the three months ended March 31, 2008 and 2007, depreciation and amortization expense of property and equipment was \$2.9 million and \$2.2 million, respectively.

Goodwill (in thousands):

The following summarizes the activity in goodwill for the three months ended March 31, 2008 (in thousands):

	2008		December 31,		March 31,		Identity
Solutions Services	Total Balance	beginning of period	\$ 784,595	\$ 269,675	\$ 1,054,270	Reclassification of	
ComnetiX products business	9,779	(9,779)	—	Bioscrypt acquisition	26,933	—	26,933
translation adjustment	1,642	—	1,642	Contingent consideration	—	1,845	1,845
181	\$ 822,949	\$ 261,922	\$ 1,084,871	Other	—	181	

During the three months ended March 31, 2008, the Company accrued an earnout payment pursuant to the 2006 SpecTal purchase agreement of \$1.8 million which resulted in an increase in goodwill.

Intangible Assets (in thousands):

	March 31, 2008	December 31, 2007	Cost	Accumulated				
Amortization	Cost	Accumulated						
Amortization Acquisition related intangibles:			Completed technology	\$ 122,307	\$ (31,458)			
\$ 121,207	\$ (27,210)	Core technology	5,600	(2,303)	5,600	(2,015)		
30,570	(2,959)	28,514	(2,456)	Customer contracts and relationships	77,870	(19,081)	65,583	
(15,808)	236,347	(55,801)	220,904	(47,489)	Other intangibles	13,218	(2,625)	14,166
(3,344)	\$ 249,565	\$ (58,426)	\$ 235,070	\$ (50,833)				

Amortization of intangible assets was \$6.7 million and \$6.9 million for the three months March 31, 2008 and March 31, 2007, respectively. Amortization for the current and subsequent five years and thereafter is as follows: \$21.7 million, \$25.7 million, \$23.7 million, \$22.6 million, \$21.3 million and \$65.5 million.

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Products and Services Revenues:

The following represents details of the products and services for revenues for the three months ended March 31, 2008 and 2007 (in thousands):

	Three months ended			
March 31, 2008	March 31, 2007			
Federal Government services	\$ 50,215	\$ 18,026	Hardware, software, and consumables	27,115
State and local government services	21,074	25,561	Maintenance	6,495
and services	6,610	3,209	Total revenues	\$ 115,996
Comprehensive Loss:				\$ 70,007

	Three months ended			
March 31, 2008	March 31, 2007			
Net loss	\$(1,885)	\$(8,831)	Translation gain	1,293
Comprehensive loss				102
				\$(592)

9. LONG-TERM DEBT

Long-term debt consists of the following (in thousands):

	March 31,			
2008	December 31, 2007			
\$175.0 million aggregate principal amount 3.75% Convertible Senior Notes due May 15, 2020	\$ 175,000	\$		
175,000 Borrowings under revolving credit agreement	94,000	84,000	\$ 269,000	\$ 259,000
Convertible Senior Notes				

On May 17, 2007, the Company issued \$175.0 million of convertible senior notes (the "Convertible Notes" or "Notes") with a conversion feature which allows the Company the option to settle the debt either in shares of common stock or to settle the principal amount in cash and the conversion spread in cash or common stock. The proceeds of the Convertible Notes offering, net of deferred financing costs amounted to \$168.7 million. Pursuant to the provisions of SFAS No. 133, EITF 90-19 and EITF 01-06, the embedded conversion feature has not been deemed a derivative since the conversion feature is indexed to Company's stock and would be classified as equity.

