

---

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2014

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-15757

**IMAGEWARE SYSTEMS, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or  
Organization)

**33-0224167**

(IRS Employer Identification No.)

**10815 Rancho Bernardo Rd., Suite 310**

**San Diego, CA 92127**

(Address of Principal Executive Offices)

**(858) 673-8600**

(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 check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

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

The number of shares of common stock, with \$0.01 par value, outstanding on August 6, 2014 was 93,192,711.

---

---

**IMAGEWARE SYSTEMS, INC.**  
**INDEX**

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
ITEM 1. <a href="#">Financial Statements</a>	1
<a href="#">Condensed Consolidated Balance Sheets as of June 30, 2014 (unaudited) and December 31, 2013</a>	1
<a href="#">Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2014 and 2013 (unaudited)</a>	2
<a href="#">Condensed Consolidated Statements of Comprehensive Loss for the three and six months ended June 30, 2014 and 2013 (unaudited)</a>	3
<a href="#">Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 (unaudited)</a>	4
<a href="#">Notes to unaudited Condensed Consolidated Financial Statements</a>	5
ITEM 2. <a href="#">Management’s Discussion and Analysis of Financial Condition and Results of Operations</a>	22
ITEM 3. <a href="#">Quantitative and Qualitative Disclosures About Market Risk</a>	38
ITEM 4. <a href="#">Controls and Procedures</a>	38
<b>PART II. OTHER INFORMATION</b>	
ITEM 1. <a href="#">Legal Proceedings</a>	39
ITEM 1A. <a href="#">Risk Factors</a>	39
ITEM 6. <a href="#">Exhibits</a>	40

[SIGNATURES](#)

PART I

ITEM 1. FINANCIAL STATEMENTS

IMAGEWARE SYSTEMS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In Thousands, except share and per share data)

	June 30, 2014	December 31, 2013
	(Unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 1,415	\$ 2,363
Accounts receivable, net of allowance for doubtful accounts of \$3 at June 30, 2014 and December 31, 2013	400	302
Inventory, net	603	505
Other current assets	522	148
<b>Total Current Assets</b>	<b>2,940</b>	<b>3,318</b>
Property and equipment, net	241	245
Other assets	30	395
Intangible assets, net of accumulated amortization	158	172
Goodwill	3,416	3,416
<b>Total Assets</b>	<b>\$ 6,785</b>	<b>\$ 7,546</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 386	\$ 486
Deferred revenue	1,304	1,662
Accrued expenses	963	924
Derivative liabilities	-	57
Notes payable to related parties	-	55
<b>Total Current Liabilities</b>	<b>2,653</b>	<b>3,184</b>
Pension obligation	1,058	1,031
<b>Total Liabilities</b>	<b>3,711</b>	<b>4,215</b>
Shareholders' Equity:		
Preferred stock, authorized 4,000,000 shares:		
Series B Convertible Redeemable Preferred Stock, \$0.01 par value; designated 750,000 shares, 389,400 shares issued, and 239,400 shares outstanding at June 30, 2014 and December 31, 2013, respectively; liquidation preference \$607 at June 30, 2014 and December 31, 2013, respectively.	2	2
Common stock, \$0.01 par value, 150,000,000 shares authorized; 92,592,455 and 87,555,317 shares issued at June 30, 2014 and December 31, 2013, respectively, and 92,585,751 and 87,548,613 shares outstanding at June 30, 2014 and December 31, 2013, respectively.	925	874
Additional paid-in capital	135,149	131,652
Treasury stock, at cost 6,704 shares	(64)	(64)
Accumulated other comprehensive loss	(847)	(830)
Accumulated deficit	(132,091)	(128,303)
<b>Total Shareholders' Equity</b>	<b>3,074</b>	<b>3,331</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 6,785</b>	<b>\$ 7,546</b>

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

**IMAGEWARE SYSTEMS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In Thousands, except share and per share amounts)  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
<b>Revenues:</b>				
Product	\$ 281	\$ 364	\$ 715	\$ 571
Maintenance	656	660	1,285	1,309
	<u>937</u>	<u>1,024</u>	<u>2,000</u>	<u>1,880</u>
<b>Cost of revenues:</b>				
Product	48	114	118	158
Maintenance	184	182	365	376
Gross profit	<u>705</u>	<u>728</u>	<u>1,517</u>	<u>1,346</u>
<b>Operating expenses:</b>				
General and administrative	873	775	1,890	1,667
Sales and marketing	596	510	1,214	985
Research and development	1,152	995	2,181	1,914
Depreciation and amortization	46	26	88	55
	<u>2,667</u>	<u>2,306</u>	<u>5,373</u>	<u>4,621</u>
Loss from operations	(1,962)	(1,578)	(3,856)	(3,275)
Interest expense, net	105	73	184	75
Change in fair value of derivative liabilities	-	3,973	-	5,148
Other income, net	(5)	(4)	(289)	(108)
Loss before income taxes	(2,062)	(5,620)	(3,751)	(8,390)
Income tax expense (benefit)	12	(1)	12	2
Net loss	(2,074)	(5,619)	(3,763)	(8,392)
Preferred dividends	(13)	(13)	(25)	(25)
Net loss available to common shareholders	<u>\$ (2,087)</u>	<u>\$ (5,632)</u>	<u>\$ (3,788)</u>	<u>\$ (8,417)</u>
<b>Basic loss per common share - see Note 3:</b>				
Net loss	\$ (0.02)	\$ (0.07)	\$ (0.04)	\$ (0.11)
Preferred dividends	(0.00)	(0.00)	(0.00)	(0.00)
Basic loss per share available to common shareholders	<u>\$ (0.02)</u>	<u>\$ (0.07)</u>	<u>\$ (0.04)</u>	<u>\$ (0.11)</u>
Basic weighted-average shares	91,930,400	78,581,502	90,293,758	77,718,825
<b>Diluted loss per common share - see Note 3:</b>				
Diluted loss per share	\$ (0.02)	\$ (0.07)	\$ (0.04)	\$ (0.11)
Diluted weighted-average shares	<u>91,930,400</u>	<u>78,581,502</u>	<u>90,293,758</u>	<u>77,718,825</u>

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

**IMAGEWARE SYSTEMS, INC**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**  
**(In Thousands)**  
**(Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Net loss	\$ (2,074)	\$ (5,619)	\$ (3,763)	\$ (8,392)
Other comprehensive loss:				
Foreign currency translation adjustment	(7)	(15)	(16)	(8)
Comprehensive loss	<u>\$ (2,081)</u>	<u>\$ (5,634)</u>	<u>\$ (3,779)</u>	<u>\$ (8,400)</u>

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

**IMAGEWARE SYSTEMS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands)  
(Unaudited)

	Six Months Ended June 30,	
	2014	2013
<b>Cash flows from operating activities</b>		
Net loss	\$ (3,763)	\$ (8,392)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	88	55
Amortization of debt issuance costs	182	72
Reduction in accounts payable and accrued expenses from the expiration of statute of limitations	(216)	(104)
Change in fair value of derivative liabilities	—	5,148
Warrants issued in lieu of cash paid for services		1
Stock-based compensation	425	269
Change in assets and liabilities		
Accounts receivable	(98)	(177)
Inventory	(98)	(165)
Other assets	(64)	26
Accounts payable	106	(157)
Deferred revenue	(357)	(169)
Accrued expenses	78	(40)
Pension obligation	27	17
Total adjustments	73	4,776
Net cash used in operating activities	(3,690)	(3,616)
<b>Cash flows from investing activities</b>		
Purchase of property and equipment	(70)	(74)
Net cash used in investing activities	(70)	(74)
<b>Cash flows from financing activities</b>		
Proceeds from exercised stock options	55	3
Proceeds from exercised warrants to purchase stock	2,798	528
Dividends paid	(25)	(25)
Net cash provided by financing activities	2,828	506
Effect of exchange rate changes on cash	(16)	(8)
Net decrease in cash and cash equivalents	(948)	(3,192)
Cash and cash equivalents at beginning of period	2,363	4,225
Cash and cash equivalents at end of period	\$ 1,415	\$ 1,033
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 2	\$ —
Cash paid for income taxes	\$ —	\$ —
<b>Summary of non-cash investing and financing activities:</b>		
Reclassification of warrants previously classified as derivative liabilities to additional paid-in capital	\$ 57	\$ 6,132
Issuance of common stock warrants securing line of credit borrowing facility	\$ 127	\$ 580
Issuance of common stock pursuant to cashless warrant exercises	\$ 2	\$ 40
Issuance of common stock pursuant to conversion of Related-Party notes payable and accrued interest	\$ 85	\$ —
Issuance of common stock pursuant to achievement of vesting conditions	\$ —	\$ 1

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

**IMAGEWARE SYSTEMS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

**Overview**

ImageWare Systems, Inc. (the “*Company*”) is incorporated in the state of Delaware. The Company is a pioneer and leader in the market for biometrically enabled software-based identity management solutions. The Company develops mobile and cloud-based identity management solutions providing biometric, secure credential and law enforcement technologies. Our patented biometric product line includes our flagship product, the Biometric Engine®, a hardware and algorithm independent multi-biometric engine that enables the enrollment and management of unlimited population sizes. Our identification products are used to create, issue and manage secure credentials, including national IDs, passports, driver's licenses, smart cards and access control credentials. Our digital booking products provide law enforcement with integrated mugshots, fingerprint livescans, and investigative capabilities. The Company is headquartered in San Diego, CA, with offices in Portland, OR, Washington, D.C., Mexico, and Ottawa, Ontario.

**Recent Developments**

*New Contracts*

On June 27, 2014, the Company announced that it was selected to implement a multi-modal biometric driver license system for the State of Baja California, Mexico. The contract was awarded by the Funciones Ocupacionales Insha, S.A. de C.V., the prime contractor on the project. The contract is valued at more than \$1.0 million and its software will help generate more than one million driver licenses over the next three years. The Company anticipates that it will receive one-time license fees for its software upon delivery, and ongoing payments for its professional services and maintenance as delivered. The Company will help to deploy the system at governmental offices in the largest cities in the state, including Tijuana, Mexicali, Tecate and Rosarito, as well as implement mobile stations through the state. The project began in the third quarter of 2014.