The Notes are governed by an indenture, dated May 17, 2007 (the "Indenture"), between the Company and The Bank of New York, as trustee. The Notes will be convertible only under certain circumstances, as described below. If, at the time of conversion, the daily volume-weighted average price per share for a 25 trading day period calculated in accordance with the Indenture (as defined in greater detail in the Indenture, "VWAP") of the Company's common stock is less than or equal to \$32.00 per share, which is referred to as the base conversion price, the Notes will be convertible into 31.25 shares of common stock of the Company per \$1,000 principal amount of the Notes, subject to

adjustment upon the occurrence of certain events. If, at the time of conversion, the VWAP of the shares of common stock of the Company exceeds the base conversion price of \$32.00 per share, the conversion rate will be determined pursuant to a formula resulting in holders' receipt of up to an

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additional 14 shares of common stock per \$1,000 principal amount of the Notes, subject to adjustment upon the occurrence of certain events and determined as set forth in the Indenture. The Notes are convertible until the close of business on the second business day immediately preceding May 15, 2027, in multiples of \$1,000 in principal amount, at the option of the holder under the following circumstances: (1) during the five business-day period after any five consecutive trading day period (the “measurement period”) in which the trading price the Note, for each day of such measurement period was less than 98% of the product of the last reported sale price of shares of common stock of the Company and the applicable conversion rate for such trading day; (2) during any fiscal quarter after March 31, 2008, if the last reported sale price of shares of common stock of the Company for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the base conversion price on the related trading day; (3) if the Company calls any or all of the Notes for redemption; and (4) upon the occurrence of specified corporate transactions described in the Indenture. Upon conversion, the Company has the right to deliver shares of common stock based upon the applicable conversion rate, or a combination of cash and shares of common stock, if any, based on a daily conversion value as described above calculated on a proportionate basis for each trading day of a 25 trading-day observation period. In the event of a fundamental change as specified in the Indenture, the Company will increase the conversion rate by a number of additional shares of common stock specified in the Indenture, or, in lieu thereof, the Company may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that the Notes will become convertible into shares of the acquiring or surviving company.

The Notes bear interest at a rate of 3.75% per year payable semiannually in arrears in cash on May 15 and November 15 of each year, beginning November 15, 2007. The Notes will mature on May 15, 2027, unless earlier converted, redeemed or repurchased. The Company may redeem the Notes at its option, in whole or in part, on or after May 20, 2012, subject to prior notice as provided in the Indenture. The redemption price during that period will be equal to the principal amount of the Notes to be redeemed, plus any accrued and unpaid interest. The holders may require the Company to repurchase the Notes for cash on May 15, 2012, May 15, 2017 and May 15, 2020. Pursuant to the provision of SFAS Nos. 150 and 133, the embedded redemption and repurchase provisions have not been separated from the host contracts and accounted for as derivatives because such embedded derivatives are deemed to be clearly and closely related to the host contract.

The Convertible Notes are structurally subordinated to all liabilities of L-1 Operating Company. Under the term of the revolving credit agreement, L-1 Operating Company may not make any dividend payment to the Company except to permit the Company to make scheduled interest payments on the subordinated debt up to a maximum of \$10.0 million per year and certain administrative expenses. However, the Company may prepay, redeem or repurchase the convertible notes in amounts not in excess of proceeds from the issuance of additional equity securities of the Company.

Revolving Credit Agreement

On October 19, 2006, the Company entered into an Amended and Restated Credit Agreement (the “Agreement”) by and among the Company, Bank of America, N.A. (the “Bank”), Bear Stearns, Wachovia Bank, Credit Suisse, Societe Generale and TD Bank North, to amend and restate the Credit Agreement, dated as of August 16, 2006, by and between the Company and the Bank. The Agreement provides for a revolving credit facility of up to \$150.0 million, with the potential for up to \$50.0 million in additional borrowings. In order to borrow under the facility, the Company is required to comply with certain covenants as more fully described below, some of which may limit the amounts borrowed or available. The Agreement provides that up to \$25.0 million of the total facility amount may be used for the issuance of letters of credit. The proceeds from the convertible note offering were used to repay the outstanding balance of the revolving credit facility. The amount available under the revolving credit facility is reduced by letters of

credit of \$8.7 million. At March 31, 2008, the Company had approximately \$47.3 million available under the revolving credit facility. At March 31, 2008, the variable interest rates ranged from 4.2% to 4.6%.