*Amendments to Line of Credit*

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowings of up to \$2,500,000 (the “*Line of Credit*”). The Line of Credit was extended by an existing shareholder and member of our Board of Directors (the “*Holder*”). In March 2014, the Line of Credit's borrowing was increased to an aggregate total of \$3,500,000 (the “*Amendment*”). Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to \$2.5 million of the outstanding balance of the Line of Credit into shares of the Company's common stock for \$0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's common stock for \$2.25 per share. As consideration for entering into the Amendment, the Company issued to the Holder a warrant exercisable for 177,778 shares of the Company's common stock. The warrant expires on March 27, 2015 and has an exercise price of \$2.25 per share.

In April 2014, the Company and the Holder entered into a further amendment to the Line of Credit to decrease the available borrowings to \$3.0 million (the “*Second Amendment*”). Contemporaneous with the execution of the Second Amendment, the Company entered into a new unsecured line of credit with available borrowings of up to \$500,000 with a second member of the Company's Board of Directors (the “*Second Holder*”), which amount is convertible into shares of the Company's common stock for \$2.25 per share. As a result of these amendments, total available borrowings under aggregate lines of credit available to the Company remain unchanged at a total of \$3,500,000. In connection with the Second Amendment, the Holder assigned and transferred to the Second Holder one-half of the 177,778 warrants issued by the Company to the Holder to purchase shares of the Company's common stock, originally granted to the Holder upon execution of the Amendment.

Advances under the Lines of Credit are made at the Company's request. The Lines of Credit will terminate, and no further advances will be made, upon the earlier of March 2015 or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$3,500,000. In the event of such financing, the outstanding balance under the terms of the Lines of Credit will be due and payable upon demand.

As of June 30, 2014, no advances were made under the Lines of Credit.

#### *Liquidity and Capital Resources*

Historically, our principal sources of cash have included customer payments from the sale of our products, proceeds from the issuance of common and preferred stock and proceeds from the issuance of debt. Our principal uses of cash have included cash used in operations, payments relating to purchases of property and equipment and repayments of borrowing. We expect that our principal uses of cash in the future will be for product development including customization of identity management products for enterprise and consumer applications, further development of intellectual property, development of Software-as-a-Service ("SaaS") capabilities for existing products as well as general working capital and capital expenditure requirements. We expect that, as our revenues grow, our sales and marketing and research and development expenses will continue to grow, albeit as a slower rate and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

Management believes that the Company's current cash and cash equivalents will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing if we are able to increase our product revenues in accordance with our plan. If we are unable to increase our product revenues we will require additional debt or equity financing to continue our operations at the current level and there is no guarantee that such financing will be available or available on terms acceptable to the company.

## **NOTE 2. SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION**

### **Basis of Presentation**

The accompanying condensed consolidated balance sheet as of December 31, 2013, which has been derived from audited financial statements, and the unaudited interim condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") and the rules and regulations of the Securities and Exchange Commission ("SEC") related to a quarterly report on Form 10-Q. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. The interim financial statements reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results for the periods presented. All such adjustments are of a normal and recurring nature. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2013, which are included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 that was filed with the SEC on March 17, 2014.

Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ended December 31, 2014, or any other future periods.

### **Significant Accounting Policies**

#### *Principles of Consolidation*

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

#### *Operating Cycle*

Assets and liabilities related to long-term contracts are included in current assets and current liabilities in the accompanying condensed consolidated balance sheets, although they will be liquidated in the normal course of contract completion which may take more than one operating cycle.



### *Use of Estimates*

The preparation of the condensed consolidated financial statements in conformity with GAAP 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 condensed consolidated financial statements, and the reported amounts of revenue and expense during the reporting period. Significant estimates include the allowance for doubtful accounts receivable, inventory carrying values, deferred tax asset valuation allowances, accounting for loss contingencies, recoverability of goodwill and acquired intangible assets and amortization periods, assumptions used in the Black-Scholes model to calculate the fair value of share-based payments, assumptions used in the application of fair value methodologies to calculate the fair value of derivative liabilities, revenue and cost of revenues recognized under the percentage of completion method and assumptions used in the application of fair value methodologies to calculate the fair value of pension assets and obligations. Actual results could differ from estimates.

### *Cash and Cash Equivalents*

The Company defines cash equivalents as highly liquid investments with original maturities of less than 90 days that are not held for sale in the ordinary course of business.

### *Accounts Receivable*

In the normal course of business, the Company extends credit without collateral requirements to its customers that satisfy pre-defined credit criteria. Accounts receivable are recorded net of an allowance for doubtful accounts. The Company records its allowance for doubtful accounts based upon an assessment of various factors. The Company considers historical experience, the age of the accounts receivable balances, the credit quality of its customers, current economic conditions and other factors that may affect customers' ability to pay to determine the level of allowance required. Accounts receivable are written off against the allowance for doubtful accounts when all collection efforts by the Company have been unsuccessful.

### *Inventories*

Finished goods inventories are stated at the lower of cost, determined using the average cost method, or market. See Note 4, "Inventory", below.

### *Fair Value of Financial Instruments*

For certain of the Company's financial instruments, including accounts receivable, accounts payable, accrued expenses, deferred revenue and notes payable to related-parties, the carrying amounts approximate fair value due to their relatively short maturities.

### *Derivative Financial Instruments*

The Company does not use derivative instruments to hedge exposures to cash flow, market or foreign currency risks.

The Company reviews the terms of common stock, preferred stock, warrants and convertible debt it issues to determine if there are embedded derivative instruments, including embedded conversion options that must be bifurcated and accounted for separately as derivative financial instruments. In circumstances where the host instrument contains more than one embedded derivative instrument, including the conversion option, requiring bifurcation, the bifurcated derivative instruments are accounted for as a single, compound derivative instrument.

Bifurcated embedded derivatives are initially recorded at fair value and are then revalued at each reporting date with changes in the fair value reported as non-operating income or expense. When the equity or convertible debt instruments contain embedded derivative instruments that are to be bifurcated and accounted for as liabilities, the total proceeds received are first allocated to the fair value of all the bifurcated derivative instruments. The remaining proceeds, if any, are then allocated to the host instruments themselves, usually resulting in those instruments being recorded at a discount from their face value.

The discount from the face value of the convertible debt, together with the stated interest on the instrument, is amortized over the life of the instrument through periodic charges to interest expense, using the effective interest method.

#### *Revenue Recognition*

The Company recognizes revenue from the following major revenue sources:

- Long-term fixed-price contracts involving significant customization
- Fixed-price contracts involving minimal customization
- Software licensing
- Sales of computer hardware and identification media
- Post-contract customer support (“PCS”)

The Company’s revenue recognition policies are consistent with GAAP including the Financial Accounting Standards Board (“FASB”), Accounting Standards Codification (“ASC”) 985-605, *Software Revenue Recognition*, ASC 605-35, *Revenue Recognition, Construction-Type and Production-Type Contracts*, SEC Staff Accounting Bulletin 104, and ASC 605-25, *Revenue Recognition, Multiple Element Arrangements*. Accordingly, the Company recognizes revenue when all of the following criteria are met: (i) persuasive evidence that an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the fee is fixed or determinable and (iv) collectability is reasonably assured.

The Company recognizes revenue and profit as work progresses on long-term, fixed-price contracts involving significant amounts of hardware and software customization using the percentage of completion method based on costs incurred to date, compared to total estimated costs upon completion. The primary components of costs incurred are third party software and direct labor cost including fringe benefits. Revenues recognized in excess of amounts billed are classified as current assets under “Costs and estimated earnings in excess of billings on uncompleted contracts”. Amounts billed to customers in excess of revenue recognized are classified as current liabilities under “Billings in excess of costs and estimated earnings on uncompleted contracts”. Revenue from contracts for which the Company cannot reliably estimate total costs, or there are not significant amounts of customization, are recognized upon completion. The Company also generates non-recurring revenue from the licensing of its software. Software license revenue is recognized upon the execution of a license agreement, upon deliverance, when fees are fixed and determinable, when collectability is probable and when all other significant obligations have been fulfilled. The Company also generates revenue from the sale of computer hardware and identification media. Revenue for these items is recognized upon delivery of these products to the customer. The Company’s revenue from periodic maintenance agreements is generally recognized ratably over the respective maintenance periods provided no significant obligations remain and collectability of the related receivable is probable. Amounts collected in advance for maintenance services are included in current liabilities under “Deferred revenues”. Sales tax collected from customers is excluded from revenue.

## Customer Concentration

For the three months ended June 30, 2014, one customer accounted for approximately 19% or \$174,000 of total revenues and had trade receivables at June 30, 2014 of \$0. For the six months ended June 30, 2014, one customer accounted for approximately 19% or \$376,000 of total revenues and had trade receivables at June 30, 2014 of \$0. For the three months ended June 30, 2013, two customers accounted for approximately 25% or 256,000 of total revenues and had trade receivables at June 30, 2013 of \$155,000. For the six months ended June 30, 2013, one customer accounted for approximately 16% or \$304,000 of total revenues and had trade receivables at June 30, 2013 of \$0.

## Recently Issued Accounting Standards

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (the “FASB”), or other standard setting bodies, which are adopted by us as of the specified effective date. Unless otherwise discussed, the Company’s management believes the impact of recently issued standards not yet effective will not have a material impact on the Company’s consolidated financial statements upon adoption.

*FASB ASU 2014-09.* In May 2014, FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU No. 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for us on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU No. 2014-09 will have on our consolidated financial statements and related disclosures.

*FASB ASU No. 2014-12.* In June 2014, FASB issued ASU No. 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (a consensus of the FASB Emerging Issues Task Force), which is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015. We do not expect adoption of ASU No. 2014-12 to have a significant impact on our consolidated financial statements.

## NOTE 3. NET LOSS PER COMMON SHARE

Basic loss per common share is calculated by dividing net loss available to common shareholders for the period by the weighted-average number of common shares outstanding during the period. Diluted loss per common share is calculated by dividing net loss available to common shareholders for the period by the weighted-average number of common shares outstanding during the period, adjusted to include, if dilutive, potential dilutive shares consisting of convertible preferred stock, convertible notes payable, stock options and warrants, calculated using the treasury stock and if-converted methods. For diluted loss per share calculation purposes, the net loss available to common shareholders is adjusted to add back any preferred stock dividends and any interest on convertible debt reflected in the condensed consolidated statement of operations for the respective periods.

The table below presents the computation of basic and diluted loss per share:

(Amounts in thousands except share and per share amounts)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Numerator for basic and diluted loss per share:				
Net loss	\$ (2,074)	\$ (5,619)	\$ (3,763)	\$ (8,392)
Preferred dividends	(13)	(13)	(25)	(25)
Net loss available to common shareholders	(2,087)	(5,632)	(3,788)	(8,417)
Denominator for basic and dilutive loss per share – weighted-average shares outstanding				
	91,930,400	78,581,502	90,293,758	77,718,825
Net loss	(0.02)	(0.07)	(0.04)	(0.11)
Preferred dividends	(0.00)	(0.00)	(0.00)	(0.00)
Basic and diluted loss per share available to common shareholders	(0.02)	(0.07)	(0.04)	(0.11)

The following potentially dilutive securities have been excluded from the computations of diluted weighted-average shares outstanding for the periods presented, as they would be anti-dilutive:

Dilutive securities	For the three and six months ended June 30,	
	2014	2013
Convertible notes payable	-	175,013
Convertible preferred stock	46,027	46,027
Stock Options	3,668,416	3,436,221
Warrants	1,973,562	12,591,168
Total anti-dilutive common share equivalents	5,668,005	16,248,429

**NOTE 4. SELECT BALANCE SHEET DETAILS**

**Inventory**

Inventories of \$603,000 as of June 30, 2014 were comprised of work in process of \$595,000 representing direct labor costs on in-process projects and finished goods of \$8,000 net of reserves for obsolete and slow-moving items of \$3,000. Inventories of \$505,000 as of December 31, 2013 were comprised of work in process of \$499,000 representing direct labor costs on in-process projects and finished goods of \$6,000 net of reserves for obsolete and slow-moving items of \$3,000. Appropriate consideration is given to obsolescence, excessive levels, deterioration and other factors in evaluating net realizable value and required reserve levels.

## Intangible Assets

The Company has intangible assets in the form of trademarks, trade names and patents. The carrying amounts of the Company's acquired trademark and trade name intangible assets were \$23,000 and \$31,000 as of June 30, 2014 and December 31, 2013, respectively, which include accumulated amortization of \$324,000 and \$316,000 as of June 30, 2014 and December 31, 2013, respectively. Amortization expense for the intangible assets was \$4,000 and \$8,000 for the three and six months ended June 30, 2014 and 2013, respectively. All intangible assets are being amortized over their estimated useful lives with no estimated residual values. Any costs incurred by the Company to renew or extend the life of intangible assets will be evaluated under ASC No. 350, *Intangibles – Goodwill and Other*, for proper treatment.

The carrying amounts of the Company's patent intangible assets were \$135,000 and \$141,000 as of June 30, 2014 and December 31, 2013, respectively, which include accumulated amortization of \$524,000 and \$518,000 as of June 30, 2014 and December 31, 2013, respectively. Amortization expense for patent intangible assets was \$3,000 and \$6,000 for the three and six months ended June 30, 2014 and 2013, respectively. Patent intangible assets are being amortized on a straight-line basis over their weighted-average remaining life of approximately 13.5 years.

The estimated acquired intangible amortization expense for the next five fiscal years is as follows:

<b>Fiscal Year Ended December 31,</b>	<b>Estimated Amortization Expense (\$ in thousands)</b>
2014 (6 months)	\$ 14
2015	27
2016	12
2017	12
2018	12
Thereafter	81
<b>Totals</b>	<b>\$ 158</b>

## Goodwill

The Company annually, or more frequently if events or circumstances indicate a need, tests the carrying amount of goodwill for impairment. A two-step impairment test is used to first identify potential goodwill impairment and then measure the amount of goodwill impairment loss, if any. The first step was conducted by determining and comparing the fair value, employing the market approach, of the Company's reporting unit to the carrying value of the reporting unit. The Company continues to have only one reporting unit, Identity Management. Based on the results of this impairment test, the Company determined that its goodwill was not impaired as of June 30, 2014 and December 31, 2013.

**NOTE 5. NOTES PAYABLE AND LINES OF CREDIT**

Notes payable consist of the following:

(\$ in thousands)	June 30, 2014	December 31, 2013
Notes payable to related parties:		
7% convertible promissory notes. Face value of notes \$0 at June 30, 2014 and \$55 at December 31, 2013. Discount on notes is \$0 at June 30, 2014 and December 31, 2013. In January 2013, the Company received an extension to June 30, 2014. Notes were converted in their entirety as of June 30, 2014.	\$ —	\$ 55
Total notes payable to related parties	<u>\$ —</u>	<u>\$ 55</u>
Total notes payable		55
Less current portion	(—)	(55)
Long-term notes payable	<u>\$ —</u>	<u>\$ —</u>

*7% Convertible Promissory Notes to Related Parties*

On November 14, 2008, the Company entered into a series of convertible promissory notes (the "*Related-Party Convertible Notes*"), in the principal aggregate amount of \$110,000, with certain officers and members of the Company's Board of Directors. The Related-Party Convertible Notes bear interest at 7.0% per annum and were due February 14, 2009. The principal amount of the Related-Party Convertible Notes plus accrued but unpaid interest is convertible at the option of the holder into common stock of the Company. The number of shares into which the Related-Party Convertible Notes are convertible is calculated by dividing the outstanding principal and accrued but unpaid interest by \$0.55 (the "*Conversion Price*").

In conjunction with the issuance of the Related-Party Convertible Notes, the Company issued an aggregate of 149,996 warrants to the note holders to purchase common stock of the Company which were exercised in their entirety, on a cashless basis, between October and November 2013 resulting in the issuance of 111,783 shares of the Company's common stock.

The Company, in 2008, initially recorded the convertible notes net of a discount equal to the fair value allocated to the warrants of approximately \$13,000. The Company estimated the fair value of the warrants using the Black-Scholes option pricing model using the following assumptions: term of 5 years, a risk free interest rate of 2.53%, a dividend yield of 0%, and volatility of 96%. The Related-Party Convertible Notes also contain a beneficial conversion feature, resulting in an additional debt discount of \$12,000. The beneficial conversion amount was measured using the accounting intrinsic value, i.e. the excess of the aggregate fair value of the common stock into which the debt is convertible over the proceeds allocated to the security. The Company has accreted the beneficial conversion feature over the life of the Related-Party Convertible Notes.

The Company did not repay the Related-Party Convertible Notes on the due date. In August 2009, the Company received from the Related-Party Convertible Note holders a waiver of default and extension of the Maturity Date to January 31, 2010. As consideration for the waiver and note extension, the Company issued to the Related-Party Convertible Note holders warrants to purchase an aggregate of 150,000 shares of the Company's common stock. The warrants have an exercise price of \$0.50 per share and expire on August 25, 2014.

The Company did not repay the notes on January 31, 2010. During the year ended December 31, 2012, the Company repaid \$45,000 in principal to certain holders of the Related-Party Convertible Notes. On January 21, 2013, the holders of the Related-Party Convertible Notes agreed to extend the due date on their respective notes to be due and payable no later than June 30, 2014 however, the Related-Party Convertible Notes would be callable at any time, at the option of the note holder, prior to June 30, 2014. In December 2013, a holder converted \$10,000 of the Related-Party Convertible Notes into 18,182 shares of common stock of the Company. Also, in December 2013, 13,636 warrants were exercised, on a cashless basis, resulting in the issuance of 9,969 shares of the Company's common stock.

In June 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of \$55,000 into 100,000 shares of common stock of the Company. The holders also elected to convert approximately \$30,000 in accrued interest into 54,607 shares of the Company's common stock.

#### *Lines of Credit*

In March 2013, the Company entered into the Line of Credit with available borrowings of up to \$2,500,000, and in March 2014, the Line of Credit was amended to increase available borrowings to an aggregate total of \$3,500,000. Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to \$2.5 million of the outstanding balance of the Line of Credit into shares of the Company's common stock for \$0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's common stock for \$2.25 per share.

As consideration for the initial Line of Credit, the Company issued to the Holder the Line of Credit Warrant, exercisable for 1,052,632 shares of the Company's common stock. The Line of Credit Warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share. As consideration for entering into the Amendment, the Company issued to the Holder the Amendment Warrant, exercisable for 177,778 shares of the Company's common stock. The Amendment Warrant expires on March 27, 2015 and has an exercise price of \$2.25 per share.

In April 2014, the Company and Holder entered into the Second Amendment to the Line of Credit to decrease the available borrowings to \$3.0 million. Contemporaneous with the execution of the Second Amendment, the Company entered into a new unsecured line of credit with available borrowings of up to \$500,000 with the Second Holder, which amount is convertible into shares of the Company's common stock for \$2.25 per share. As a result of these amendments, total available borrowings under aggregate Lines of Credit available to the Company remain unchanged at a total of \$3,500,000. In connection with the Second Amendment, the Holder assigned and transferred to the Second Holder one-half of the 177,778 Amendment Warrants issued by the Company to the Holder to purchase shares of the Company's common stock, originally granted to the Holder upon execution of the Amendment.

Borrowings under the Lines of Credit accrue interest at a rate of 8% per annum and are due in March 2015. Advances under the credit facilities are made at the Company's request. The Lines of Credit will terminate, and no further advances will be made, upon the earlier of March 2015 or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$3.5 million. In the event of such financing, the outstanding balance under the terms of the Lines of Credit shall be due and payable upon demand.

The Company estimated the fair value of the Line of Credit Warrant and the Amendment Warrants using the Black-Scholes option pricing model using the following assumptions: term of two years for the Line of Credit Warrants issued March 2013 and a term of one year for the Amendment Warrants issued in March 2014, a risk free interest rate of 2.58%, a dividend yield of 0%, and volatility of 79% for the Line of Credit Warrant and 74% for the Amendment Warrant. The Company recorded the fair value of the Line of Credit Warrant and the Amendment Warrants as deferred financing fees of approximately \$707,000 to be amortized over the life of the Lines of Credit.

The Company evaluated the Lines of Credit and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the Lines of Credit). The Company has considered the accounting for this contingent beneficial conversion feature using the guidance in ASC 470, *Debt*. The guidance in ASC 470 states that a contingent beneficial conversion feature in an instrument shall not be recognized in earnings until the contingency is resolved. The beneficial conversion features of future borrowings under the Lines of Credit will be measured using the intrinsic value calculated at the date the contingency is resolved using the exercise price and trading value of the Company's common stock at the date the Lines of Credit were issued (commitment date). Such amounts could range from \$0 to approximately \$500,000 depending on the amount borrowed by the Company under the Lines of Credit.