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Amounts borrowed under the Agreement bear interest for any interest period (as defined in the Agreement) at the British Bankers Association LIBOR Rate, plus a margin of 1.75% (subject to adjustment to a minimum margin of 1.50% and a maximum margin of 2.00% based on the Company's indebtedness to EBITDA ratio described below), and must be repaid on or before October 19, 2011. The Company also has the option to borrow at a fluctuating rate per annum equal to the higher of (a) the Federal Funds Rate plus 1/2 of 1% and (b) the rate of interest in effect for such day as publicly announced from time to time by Bank of America as its "prime rate", with respect to base rate loans plus the margin described above. If the Company has not borrowed all available amounts under the facility, it must pay a commitment fee of 0.375% per annum on such unutilized amounts. At March 31, 2008, debt outstanding under the Agreement amounted to \$94 million.

In accordance with the Agreement, borrowings are secured by all assets of the Company and certain of its affiliates. The Company is required to maintain the following financial covenants under the Agreement:

- As of the end of any fiscal quarter, the ratio of the Company's consolidated EBITDA (as defined in the Agreement) to consolidated interest charges (as defined in the Agreement) for the period of the prior four fiscal quarters may not be less than 2.50: 1.00, beginning with the fiscal quarter ending on December 31, 2006. At March 31, 2008 the ratio was 8.22:1.00.

- As of the end of any fiscal quarter, the ratio of the Company's consolidated funded indebtedness (as defined in the Agreement) to its consolidated EBITDA for the period of the prior four fiscal quarters may not be more than: (i) 4.50:1.00 at March 31, 2008 and September 30, 2008, (ii) 4.25: 1.00 at September 30, 2008, and (iii) 4.00: 1.00 at December 31, 2008 and at the end of each fiscal quarter thereafter. At March 31, 2008 the ratio was 1.44:1.00.

Under the terms of the Agreement, L-1 Operating Company may incur, assume or guarantee unsecured subordinated indebtedness of up to \$200 million and the Company may incur an additional \$25.0 million of unsecured convertible subordinated indebtedness. Among other restrictions, the Agreement limits the Company's ability to (i) pay dividends or repurchase capital stock, except with the proceeds of equity issuances or permitted subordinated debt, (ii) incur indebtedness (subject to the exceptions described above, among others), (iii) incur liens upon the collateral pledged to the Bank, (iv) sell or otherwise dispose of assets, including capital stock of subsidiaries, (v) merge, consolidate, sell or otherwise dispose of substantially all of the Company's assets, (vi) make capital expenditures above certain thresholds, (vii) make investments, including acquisitions for cash in excess of \$300 million in the aggregate and (viii) enter into transactions with affiliates. These covenants are subject to a number of additional exceptions and qualifications. The Agreement provides for customary events of default which include (subject in certain cases to customary grace and cure periods), among others: nonpayment, breach of covenants or other agreements in the Agreement, payment defaults or acceleration of other indebtedness, a failure to pay certain judgments and certain events of bankruptcy, insolvency or reorganization. Generally, if an event of default occurs, the Bank, with the consent of lenders holding a majority of the aggregate commitments under the facility, may declare all outstanding indebtedness under the Agreement to be due and payable. At March 31, 2008, the Company was in compliance with these covenants.

10. PRE-PAID FORWARD CONTRACT

In connection with the issuance of the Convertible Notes on May 17, 2007, the Company entered into a contract with Bear Stearns to purchase 3,490,400 shares of the Company's common stock at a purchase price of \$20.00 per share. Under the agreement, Bear Stearns is required to deliver the shares to the Company in April-May 2012. The transaction is subject to early settlement or settlement with alternative consideration in the event of certain significant corporate transactions such as a change in control. At closing of the Convertible Notes, the Company settled its obligation under the pre-paid forward contract to Bear Stearns for cash of \$69.8 million. As required by SFAS No.