As of June 30, 2014, no advances were made under the Lines of Credit.

**NOTE 6. EQUITY**

The Company’s Certificate of Incorporation, as amended, authorized the issuance of two classes of stock to be designated “common stock” and “preferred stock”. The preferred stock may be divided into such number of series and with the rights, preferences, privileges and restrictions as the Board of Directors may determine.

**Series B Convertible Redeemable Preferred Stock**

The Company had 239,400 shares of Series B Convertible Redeemable Preferred (“*Series B Preferred*”) outstanding as of June 30, 2014 and December 31, 2013. At June 30, 2014 and December 31, 2013, the Company had cumulative undeclared dividends of approximately \$8,000, respectively. There were no conversions of Series B Preferred into common stock during the six months ended June 30, 2014 or 2013.

**Common Stock**

The following table summarizes common stock activity for the six months ended June 30, 2014:

	<b>Common Stock</b>
Shares outstanding at December 31, 2013	87,548,613
Shares issued pursuant to options exercised for cash	83,745
Shares issued pursuant to Related-Party note payable conversion	154,607
Shares issued pursuant to cashless warrants exercised	156,154
Shares issued pursuant to warrants exercised for cash	4,642,632
Shares outstanding at June 30, 2014	92,585,751

During the six months ended June 30, 2014, the Company issued 83,745 shares of common stock pursuant to the exercise of 83,745 options for cash proceeds of approximately \$55,000. During the six months ended June 30, 2014, the Company issued 4,642,632 shares of common stock pursuant to the exercise of 4,642,632 warrants for cash proceeds of approximately \$2,798,000. During the six months ended June 30, 2014, the Company issued 156,154 shares of common stock pursuant to the cashless exercise of 210,000 warrants.

**Warrants**

The following table summarizes warrant activity for the following periods:

	<b>Warrants</b>	<b>Weighted- Average Exercise Price</b>
Balance at December 31, 2013	6,598,416	\$ 0.52
Granted	277,778	\$ 2.10
Expired / Canceled	(50,000)	\$ 1.08
Exercised	(4,852,632)	\$ 0.60
Balance at June 30, 2014	1,973,562	\$ 0.85

During the six months ended June 30, 2014, the Company issued to certain consultants warrants to purchase an aggregate of 100,000 shares of the Company’s common stock. Such warrants have an exercise prices ranging of \$1.83 per share and vest only upon the attainment of specified events. No such events were obtained during the six months ended June 30, 2014.

During the six months ended June 30, 2014, the Company issued to existing shareholders and members of our Board of Directors warrants to purchase an aggregate of 177,778 shares of the Company’s common stock. Such warrants have an exercise price of \$2.25 per share and expire on March 27, 2015.



During the six months ended June 30, 2014, there were 4,642,632 warrants exercised for cash resulting in the issuance of 4,642,632 shares of common stock and proceeds to the Company of approximately \$2,798,000 and 50,000 warrants that expired. Also during the six months ended June 30, 2014, there were 210,000 warrants exercised on a cashless basis resulting in the issuance of 156,154 shares of the Company's common stock.

As of June 30, 2014, warrants to purchase 1,973,562 shares of common stock at prices ranging from \$0.50 to \$2.40 were outstanding. All warrants are exercisable as of June 30, 2014, and expire at various dates through December 2016, with the exception of an aggregate of 380,000 warrants, which become exercisable only upon the attainment of specified events.

#### *Stock-Based Compensation*

As of June 30, 2014, the Company had two active stock-based compensation plans for employees and nonemployee directors, which authorize the granting of various equity-based incentives including stock options and restricted stock. On July 1, 2014, the Company began soliciting written consents from its shareholders to approve an amendment to the Company's 1999 Stock Option Plan to increase the number of shares authorized for issuance thereunder from approximately 4.0 million to approximately 7.0 million (the "Amendment"). As of July 21, 2014, the Company had received written consents approving the Amendment from over 50% of the Company's stockholders. As such, the Amendment was approved.

The Company estimates the fair value of its stock options using a Black-Scholes option-pricing model, consistent with the provisions of ASC No. 718, *Compensation – Stock Compensation*. The fair value of stock options granted is recognized to expense over the requisite service period. Stock-based compensation expense is reported in general and administrative, sales and marketing, engineering and customer service expenses based upon the departments to which substantially all of the associated employees report and credited to additional paid-in capital. Stock-based compensation expense related to equity options was approximately \$148,000 and \$306,000 for the three and six months ended June 30, 2014, respectively. Stock-based compensation expense related to equity options was approximately \$144,000 and \$269,000 for the three and six months ended June 30, 2013, respectively.

ASC 718 requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the Black-Scholes option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The Company is required to make various assumptions in the application of the Black-Scholes option-pricing model. The Company has determined that the best measure of expected volatility is based on the historical weekly volatility of the Company's common stock. Historical volatility factors utilized in the Company's Black-Scholes computations for the six months ended June 30, 2014 and 2013 ranged from 78% to 135%. The Company has elected to estimate the expected life of an award based upon the SEC approved "simplified method" noted under the provisions of Staff Accounting Bulletin No. 110. The expected term used by the Company during the six months ended June 31, 2014 and 2013 was 5.9 years. The difference between the actual historical expected life and the simplified method was immaterial. The interest rate used is the risk free interest rate and is based upon U.S. Treasury rates appropriate for the expected term. Interest rates used in the Company's Black-Scholes calculations for the six months ended June 30, 2014 and 2013 was 2.6%. Dividend yield is zero as the Company does not expect to declare any dividends on the Company's common stock in the foreseeable future.

In addition to the key assumptions used in the Black-Scholes model, the estimated forfeiture rate at the time of valuation is a critical assumption. The Company has estimated an annualized forfeiture rate of approximately 0% for corporate officers, 4.1% for members of the Board of Directors and 6.0% for all other employees. The Company reviews the expected forfeiture rate annually to determine if that percent is still reasonable based on historical experience.

A summary of the activity under the Company's stock option plans is as follows:

	Options	Weighted-Average Exercise Price
Balance at December 31, 2013	3,783,411	\$ 0.94
Granted	15,000	\$ 2.31
Expired/Cancelled	(46,250)	\$ 1.85
Exercised	(83,745)	\$ 0.78
Balance at June 30, 2014	3,668,416	\$ 0.94

In December 2013, the Company issued 144,000 shares of its common stock to certain members of the Company's Board of Directors as compensation for services to be rendered through December 2014. Such shares are forfeitable should the Board members' service be terminated. For the three and six months ended June 30, 2014, the Company recorded \$60,000 and \$119,000, respectively, as compensation expense.

#### NOTE 7. DERIVATIVE LIABILITIES

The Company accounts for its derivative instruments under the provisions of ASC 815, *Derivatives and Hedging-Contracts in Entity's Own Equity-Scope and Scope Exceptions*. Under the provisions of ASC 815, the anti-dilution and cash settlement provisions in certain warrants (collectively the "*Derivative Liabilities*") qualify as derivative instruments.

The Company is required to mark-to-market at the end of each reporting period the value of the derivative liabilities. The Company revalues these derivative liabilities at the end of each reporting period by using available market information and commonly accepted valuation methodologies. The periodic change in value of the derivative liabilities is recorded as either non-cash derivative income (if the value of the embedded derivative and warrants decrease) or as non-cash derivative expense (if the value of the embedded derivative and warrants increase). Although the values of the embedded derivative and warrants are affected by interest rates, the remaining contractual conversion period and the Company's stock volatility, the primary cause of the change in the values of the derivative liabilities will be the value of the Company's common stock. If the stock price goes up, the value of these derivatives will generally increase and if the stock price goes down the value of these derivatives will generally decrease.

The Company uses a Monte-Carlo simulation methodology and the Black-Scholes option-pricing model in the determination of the fair value of the Derivative Liabilities. The Monte-Carlo simulation methodology is affected by the Company's stock price as well as assumptions regarding the expected stock price volatility over the term of the Derivative Liabilities and assumptions regarding future financings. The Company utilized the services of an independent valuation firm, Vantage Point Advisors, Inc. to perform the Monte-Carlo simulations.

The Black-Scholes option-pricing model is affected by the Company's stock prices as well as assumptions regarding the expected stock price volatility of the term of the derivative liabilities in addition to interest rates and dividend yields.

As of December 31, 2013, the Company had 40,000 outstanding warrants to purchase shares of the Company's common stock that qualified for derivative liability treatment. The recorded fair market value of those warrants at December 31, 2013 was approximately \$57,000, which is reflected as a current liability in the condensed consolidated balance sheet as of December 31, 2013. During the six months ended June 30, 2014, all remaining warrants qualifying for derivative liability treatment were exercised for cash proceeds of \$20,000 resulting in the issuance of 40,000 shares of the Company's common stock with an aggregate fair value of approximately \$57,000.

**NOTE 8. FAIR VALUE ACCOUNTING**

The Company accounts for fair value measurements in accordance with ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements.

ASC 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described below:

- Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Level 2 Applies to assets or liabilities for which there are inputs other than quoted prices included within Level 1 that are observable for the asset or liability such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.
- Level 3 Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (supported by little or no market activity).

The following table sets forth the Company's financial assets and liabilities measured at fair value by level within the fair value hierarchy. As required by ASC 820, assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(\$ in thousands)	<b>Fair Value at June 30, 2014</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Pension assets	\$ 1,795	\$ 1,795	\$ —	\$ —
Totals	<u>\$ 1,795</u>	<u>\$ 1,795</u>	<u>\$ —</u>	<u>\$ —</u>
<b>Liabilities:</b>				
Derivative liabilities	\$ —	\$ —	\$ —	\$ —
Totals	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
(\$ in thousands)	<b>Fair Value at December 31, 2013</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Pension assets	\$ 1,790	\$ 1,790	\$ —	\$ —
Totals	<u>\$ 1,790</u>	<u>\$ 1,790</u>	<u>\$ —</u>	<u>\$ —</u>
<b>Liabilities:</b>				
Derivative liabilities	\$ 57	\$ —	\$ —	\$ 57
Totals	<u>\$ 57</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 57</u>

The Company's pension assets are classified within Level 1 of the fair value hierarchy because they are valued using market prices. The pension assets are primarily comprised of the cash surrender value of insurance contracts. All plan assets are managed in a policyholder pool in Germany by outside investment managers. The investment objectives for the plan are the preservation of capital, current income and long-term growth of capital.

As of December 31, 2013, the Company had 40,000 outstanding warrants to purchase shares of the Company's common stock that qualified for derivative liability treatment. The recorded fair market value of those warrants at December 31, 2013 was approximately \$57,000 which is reflected as a current liability in the condensed consolidated balance sheet as of December 31, 2013. The fair value of the Company's derivative liabilities are classified within Level 3 of the fair value hierarchy because they are valued using pricing models that incorporate management assumptions that cannot be corroborated with observable market data. The Company uses Black-Scholes or Monte-Carlo simulation methodologies in the determination of the fair value of the derivative liabilities. During the six months ended June 30, 2014, all remaining warrants qualifying for derivative liability treatment were exercised by their holders.

The Monte-Carlo simulation methodology is affected by the Company's stock price as well as assumptions regarding the expected stock price volatility over the term of the derivative liabilities in addition to the probability of future financings. The Black-Scholes valuation model is affected by the Company's stock price as well as assumptions regarding the expected stock price volatility over the term of the derivative liabilities in addition to expected dividend yield and risk free interest rates appropriate for the expected term.

The Company monitors the activity within each level and any changes with the underlying valuation techniques or inputs utilized to recognize if any transfers between levels are necessary. That determination is made, in part, by working with outside valuation experts for Level 3 instruments and monitoring market related data and other valuation inputs for Level 1 and Level 2 instruments.

A reconciliation of the Company's liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) is as follows:

(\$ in thousands)	<u>Derivative Liabilities</u>
Balance at December 31, 2013	\$ 57
Total unrealized gains	—
Included in earnings	—
Settlements	(57)
Issuances	—
Transfers in and/or out of Level 3	—
Balance at June 30, 2014	\$ —

All unrealized gains or losses resulting from changes in value of any Level 3 instruments are reflected as a separate line in the condensed consolidated statement of operations in arriving at net loss. The Company is not a party to any hedge arrangements, commodity swap agreements or any other derivative financial instruments.

Certain assets are measured at fair value on a non-recurring basis and are subject to fair value adjustments only in certain circumstances. Included in this category is goodwill written down to fair value when determined to be impaired. The valuation methods for goodwill involve assumptions based on management's judgment using internal and external data, and which are classified in Level 3 of the valuation hierarchy.

## NOTE 9. RELATED PARTY TRANSACTIONS

### Related-Party Convertible Notes

As more fully described in Note 5, above, to these consolidated financial statements, on November 14, 2008, the Company entered into a series of Related-Party Convertible Notes, aggregating \$110,000, with certain officers and members of the Company's Board of Directors, including S. James Miller, the Company's Chief Executive Officer and Chairman, and Charles AuBuchon. The Related-Party Convertible Notes bear interest at 7.0% per annum and were originally due February 14, 2009.

In conjunction with the issuance of the Related-Party Convertible Notes, the Company issued an aggregate of 149,996 warrants to the note holders to purchase common stock of the Company. All such warrants were exercised, on a cashless basis, between October and November 2013.

The Company did not repay the Related-Party Convertible Notes on the due date. In August 2009, the Company received from the Related-Party Convertible Note holders a waiver of default and extension of the Maturity Date to January 31, 2010. As consideration for the waiver and note extension, the Company issued to the Related-Party Convertible Note holders warrants to purchase an aggregate of 150,000 shares of the Company's common stock. The warrants have an exercise price of \$0.50 per share and expire on August 25, 2014, of which warrants to purchase 136,364 shares of common stock were outstanding and exercisable as of December 31, 2013.

On January 21, 2013, the holders of the Related-Party Convertible Notes agreed to extend the due date on their respective convertible notes to be due and payable not later than June 30, 2014; however, the Related-Party Convertible Notes will be callable at any time, at the option of the note holder, prior to June 30, 2014. During the year ended December 31, 2013, a Related Party Convertible Note holder elected to convert the principal amount of \$10,000 of their respective Related-Party Convertible Note into 18,182 shares of common stock.

In June, 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of \$55,000 into 100,000 shares of common stock of the Company. The holders also elected to convert approximately \$30,000 in accrued interest into 54,607 shares of the Company's common stock.

#### **Lines of Credit**

In March 2013 and April 2014, the Company entered into the Lines of Credit with two members of our Board of Directors, providing for maximum available borrowings of up to \$3.5 million. As additional consideration for extending the Lines of Credit, the Company issued to the directors warrants to purchase an aggregate of 1,230,410 shares of our common stock. See Note 5, "*Lines of Credit*", above for a complete description of the Lines of Credit and related transactions.

## NOTE 10. CONTINGENT LIABILITIES

During the six months ended June 30, 2014 and 2013, the Company wrote off certain accounts payable and accrued expenses totaling approximately \$216,000 and \$104,000, respectively, which is included in “Other income” in the accompanying condensed consolidated statements of operations. Such accounts payable and accrued expenses represented amounts that could not be paid in full at the time, or were, in the view of management, unenforceable. While management believes that such amounts no longer represent recognized liabilities of the Company, such creditors may subsequently assert a claim against the Company.

### *Employment Agreements*

The Company has employment agreements with its Chief Executive Officer, Senior Vice President of Administration and Chief Financial Officer, Chief Technical Officer, and Vice President of Business Development. The Company may terminate the agreements with or without cause. Subject to the conditions and other limitations set forth in each respective employment agreement, each executive will be entitled to the following severance benefits if the Company terminates the executive’s employment without cause or in the event of an involuntary termination (as defined in the employment agreements) by the Company or by the executive:

Under the terms of the agreement, the Chief Executive Officer will be entitled to the following severance benefits if we terminate his employment without cause or in the event of an involuntary termination: (i) a lump sum cash payment equal to twenty-four months base salary; (ii) continuation of fringe benefits and medical insurance for a period of three years; and (iii) immediate vesting of 50% of outstanding stock options and restricted stock awards. In the event that the Chief Executive Officer’s employment is terminated within six months prior to or thirteen months following a change of control, the Chief Executive Officer is entitled to the severance benefits described above, except that 100% of the Chief Executive Officer’s outstanding stock options and restricted stock awards will immediately vest.

Under the terms of the employment agreements with our Senior Vice President of Administration and Chief Financial Officer, Chief Technical Officer, and Vice President of Business Development, these executives will be entitled to the following severance benefits if we terminate their employment without cause or in the event of an involuntary termination: (i) a lump sum cash payment equal to six months of base salary; (ii) continuation of their fringe benefits and medical insurance for a period of six months; (iii) immediate vesting of 50% of their outstanding stock options and restricted stock awards. In the event that their employment is terminated within six months prior to or thirteen months following a change of control (defined below), they are entitled to the severance benefits described above, except that 100% of their outstanding stock options and restricted stock awards will immediately vest.

### *Litigation*

On August 21, 2012, a complaint for patent infringement was filed against the Company in the United States District Court for the Eastern District of Texas, entitled *Blue Spike, LLC v. ImageWare Systems, Inc.*, Case No. 12-cv-688-LED. The case is one of approximately 80-plus lawsuits filed by Blue Spike, LLC. All cases have been consolidated for all pretrial purposes, other than venue, with the first-filed, lead action entitled *Blue Spike, LLC v. Texas Instruments, Inc.*, Case No. 12-cv-499-LED, filed on August 9, 2012. The four patents-in-suit relate to digital signal abstracting technology. On March 14, 2014, the Court granted the Company's motion to sever and transfer its case to the United States District Court for the Southern District of California. Accordingly, Blue Spike's case against the Company has been severed from the consolidated action and transferred to the Southern District of California. The Court also denied without prejudice the Company's motion to dismiss claims for indirect and willful infringement, without prejudice to re-filing the motion in the Southern District of California. The Company contends that the asserted patents are invalid, unenforceable and/or not infringed and intends to defend against the action vigorously.

Other than as specifically described above, we are currently not involved in any litigation that we believe could have a material adverse effect on our financial condition or results of operations. Other than described above, there is no action, suit, proceeding, inquiry or investigation before or by any court, public board, government agency, self-regulatory organization or body pending or, to the knowledge of the executive officers of the Company or any of our subsidiaries, threatened against or affecting the Company, our common stock, any of our subsidiaries or of the Company's or our subsidiaries' officers or directors in their capacities as such, in which an adverse decision could have a material adverse effect.

### *Leases*

In December 2010, we relocated our corporate headquarters to Rancho Bernardo Road in San Diego, California and entered into a three-year lease agreement. In August 2013, we entered into an amendment effective November 2013, whereby the Company consolidated its existing leases. The Company leased an additional 4,793 square feet of space in the same location while simultaneously vacating 2,560 square feet of space resulting in total rented square feet of 9,927. The lease term commenced on November 1, 2013 and ends on October 31, 2017. Future minimum rent payments under the amended lease will be approximately \$105,000 in 2014 (6 months), \$216,000 in 2015, \$222,000 in 2016 and \$190,000 in 2017.

In July 2014, we amended our Portland, Oregon office lease by increasing our leased square footage by 1,499 square feet resulting in 8,045 total leased square footage and extended our lease for 36 months to October 31, 2018. Future minimum rent payments will be approximately \$73,000 in 2014 (6 months), \$148,000 in 2015, \$152,000 in 2016, \$157,000 in 2017 and \$134,000 in 2018.

In addition to the corporate headquarters lease in San Diego, California, we also lease space in Ottawa, Province of Ontario, Canada; and Mexico City, Mexico.

At June 30, 2014, future minimum lease payments are as follows:

<b>(\$ in thousands)</b>	
2014 (6 months)	\$ 214
2015	\$ 443
2016	\$ 423
2017	\$ 386
2018 and thereafter	\$ 167
	<u>\$ 1,633</u>

Rental expense incurred under operating leases for the six months ended June 30, 2014 and 2013, was approximately \$209,000 and \$227,000, respectively.

## **NOTE 11. SUBSEQUENT EVENTS**

In July 2014, holders of 779,420 warrants cashless exercised such warrants resulting in the issuance of 606,960 shares of the Company's common stock.