150, the fair value of the obligation (which is equal to the cash paid) has been accounted for as a repurchase of common stock and as a reduction of shareholders' equity. Under terms of the contract, any dividend

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payment that Bear Stearns would otherwise be entitled to on the common stock during the term of the contract would be paid to the Company.

11. CONTINGENCIES

In January 2004, LG Electronics USA, Inc. (“LGE USA”) and LG Electronics, Inc., (“LGE”) a Korean corporation (LGE USA and LGE, together, “LG”) filed a lawsuit against Iridian Technologies, Inc., a wholly owned subsidiary of the Company, in federal court in New Jersey seeking to cancel Iridian’s federal trademark registration for its IrisAccess trademark, and alleging that Iridian had made false statements by announcing that it had discontinued its IrisAccess line of products. At the time LG filed this lawsuit, the parties had been engaged in an ongoing negotiation regarding Iridian’s introduction of new standard pricing for its licenses. LG contended that Iridian was not entitled to impose its new standard “per user” pricing on LG pursuant to the terms of the parties’ 2000 Amended and Restated Development, Distribution and Supply agreement (the “License Agreement”). In August 2004, LG filed a demand for arbitration before the American Arbitration Association, seeking a finding that its fee for using Iridian’s iris recognition technology remained at the original “per unit” pricing structure under the License Agreement. Shortly thereafter, Iridian terminated the License Agreement due to LG’s failure to pay royalties as required under Iridian’s new standard pricing. In response, LG filed another lawsuit in New Jersey federal court, asking the court to enter a finding that Iridian’s termination of the License Agreement was improper and that LG’s continued use of Iridian’s technology did not infringe upon Iridian’s patent rights. The issues in all three cases were consolidated into one action in New Jersey federal court. Iridian vigorously denied all of LG’s claims and counterclaimed for LG’s breach of contract, infringement of Iridian’s patents and copyrights, and misappropriation of Iridian’s trade secrets. LG replied to Iridian’s counterclaims and asserted defenses that include, among other things, the alleged invalidity or unenforceability of Iridian’s patents, copyrights and trade secrets. The court subsequently allowed LG to further amend its complaint to add allegations of antitrust violations by Iridian and to assert claims against L-1 and SecuriMetrics as defendants. Iridian subsequently requested to assert additional counterclaims against LG, which request remained pending while the Court conducted mediation with all parties in an effort to reach settlement terms. On May 1, 2008, the Company settled the litigation, which resolves all historical issues and disputes among the parties and dismisses with prejudice the pending litigation in the U.S. District Court for the District of New Jersey. Concurrently with the settlement, LG entered into a new license agreement with Iridian to license Iridian’s proprietary 2pi iris recognition software, and LGE USA entered into a separate agreement to obtain certain continuing consultation services from Iridian and L-1. In addition, Iridian assigned to LGE its “IRISACCESS” trademark.

In April 2005, two purported shareholder derivative actions also were filed against directors, naming Viisage as a nominal defendant. The suits claim that these directors breached their fiduciary duties to Viisage’s shareholders and to Viisage generally in connection with the same set of circumstances alleged in the class action lawsuit. The complaints are derivative in nature and do not seek relief from the Company. One of these actions was filed in Massachusetts Superior Court and the other was filed in the United States District Court for the District of Massachusetts. In July 2005, the state court action was dismissed with prejudice at the plaintiff’s request. An amended complaint in the federal court derivative action was filed in July 2006 in which the plaintiff added allegations regarding disclosures by Viisage’s representatives that generally appear to be intended to support her contention that she was excused from making a demand on the board of directors before filing a derivative complaint. The Company filed a motion to dismiss the amended complaint. After briefing and oral argument, the Court issued a memorandum and order allowing the motion and dismissing the amended complaint on August 23, 2007. The plaintiff filed a notice of appeal from this order on September 24, 2007. On March 25, 2008, a stipulation was filed by the parties in the Court of Appeals dismissing the appeal with prejudice. In consequence, the District Court’s order dismissing the amended complaint is final and this action is concluded.