On July 1, 2014, the Company began soliciting written consents from its shareholders to approve an amendment to the Company's 1999 Stock Option Plan to increase the number of shares authorized for issuance thereunder from approximately 4.0 million to approximately 7.0 million, which amendment was approved on July 21, 2014, when the Company received approvals from over 50% of the Company's stockholders.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

### **Forward-Looking Statements**

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All forward-looking statements included in this report are based on information available to us as of the date hereof and we assume no obligation to update any forward-looking statements. Forward-looking statements involve known or unknown risks, uncertainties and other factors, which may cause our actual results, performance or achievements, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include but are not limited to those items discussed under "Risk Factors" in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, and in Item 1A of Part II of this Quarterly Report on Form 10-Q.*

*The following discussion of the financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements included elsewhere within this Quarterly Report. Fluctuations in annual and quarterly results may occur as a result of factors affecting demand for our products such as the timing of new product introductions by us and by our competitors and our customers' political and budgetary constraints. Due to such fluctuations, historical results and percentage relationships are not necessarily indicative of the operating results for any future period.*

### **Overview**

The Company is a pioneer and leader in the emerging market for biometrically enabled software-based identity management solutions. Using those human characteristics that are unique to us all, the Company creates software that provides a highly reliable indication of a person's identity, including the Company's "flagship" product – the patented IWS Biometric Engine®. Our products are used to manage and issue secure credentials including national IDs, passports, driver's licenses and access control credentials. Our products also provide law enforcement with integrated mug shot, LiveScan fingerprint and investigative capabilities. We also provide comprehensive authentication security software using biometrics to secure physical and logistical access to facilities, computer networks and Internet sites. Biometric technology is now an integral part of all markets we address, and all of our products are integrated into the IWS Biometric Engine.

### **Recent Developments**

#### *New Contracts*

On June 27, 2014, the Company announced that it was selected to implement a multi-modal biometric driver license system for the State of Baja California, Mexico. The contract was awarded by the Funciones Ocupacionales Insha, S.A. de C.V., the prime contractor on the project. The contract is valued at more than \$1.0 million and its software will help generate more than one million driver licenses over the next three years. The Company anticipates that it will receive one-time license fees for its software upon delivery and ongoing payments for its professional services and maintenance as delivered. The Company will help to deploy the system at governmental offices in the largest cities in the state, including Tijuana, Mexicali, Tecate and Rosarito, as well as implement mobile stations through the state. The project will begin in the third quarter of 2014.



*Amendments to Lines of Credit*

In March 2013, the Company entered into the Line of Credit with available borrowings of up to \$2,500,000, and in March 2014, the Line of Credit was amended to increase available borrowings to an aggregate total of \$3,500,000. Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to \$2.5 million of the outstanding balance of the Line of Credit into shares of the Company's common stock for \$0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's common stock for \$2.25 per share.

As consideration for the initial Line of Credit, the Company issued to the Holder the Line of Credit Warrant, exercisable for 1,052,632 shares of the Company's common stock. The Line of Credit Warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share. As consideration for entering into the Amendment, the Company issued to the Holder the Amendment Warrant, exercisable for 177,778 shares of the Company's common stock. The Amendment Warrant expires on March 27, 2015 and has an exercise price of \$2.25 per share.

In April 2014, the Company and Holder entered into the Second Amendment to the Line of Credit to decrease the available borrowings to \$3.0 million. Contemporaneous with the execution of the Second Amendment, the Company entered into a new unsecured line of credit with available borrowings of up to \$500,000 with the Second Holder, which amount is convertible into shares of the Company's common stock for \$2.25 per share. As a result of these amendments, total available borrowings under aggregate Lines of Credit available to the Company remain unchanged at a total of \$3,500,000. In connection with the Second Amendment, the Holder assigned and transferred to the Second Holder one-half of the 177,778 Amendment Warrants issued by the Company to the Holder to purchase shares of the Company's common stock, originally granted to the Holder upon execution of the Amendment.

Advances under the credit facilities are made at the Company's request. The Lines of Credit will terminate, and no further advances will be made, upon the earlier of March 2015 or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$3.5 million. In the event of such financing, the outstanding balance under the terms of the Lines of Credit shall be due and payable upon demand.

As of June 30, 2014, no advances were made under the Lines of Credit.

## Critical Accounting Policies and Estimates

The discussion and analysis of our condensed consolidated financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of these condensed consolidated financial statements in accordance with GAAP requires us to utilize accounting policies and make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during a fiscal period. The SEC considers an accounting policy to be critical if it is important to a company’s financial condition and results of operations, and if it requires significant judgment and estimates on the part of management in its application.

Significant estimates include the allowance for doubtful accounts receivable, inventory carrying values, deferred tax asset valuation allowances, accounting for loss contingencies, recoverability of goodwill and acquired intangible assets and amortization periods, assumptions used in the Black-Scholes model to calculate the fair value of share based payments, assumptions used in the application of fair value methodologies to calculate the fair value of derivative liabilities, revenue and cost of revenues recognized under the percentage of completion method and assumptions used in the application of fair value methodologies to calculate the fair value of pension assets and obligations.

Critical accounting policies are those that, in management’s view, are most important in the portrayal of our financial condition and results of operations. Management believes there have been no material changes during the six months ended June 30, 2014 to the critical accounting policies discussed in the Management’s Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended December 31, 2013.

## Results of Operations

This management’s discussion and analysis of financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and related notes contained elsewhere in this Quarterly Report.

### *Comparison of the Three Months Ended June 30, 2014 to the Three Months Ended June 30, 2013.*

#### *Product Revenue*

Net Product Revenue (dollars in thousands)	Three Months Ended June 30,		<u>\$ Change</u>	<u>% Change</u>
	<u>2014</u>	<u>2013</u>		
Software and royalties	\$ 238	\$ 265	\$ (27)	(10)%
Percentage of total net product revenue	85%	73%		
Hardware and consumables	\$ 28	\$ 48	\$ (20)	(42)%
Percentage of total net product revenue	10%	13%		
Services	\$ 15	\$ 51	\$ (36)	(71)%
Percentage of total net product revenue	5%	14%		
Total net product revenue	<u>\$ 281</u>	<u>\$ 364</u>	<u>\$ (83)</u>	<u>(23)%</u>

Software and royalty revenue decreased 10% or approximately \$27,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013. This decrease is due to lower law enforcement project revenues of approximately \$94,000 offset by higher royalty revenues of approximately \$67,000 for the three months ended June 30, 2014 as compared to the corresponding period of 2013.

Revenue from the sale of hardware and consumables decreased 42% or approximately \$20,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013. The decrease resulted from lower revenues from project solutions containing hardware and consumable components.

Services revenue is comprised primarily of software integration services, system installation services and customer training. Such revenue decreased approximately \$36,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013 due to lower service revenue components in law enforcement and identification project solutions.

We believe that the period-to-period fluctuations of identity management software revenue in project-oriented solutions are largely due to the timing of government procurement with respect to the various programs we are pursuing. Based on management's current visibility into the timing of potential government procurements, we believe that we will see a significant increase in government procurement and implementations with respect to identity management initiatives; however, we cannot predict the timing of such initiatives. During the quarter ended June 30, 2014, we continued to accelerate our efforts to move the Biometric Engine into cloud and mobile markets and expanding our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the next six months, which should help us to begin to smooth out our period-to-period fluctuations in revenue and enable us to provide better visibility into the timing of future revenues.

**Maintenance Revenue**

	<b>Three Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
<b>Maintenance Revenue (dollars in thousands)</b>				
Maintenance revenue	\$ 656	\$ 660	\$ (4)	(1)%

Maintenance revenue was \$656,000 for the three months ended June 30, 2014 as compared to \$660,000 for the corresponding period in 2013. Identity management maintenance revenue generated from identification software solutions were \$243,000 for the three months ended June 30, 2014 as compared to \$222,000 during the comparable period in 2013. The increase of \$21,000 results from the expansion of our installed base. Law enforcement maintenance revenues were \$413,000 for the three months ended June 30, 2014 as compared to \$438,000 during the comparable period in 2013. The decrease of \$25,000 results from the expiration of certain maintenance contracts.

We anticipate growth of our maintenance revenue through the retention of existing customers combined with the expansion of our installed base resulting from the completion of project-oriented work, however, we cannot predict the timing of this anticipated growth.

**Cost of Product Revenue**

	<b>Three Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
<b>Cost of Product Revenue: (dollars in thousands)</b>				
Software and royalties	\$ 16	\$ 31	\$ (15)	(48)%
Percentage of software and royalty product revenue	7%	12%		
Hardware and consumables	\$ 22	\$ 37	\$ (15)	(41)%
Percentage of hardware and consumables product revenue	79%	77%		
Services	\$ 10	\$ 46	\$ (36)	(78)%
Percentage of services product revenue	67%	90%		
<b>Total product cost of revenue</b>	<b>\$ 48</b>	<b>\$ 114</b>	<b>\$ (66)</b>	<b>(58)%</b>
Percentage of total product revenue	17%	31%		

The cost of software and royalty product revenue decreased 48% or approximately \$15,000 for the three months ended June 30, 2014 as compared to the corresponding period of 2013. The decrease in software and royalty cost of product revenue is due primarily to lower software revenues of approximately \$27,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

The decrease in the cost of product revenue for our hardware and consumable sales of 41% or approximately \$15,000 for the three months ended June 30, 2014 as compared to the corresponding period in 2013 reflects the decrease in hardware and consumable revenue for the three months ended June 30, 2014 as compared to the corresponding period in 2013.

The cost of services revenue decreased approximately \$36,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013. This decrease reflects lower services revenue related to project-oriented work during the three months ended June 30, 2014.

***Cost of Maintenance Revenue***

	<b>Three Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
<b>Maintenance cost of revenue (dollars in thousands)</b>				
Total maintenance cost of revenue	\$ 184	\$ 182	\$ 2	1%
Percentage of total maintenance revenue	28%	28%		

Cost of maintenance revenue increased 1% or approximately \$2,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013 as overall maintenance revenue levels varied by only \$4,000 for the three months ended June 30, 2014 as compared to the comparable period of 2013.

***Product Gross Profit***

	<b>Three Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
<b>Product gross profit (dollars in thousands)</b>				
Software and royalties	\$ 222	\$ 234	\$ (12)	(5)%
Percentage of software and royalty product revenue	93%	88%		
Hardware and consumables	\$ 6	\$ 11	\$ (5)	(45)%
Percentage of hardware and consumables product revenue	21%	23%		
Services	\$ 5	\$ 5	\$ -	-%
Percentage of services product revenue	33%	10%		
Total product gross profit	\$ 233	\$ 250	\$ (17)	(7)%
Percentage of total product revenue	83%	69%		

Software and royalty gross profit decreased 5% or approximately \$12,000 for the three months ended June 30, 2014 from the corresponding period in 2013 due primarily to lower software and royalty product revenue of approximately \$27,000. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

Hardware and consumables gross profit decreased approximately \$5,000 for the three month period ended June 30, 2014 as compared to the corresponding period in 2013. This decrease was primarily due to lower hardware and consumables revenue of approximately \$20,000 in the three month period ended June 30, 2014 as compared to the corresponding period in the 2013 year.

***Maintenance Gross Profit***

	Three Months Ended June 30,		<u>\$ Change</u>	<u>% Change</u>
	<u>2014</u>	<u>2013</u>		
<b>Maintenance gross profit (dollars in thousands)</b>				
Total maintenance gross profit	\$ 472	\$ 478	\$ (6)	(1)%
Percentage of total maintenance revenue	72%	72%		

Gross profit related to maintenance revenue decreased 1% or approximately \$6,000 for the three months ended June 30, 2014 as compared to the same period ended June 30, 2013. That decrease is due to lower maintenance revenue of approximately \$4,000 combined with higher maintenance cost of revenues of approximately \$2,000.

***Operating Expense***

	Three Months Ended June 30,		<u>\$ Change</u>	<u>% Change</u>
	<u>2014</u>	<u>2013</u>		
<b>Operating expenses (dollars in thousands)</b>				
General and administrative	\$ 873	\$ 775	\$ 98	13%
Percentage of total net revenue	93%	76%		
Sales and marketing	\$ 596	\$ 510	\$ 86	17%
Percentage of total net revenue	64%	50%		
Research and development	\$ 1,152	\$ 995	\$ 157	16%
Percentage of total net revenue	123%	97%		
Depreciation and amortization	\$ 46	\$ 26	\$ 20	77%
Percentage of total net revenue	5%	3%		

***General and Administrative Expense***

General and administrative expense is comprised primarily of salaries and other employee-related costs for executive, financial, and other infrastructure personnel. General legal, accounting and consulting services, insurance, occupancy and communication costs are also included with general and administrative expense. The dollar increase of \$98,000 is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately \$58,000 due primarily to increases in professional services and investor relation fees of approximately \$28,000 and increases in legal fees of approximately \$44,000, offset by decreases in various consulting and contract services of approximately \$14,000.
- Increase in personnel related expense of approximately \$12,000.
- Increase in stock-based compensation expense of approximately \$2,000.
- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately \$26,000.

We continue to focus our efforts on achieving additional future operating efficiencies by reviewing and improving upon existing business processes and evaluating our cost structure. We believe these efforts will allow us to continue to gradually decrease our level of general and administrative expense expressed as a percentage of total revenue.

### ***Sales and Marketing***

Sales and marketing expense consists primarily of the salaries, commissions, other incentive compensation, employee benefits and travel expenses of our sales, marketing, and business development functions. The dollar increase of approximately \$86,000 during the three months ended June 30, 2014 as compared to the corresponding period in 2013 is primarily comprised of the following major components:

- Increase in personnel related expense of approximately \$61,000 due primarily to headcount increases.
- Decrease in professional services of approximately \$18,000.
- Increase in contract services, travel and trade show expenses and office related expenses of approximately \$42,000.
- Increase in stock-based compensation expense of approximately \$1,000.

### ***Research and Development***

Research and development expense consists primarily of salaries, employee benefits and outside contractors for new product development, product enhancements, custom integration work and related facility costs. Such expense increased approximately \$157,000 for the three months ended June 30, 2014 as compared to the corresponding period in 2013 due primarily to the following major components:

- Increase in personnel expenditures of approximately \$122,000 due to headcount increases.
- Increase in contractor fees and contract services of approximately \$20,000.
- Increase in stock-based compensation of approximately \$1,000.
- Increase in office related expenses of approximately \$14,000.

Our level of expenditures in research and development reflects our belief that to maintain our competitive position in markets characterized by rapid rates of technological advancement, we must continue to invest significant resources in new systems and software development as well as continue to enhance existing products.

### ***Depreciation and Amortization***

During the three months ended June 30, 2014, depreciation and amortization expense increased approximately \$20,000 as compared to the corresponding period in 2013. The relatively small amount of depreciation and amortization is a reflection of the relatively small property and equipment carrying value. The increase of approximately \$20,000 reflects the replacement of fully depreciated equipment.

### ***Interest Expense***

For the three months ended June 30, 2014, we recognized interest expense of approximately \$105,000. For the three months ended June 30, 2013, we recognized interest expense of approximately \$73,000. Interest expense for the three months ended June 30, 2014 is comprised of approximately \$104,000 of amortization expense of deferred financing fees related to our unsecured line of credit and approximately \$1,000 related to coupon interest on our 7% related party convertible notes.

**Change in Fair Value of Derivative Liabilities**

For the three months ended June 30, 2014, we recognized non-cash expense of \$0 compared to approximately \$3,973,000 for the corresponding period of 2013. This expense is related to the change in fair value of the Company's derivative liabilities associated with the anti-dilution provisions in certain warrants to purchase shares of our common stock. During the three months ended March 31, 2014, all remaining warrants qualifying for derivative liability treatment were exercised.

**Other Income**

For the three months ended June 30, 2014, we recognized other income of approximately \$5,000. For the three months ended June 30, 2013, we recognized other income of approximately \$4,000. Other income for the three months ended June 30, 2014 is comprised of approximately \$5,000 from the write-off of certain accrued expenses due to the expiration of the legal statute of limitation on such accrued expenses.

**Comparison of the Six Months Ended June 30, 2014 to the Six Months Ended June 30, 2013.****Product Revenue**

Net Product Revenue (dollars in thousands)	Six Months Ended June 30,		\$ Change	% Change
	2014	2013		
Software and royalties	\$ 580	\$ 449	\$ 131	29%
Percentage of total net product revenue	81%	79%		
Hardware and consumables	\$ 78	\$ 68	\$ 10	15%
Percentage of total net product revenue	11%	12%		
Services	\$ 57	\$ 54	\$ 3	6%
Percentage of total net product revenue	8%	9%		
Total net product revenue	\$ 715	\$ 571	\$ 144	25%

Software and royalty revenue increased 29% or approximately \$131,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013. This increase is due to higher sales of identification software licenses of approximately \$152,000, higher sales of boxed identity management software through our distribution channel of approximately \$17,000 and higher identification software royalties and license revenue of approximately \$55,000 offset by lower law enforcement project related revenues of \$93,000.

Revenue from the sale of hardware and consumables increased 15% or approximately \$10,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013. The increase resulted from higher revenues from project solutions containing hardware and consumable components.

Services revenue is comprised primarily of software integration services, system installation services and customer training. Such revenue increased 6% or approximately \$3,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013 due primarily to the completion of the service element in certain identity management project solutions.

We believe that the period-to-period fluctuations of identity management software revenue in project-oriented solutions are largely due to the timing of government procurement with respect to the various programs we are pursuing. Based on management's current visibility into the timing of potential government procurements, we believe that we will see an increase in government procurement and implementations with respect to identity management initiatives; however, we cannot predict the timing of such initiatives. During the quarter ended June 30, 2014, we accelerated our efforts to move the Biometric Engine into cloud and mobile markets and expanding our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the second half of 2014, which should help us to begin to smooth out our period-to-period fluctuations in revenue and enable us to provide better visibility into the timing of future revenues.

**Maintenance Revenue**

<b>Maintenance Revenue</b> <b>(dollars in thousands)</b>	<b>Six Months Ended</b> <b>June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
Maintenance revenue	\$ 1,285	\$ 1,309	\$ (24)	2%

Maintenance revenue was \$1,285,000 for the six months ended June 30, 2014 as compared to \$1,309,000 for the corresponding period in 2013. Identity management maintenance revenue were \$485,000 for the six months ended June 30, 2014 as compared to \$444,000 during the comparable period in 2013. The increase of \$41,000 results from the expansion of our installed base. Law enforcement maintenance revenues were \$800,000 for the six months ended June 30, 2014 as compared to \$865,000 during the comparable period in 2013. The decrease of \$65,000 results from the expiration of certain maintenance contracts.

We anticipate growth of our maintenance revenue through the retention of existing customers combined with the expansion of our installed base resulting from the completion of project-oriented work, however, we cannot predict the timing of this anticipated growth.

**Cost of Product Revenue**

<b>Cost of Product Revenue:</b> <b>(dollars in thousands)</b>	<b>Six Months Ended</b> <b>June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
Software and royalties	\$ 37	\$ 56	\$ (19)	(34)%
Percentage of software and royalty product revenue	6%	12%		
Hardware and consumables	\$ 56	\$ 55	\$ 1	2%
Percentage of hardware and consumables product revenue	72%	81%		
Services	\$ 25	\$ 47	\$ (22)	(47)%
Percentage of services product revenue	44%	87%		
Total product cost of revenue	\$ 118	\$ 158	\$ (40)	(25)%
Percentage of total product revenue	17%	28%		

The cost of software and royalty product revenue decreased 34% or approximately \$19,000 for the six months ended June 30, 2014 as compared to the corresponding period of 2013. This decrease in software and royalty cost of product revenue of approximately \$19,000 is due to higher sales of software licenses and royalties not containing third party software license content resulting in an uncharacteristically low cost of software and royalty product revenue. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

The cost of services revenue decreased 47% or approximately \$22,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013. These decreases reflect the 2013 period containing uncharacteristically high service costs incurred due to higher level engineering resources required for project completion that the comparable period in 2014.



**Cost of Maintenance Revenue**

<b>Maintenance cost of revenue</b> <b>(dollars in thousands)</b>	<b>Six Months Ended</b> <b>June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
Total maintenance cost of revenue	\$ 365	\$ 376	\$ (11)	(3)%
Percentage of total maintenance revenue	28%	29%		

Cost of maintenance revenue decreased approximately \$11,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013 due primarily to lower maintenance revenues of approximately \$24,000 for the six month period ended June 30, 2014 as compared to the comparable period in 2013.