In the ordinary course of business, the Company is subject to various claims, demands, litigation, investigations, inquiries, proceedings, or assessments and various contingent liabilities incidental to its businesses or assumed in connection with business acquisitions, including those described above. In

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accordance with SFAS No. 5, Accounting for Contingencies, the Company records a liability when management believes that it is both probable that a liability has been incurred and can reasonably estimate the amount of the potential loss. The Company believes it has adequate provisions for any such matters. The Company reviews these provisions quarterly and adjusts these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. However, litigation is inherently unpredictable and it is therefore possible that the consolidated financial position, results of operations or cash flows of the Company could be materially adversely affected in any particular period by the unfavorable resolution of one or more of these contingencies.

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

Introduction

The following discussion and analysis should be read in conjunction with the consolidated financial statements and the accompanying notes contained in our 2007 Annual Report on Form 10-K and the condensed consolidated financial statements and the accompanying notes contained in this Quarterly Report on Form 10-Q.

Business Overview

L-1 Identity Solutions, Inc. and its subsidiaries provide identity solutions and services that enable governments, law enforcement agencies and businesses to enhance security, reduce identity theft and protect personal privacy. L-1’s identity solutions are specifically designed for the identification of people and include secure credentialing, biometrics capture and access devices, automated document authentication, automated biometric identification systems, and biometrically-enabled background checks, as well as systems design, development, integration and support services. These identity solutions enable L-1’s customers to manage the entire life cycle of an individual’s identity for a variety of applications including civil identification, criminal identification, commercial, border management, military, antiterrorism and national security. L-1 also provides comprehensive consulting, training, security, technology development, and information technology solutions to the U.S. intelligence community.

The Company’s identity solutions combine products and related services, consisting of hardware, components, consumables and software, as well as maintenance, consulting and training services integral to sales of hardware and software. The Company also provides fingerprinting enrollment services and government consulting, training, security, technology development and information technology services. A customer, depending on its needs, may order solutions that include hardware, equipment, consumables, software products or services or combine hardware products, consumables, equipment, software products and services to create a multiple element arrangement.

The market for identity protection solutions has continued to develop at a rapid pace. In particular, consumers of identity protection solutions are demanding end-to-end solutions with increased functionality that can solve their spectrum of needs across the identity life cycle. Our objective is to meet those growing needs by continuing to broaden our product and solution offerings to meet our customer needs, leveraging our existing customer base to provide additional products and services, expanding our customer base both domestically and abroad, and augmenting our competitive position through strategic acquisitions. We evaluate our business primarily through financial metrics such as revenues, operating income (loss) and earnings before interest, income taxes, depreciation and amortization, asset impairments and in-process research and development charges, and stock-based compensation expense (“Adjusted EBITDA”), as well as free cash flow.

Our revenues increased to \$116.0 million for the three months ended March 31, 2008 from \$70.0 million for the three months ended March 31, 2007. Our net loss for the three months ended March 31, 2008 was \$1.9 million compared to an \$8.8 million loss for the three months ended March 31, 2007.

Sources of Revenues

Our Secure Credentialing Division, formerly known as “Viisage,” which prior to December 15, 2005 comprised our sole business, generates revenues from the sales of biometric solutions consisting of bundled proprietary software with commercial off-the-shelf equipment and related maintenance and services, the sale of secure printing solutions and

related consumables, and the design, customization and installation of secure credential issuance systems which generate revenues as the credentials are issued by the customer. The division also generates revenues from solutions using biometric technologies of other divisions. The division is included in our Identity Solutions segment.

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Our Biometrics division, formerly known as Identix, also included in our Identity Solutions segment, generates revenues from the sale of biometric solutions incorporating fingerprint, facial, skin and iris biometrics and system components necessary for the biometric capture and knowledge discovery. Identix offerings include Live Scan and mobile systems and services for biometric capture and identification, systems and biometric solutions that include modules and software for biometric matching and verification. Revenues are generated by sales of hardware, software and maintenance and other services.

Our SecuriMetrics, Inc. (“SecuriMetrics”)/Iridian Technologies, Inc. (“Iridian”) division, historically included in our Identity Solutions segment, is being integrated with the Biometric division and generates revenues through the development, customization and sale of biometrics solutions using iris technology which typically consists of proprietary multi-biometric capture devices bundled together with our proprietary software and other biometric technologies as well as sales of licenses and software.

Our Bioscrypt Inc, (“Bioscrypt”) division has generates revenues from the sales of biometric access control units and technologies. In addition, Bioscrypt’s VeriSoft software application is included on personal computers and its 3D facial recognition technology is used by the largest casino in the world. Bioscrypt is included in the Identity Solutions segment.

Our ComnetiX Inc. (“ComnetiX”) division, which was acquired on February 21, 2007, provides fingerprinting biometric authentication and identification solutions and enrollment services. In 2007, the division was included in our Services segment. Effective 2008, the company separated the biometric authentication and identification business and integrated it in the Biometrics division, in the Identity Solutions segment. The enrollment services business is now integrated with our IBT division, included in the Services segment.

Our Integrated Biometric Technology, Inc. (“IBT”)/Identix Identification Services, Inc. (“IIS”) division, included in our Services segment, generates revenues through the sales of enrollment and background screening products and services.

Our SpecTal, LLC (“SpecTal”) division, included in our Services segment, provides comprehensive security consulting services to U.S. government intelligence agencies.

Our McClendon LLC (“McClendon”) division, included in our Services segment, provides technical and professional services to the U.S. intelligence and military communities.

Our Advanced Concepts, Inc. (“ACI”) division, included in our Services segment, provides information technology and network security solutions, and system engineering and development services for the U.S. intelligence and military communities.

We market our solutions and services primarily to U.S. and foreign, federal, state and local government agencies and law enforcement agencies. We also are working to expand the use of our solutions in commercial markets, particularly financial services, transportation and healthcare. In a typical contract with a government entity for an identity solution, we design the system, supply and install equipment and software and integrate the solution within the entity’s existing network infrastructure and provide maintenance services. These contracts may be structured as fixed price contracts with payments made upon completion of agreed milestones or deliveries and with each milestone or delivery typically having a value specified in the contract. Alternatively, these contracts may be paid at a fixed price per credential issued as is typical in the drivers’ license market, per fingerprint delivered in the case of our fingerprinting services or on a time and material and fixed price level of effort basis for our government services.

Our growth in revenues is due principally to acquisitions we consummated, as well as increased demand for our identity solutions related to heightened emphasis on security, secure credentials, document authentication and biometrics. We anticipate that the U.S. government agencies will continue to be major customers for the foreseeable future. We also anticipate steadily increasing funding for major government programs. Any delay or other changes in the rollout of these programs could cause our revenues to fall short of expectations. We also expect to experience increased demand

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from a number of other government entities as they deploy identity solutions, particularly document authentication, at points of entry and exit, including borders, seaports and airports and in connection with national identification programs. Notwithstanding our expectations regarding demand for these solutions, the quantity and timing of orders from both U.S. and foreign government entities depends on a number of factors outside of our control, such as the level and timing of budget appropriations.

Acquisitions

We have pursued strategic acquisitions to complement and expand our existing solutions and services. Our acquisitions since January 1, 2007 include:

- Our March 2008 acquisition of Bioscrypt, which provides enterprise access control to over 400 global customers and its VeriSoft software application is now included on personal computers. In addition, its 3D facial recognition is used by the largest casino in the world to provide access control.
- Our July 2007 acquisitions of McClendon and ACI, which provide technical, network security and professional services to the U.S. intelligence community;
- Our February 2007 acquisition of ComnetiX, which creates an important presence for us in the Canadian market by adding a complementary base of customers to our portfolio, particularly within the law enforcement community;

The acquisitions have resulted in the consolidation of certain marketing resources, facilities and corporate functions of the separate entities in Stamford, Connecticut, and are expected to have a continuing material effect on our operations resulting from, but not limited to:

- Expected synergies resulting from providing a comprehensive product line to current and future customers.
- Expected future growth in revenues and profits from expanded markets for identity solutions.
- Enhancement of technical capabilities resulting from combining the intellectual capital of the combined entities.
- Rationalization of technology costs and research and development activities.
- Realignment of business divisions to complement each division's unique capabilities and rationalizing costs.
- Leveraging the Company's infrastructure to achieve higher revenues and profitability.

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Reportable Segments and Geographic Information

We operate in two reportable segments, the Identity Solutions segment and the Services segment. During the first quarter of 2008, we integrated the authentication and identification business of ComnetiX in the Identity Solutions segment and the fingerprinting services business in the Services segment. Accordingly, the segment data for the three months ended March 31, 2007 has been reclassified to conform to the March 31, 2008 presentation. We measure segment performance based on revenues, operating income (loss) and Adjusted EBITDA and free from cash flow. Operating results by segment, including allocation of corporate expenses, for the three months ended March 31, 2008 and 2007 were as follows (in thousands):

		Three months ended					
March 31,							
2008	March 31,						
2007	Identity Solutions:	Revenues	\$ 48,061	\$ 37,344	Gross Profit	14,290	9,971
(Loss)	(3,313)	(7,343)	Adjusted EBITDA	5,194	2,667	Depreciation and Amortization Expense	
7,503	8,008	Services:	Revenues	67,935	32,663	Gross Profit	17,064
Income	4,234	1,329	Adjusted EBITDA	7,453	3,081	Depreciation and Amortization Expense	2,169
1,052	Consolidated:	Revenues	\$ 115,996	70,007	Gross Profit	31,354	17,356
Income (Loss)	921	(6,014)	Adjusted EBITDA	12,647	5,748	Depreciation and Amortization Expense	
9,672	9,060						

Revenues by market for the three months ended March 31, 2008 and March 31, 2007 were as follows (in thousands):

		Three months ended								
March 31,										
2008	March 31,									
2007	State and local	\$ 30,754	\$ 28,557	Federal	81,937	40,305	Commercial	3,305	1,145	\$
115,996	\$ 70,007									

Revenues are attributed to each region based on the location of the customer. The following is a summary of revenues by geographic region (in thousands):

		Three months ended						
March 31,								
2008	March 31,							
2007	United States	\$ 107,953	\$ 61,476	Rest of the World	8,043	8,531	\$ 115,996	\$ 70,007
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For the three month period ended March 31, 2008, two Federal government agencies accounted for 29% of consolidated revenues. For the three month period ended March 31, 2007, one Federal government agency accounted for 26%, of consolidated revenues. As of March 31, 2008, the Company had an accounts receivable balance of approximately \$13.9 million from one Federal government agency which was the only customer that had a balance of greater than 10% of consolidated accounts receivable. As of March 31, 2007, one Federal government agency was the only customer that had a balance of greater than 10% of consolidated accounts receivable, which was approximately \$13.4 million.

RESULTS OF OPERATIONS

Consolidated Results of Operations

The 2008 results of operations were affected by the July 2007 acquisitions of ACI and McClendon and the March 2008 acquisition of Bioscrypt (collectively the "Acquisitions").

Revenues

	Three months ended
March 31,	
2008 March 31,	
2007 Revenues	\$ 115,996 \$ 70,007

Revenues were approximately \$116.0 million for the three months ended March 31, 2008 compared to approximately \$70.0 million for the three months ended March 31, 2007. Included in the results for the three months ended March 31, 2008 were \$26.9 million related to the Acquisitions. Excluding the impact of the Acquisitions, revenues increased \$19.1 million, or 27%, from the prior year period. The increase from the prior year period is due primarily to growth related to the Company's government consulting services, demand for our passport and credentialing solutions to the U.S. State Department and U.S. Department of Defense and increased revenue from our enrollment and background screening services.

Cost of revenues and gross margins

	Three months ended
March 31,	
2008 March 31,	
2007 Cost of revenues	\$ 78,741 \$ 46,177
Amortization of acquired intangible assets	5,901 6,474
Total cost of revenues	\$ 84,642 \$ 52,651
Gross profit	\$ 31,354 \$ 17,356
Gross margin	27 % 25 %

Cost of revenues increased by \$32.0 million for the three months ended March 31, 2008. The Acquisitions impacted the cost of revenues by \$18.3 million for the three months ended March 31, 2008. Excluding the Acquisitions, total cost of revenues increased by \$13.7 million or 26% compared to the corresponding period in the previous year which correlated to the growth in revenue for the first quarter of 2008. Excluding the Acquisitions, gross margin was 25% for the first quarter of 2008 and the first quarter of 2007.

Included in the cost of revenues for the first quarter of 2008 was \$5.9 million of amortization of acquired intangible assets, which decreased by approximately \$0.6 million from the prior year, reflecting additional amortization for the Acquisitions offset by lower amortization resulting from intangible impairments recorded in 2007. Amortization of acquired intangible assets reduced consolidated gross margins by 5% and 9% for the three months ended March 31, 2008 and 2007, respectively.

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Sales and marketing expenses

Three months ended

March 31,

2008 March 31,

2007 Sales and marketing expenses \$ 7,485 \$ 5,461 As a percentage of revenues 6 % 8 %

Sales and marketing expenses increased by approximately \$2.0 million for the three months ended March 31, 2008 from the prior year period, of which the Acquisitions accounted for \$0.3 million. Excluding the effects of the Acquisitions, sales and marketing expenses increased by \$1.7 million for the three months ended March 31, 2008. These increases are attributable to additional investments made to expand our focus on U.S. government and international opportunities. Sales and marketing expenses consists primarily of salaries and related personnel costs including stock-based compensation, commissions, travel and entertainment expenses, promotions and other marketing and sales support expenses. The decrease as a percentage of revenues reflects improved operating leverage of our cost structure.

Research and development expenses

Three months ended

March 31,

2008 March 31,

2007 Research and development expenses \$ 5,333 \$ 4,661 As a percentage of revenues 5 % 7 %

Research and development expenses increased by approximately \$0.7 million for the three months ended March 31, 2008 primarily related to the Acquisitions. Excluding the impact of the Acquisitions, research and development expenses increased by \$0.4 million for the three months ended March 31, 2008, as we continued to focus on the development of biometric technology. Research and development expenses were offset by higher utilization of research and development resources in the performance of contracts, the cost of which is included in cost of revenues. Gross research and development aggregated \$8.8 million and \$6.0 million for the three months ended March 31, 2008 and 2007, respectively. Most of our research and development costs are attributable to our Identity Solution segment, As a percentage of Identity Solutions revenues, gross research and development costs were 18% and 16% for the three months ended March 31, 2008 and 2007, respectively. Research and development expenses consist primarily of salaries, stock-based compensation and related personnel costs and prototype costs related to the design, development, testing and enhancement of our products.

General and administrative expenses

Three months ended

March 31,

2008 March 31,

2007 General and administrative expenses \$ 16,789 \$ 12,817 As a percentage of revenues 15 % 18 %

General and administrative expenses increased by approximately \$4.0 million for the three months ended March 31, 2008, from the prior year period of which approximately \$5.6 million is due to the Acquisitions. Excluding

the effects of the Acquisitions, for the three months ended March 31, 2008, general and administrative expenses decreased by \$1.6 million and reflects a reduction in legal costs resulting from favorable litigation experience offset by increased professional fees and other expenses. As a percentage of revenues, general and administrative expenses decreased to 15%

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