**Product Gross Profit**

<b>Product gross profit</b> <b>(dollars in thousands)</b>	<b>Six Months Ended</b> <b>June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
Software and royalties	\$ 543	\$ 393	\$ 150	38%
Percentage of software and royalty product revenue	94%	88%		
Hardware and consumables	\$ 22	\$ 13	\$ 9	69%
Percentage of hardware and consumables product revenue	28%	19%		
Services	\$ 32	\$ 7	\$ 25	357%
Percentage of services product revenue	56%	13%		
Total product gross profit	\$ 597	\$ 413	\$ 184	45%
Percentage of total product revenue	83%	72%		

Software and royalty gross profit increased 38% or approximately \$150,000 for the six months ended June 30, 2014 from the corresponding period in 2013 due primarily to higher software and royalty product revenues of approximately \$131,000 combined with lower cost of software and royalty product revenues of approximately \$19,000. The reduction in the cost of software and royalty product revenue of approximately \$19,000 despite higher software and royalty revenue of approximately \$131,000 is reflective of the 2014 period containing significant sales of software licenses with no third-party software content resulting in an uncharacteristically high software and royalty gross profit. Costs of software products can vary as a percentage of product revenue from quarter to quarter depending upon product mix and third party software licenses included in software solutions.

Hardware and consumables gross profit increased 69% or approximately \$9,000 for the six month period ended June 30, 2014 as compared to the corresponding period in 2013. This increase was primarily due to the higher sales of hardware and consumables during the six months ended June 30, 2014 as compared to the comparable period in 2013.

Services gross profit increased approximately \$25,000 for the six months ended June 30, 2014 as compared to the corresponding period in 2013 due primarily to the 2013 period containing higher professional service costs due to the required utilization of more costly engineering resources than in the 2014 period.

**Maintenance Gross Profit**

<b>Maintenance gross profit (dollars in thousands)</b>	<b>Six Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
Total maintenance gross profit	\$ 920	\$ 933	\$ (13)	(1)%
Percentage of total maintenance revenue	72%	71%		

Gross profit related to maintenance revenue decreased approximately \$13,000 for the six months ended June 30, 2014, as compared to the same period ended June 30, 2013. That decrease is due to lower maintenance revenues of approximately \$24,000 offset with by lower maintenance costs of approximately \$11,000.

**Operating Expense**

<b>Operating expenses (dollars in thousands)</b>	<b>Six Months Ended June 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
General and administrative	\$ 1,890	\$ 1,667	\$ 223	13%
Percentage of total net revenue	95%	89%		
Sales and marketing	\$ 1,214	\$ 985	\$ 229	23%
Percentage of total net revenue	61%	52%		
Research and development	\$ 2,181	\$ 1,914	\$ 267	14%
Percentage of total net revenue	109%	102%		
Depreciation and amortization	\$ 88	\$ 55	\$ 33	60%
Percentage of total net revenue	4%	3%		

**General and Administrative Expense**

General and administrative expense is comprised primarily of salaries and other employee-related costs for executive, financial, and other infrastructure personnel. General legal, accounting and consulting services, insurance, occupancy and communication costs are also included with general and administrative expense. The dollar increase of approximately \$223,000 is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately \$106,000 due primarily to increases in audit related fees of approximately \$31,000, increases in various consulting and contract services of approximately \$6,000, increases in legal fees of approximately \$62,000 and increases in Board of Director fees of approximately \$7,000,
- Increase in personnel related expense of approximately \$46,000 due to headcount increases and higher fringe benefit costs.
- Increase in stock-based compensation expense of approximately \$20,000.
- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately \$51,000.

We continue to focus our efforts on achieving additional future operating efficiencies by reviewing and improving upon existing business processes and evaluating our cost structure. We believe these efforts will allow us to continue to gradually decrease our level of general and administrative expense expressed as a percentage of total revenue.

### ***Sales and Marketing***

Sales and marketing expense consists primarily of the salaries, commissions, other incentive compensation, employee benefits and travel expenses of our sales, marketing, and business development functions. The dollar increase of approximately \$229,000 during the six months ended June 30, 2014 as compared to the corresponding period in 2013 is primarily comprised of the following major components:

- Increase in personnel related expense of approximately \$112,000 due primarily to headcount increases.
- Increase in stock-based compensation expense of approximately \$8,000.
- Decrease in professional services of approximately \$7,000.
- Increase in contract services, travel and trade show expenses and office related expenses of approximately \$108,000.
- Increase in our Mexico sales offices expenses of approximately \$8,000.

### ***Research and Development***

Research and development expense consists primarily of salaries, employee benefits and outside contractors for new product development, product enhancements, custom integration work and related facility costs. Such expense increased approximately \$267,000 for the six months ended June 30, 2014 as compared to the corresponding period in 2013 due primarily to the following major components:

- Increase in personnel expenditures of approximately \$243,000 due to headcount increases.
- Increase in rent, office related costs, contract services and travel and trade show expenses of approximately \$16,000.
- Increase in stock-based compensation of approximately \$8,000.

Our level of expenditures in research and development reflects our belief that to maintain our competitive position in markets characterized by rapid rates of technological advancement, we must continue to invest significant resources in new systems and software development as well as continue to enhance existing products.

### ***Depreciation and Amortization***

During the six months ended June 30, 2014, depreciation and amortization expense increased approximately \$33,000 as compared to the corresponding period in 2013. The relatively small amount of depreciation and amortization is a reflection of the relatively small property and equipment carrying value.

### ***Interest Expense, net***

For the six months ended June 30, 2014, we recognized interest income of approximately \$1,000 and interest expense of approximately \$185,000. For the six months ended June 30, 2013, we recognized interest income of \$0 and interest expense of \$75,000. Interest expense for the six months ended June 30, 2014 is comprised of approximately \$182,000 of amortization expense of deferred financing fees related to our unsecured line of credit and approximately \$3,000 is related to coupon interest on our 7% related party convertible notes.

### ***Change in Fair Value of Derivative Liabilities***

For the six months ended June 30, 2014, we recognized non-cash expense of \$0 compared to approximately \$5,148,000 for the corresponding period of 2013. This expense is related to the change in fair value of the Company's derivative liabilities associated with the anti-dilution provisions in certain warrants to purchase shares of our common stock. The derivative liabilities were revalued using available market information and commonly accepted valuation methodologies. During the three months ended March 31, 2014, all remaining warrants qualifying for derivative liability treatment were exercised for cash proceeds of \$20,000 resulting in the issuance of 40,000 shares of the Company's common stock with an aggregate fair value of approximately \$57,000.

### ***Other Income***

For the six months ended June 30, 2014, we recognized other income of approximately \$289,000. For the six months ended June 30, 2013, we recognized other income of approximately \$108,000. Other income for the six months ended June 30, 2014 is comprised of approximately \$217,000 from the write-off of certain accounts payable and accrued expenses due to the expiration of the legal statute of limitations on such payables and accrued liabilities, approximately \$35,000 relating to the litigation settlement of certain patent infringement matters in favor of the Company and approximately \$37,000 from the return of an advertising deposit previously written off due to uncertainties regarding its return. Other income for the six months ended June 30, 2013 is comprised of approximately \$104,000 from the write-off of certain accounts payable due to the expiration of the legal statute of limitations on such payables and \$4,000 in miscellaneous other income.

### **LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2014, our principal sources of liquidity consisted of cash and cash equivalents of \$1,415,000 and accounts receivable, net of \$400,000. As of June 30, 2014, we had positive working capital of \$287,000, which included \$1,304,000 of deferred revenue. Historically, our principal sources of cash have included customer payments from the sale of our products, proceeds from the issuance of common and preferred stock and proceeds from the issuance of debt. Our principal uses of cash have included cash used in operations, payments relating to purchases of property and equipment and repayments of borrowings. We expect that our principal uses of cash in the future will be for product development including customization of identity management products for enterprise and consumer applications, further development of intellectual property, development of our Software as a Service (“SaaS”) capabilities for existing products as well as general working capital and capital expenditure requirements. We expect that, as our revenues grow, our sales and marketing and research and development expenses will continue to grow, albeit to a lesser extent and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

For the six months ended June 30, 2014, the Company issued 4,642,632 shares of its common stock and received net proceeds of approximately \$2,798,000 from the exercise of warrants for cash.

Historically, our principal sources of cash have included customer payments from the sale of our products, proceeds from the issuance of common and preferred stock and proceeds from the issuance of debt. Our principal uses of cash have included cash used in operations, payments relating to purchases of property and equipment and repayments of borrowings. We expect that our principal uses of cash in the future will be for product development including customization of identity management products for enterprise and consumer applications, further development of intellectual property, development of Software-as-a-Service (“SaaS”) capabilities for existing products as well as general working capital and capital expenditure requirements. We expect that, as our revenues grow, our sales and marketing and research and development expenses will continue to grow, albeit at a slower rate and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

Management believes that the Company’s current cash and cash equivalents will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing if we are able to increase our product revenues in accordance with our plan. If we are unable to increase our product revenues, we will require additional debt or equity financing to continue our operations at the current level, and no assurances can be given that such financing will be available or available on terms acceptable to the Company.

### ***Operating Activities***

We used net cash of \$3,690,000 in operating activities for the six months ended June 30, 2014 as compared to net cash used of \$3,616,000 during the comparable period in 2013. During the six months ended June 30, 2014, net cash used in operating activities consisted of net loss of \$3,763,000 and an increase in working capital and other assets and liabilities of \$114,000. Those amounts were offset by \$479,000, net of non-cash costs including \$425,000 in stock based compensation, \$182,000 in debt issuance cost amortization and \$88,000 in depreciation and amortization offset by \$216,000 of non-cash income primarily from the write-off of certain accounts payable and accrued expenses due to the expiration of the statute of limitations. During the six months ended June 30, 2014, we used cash of \$260,000 to fund increases in current assets and generated cash of \$146,000 through increases in current liabilities and deferred revenues, excluding debt.

We used net cash of \$3,616,000 in operating activities for the six months ended June 30, 2013. During the six months ended June 30, 2013, net cash used in operating activities consisted of net loss of \$8,392,000 and an increase in working capital and other assets and liabilities of \$665,000. Those amounts were offset by \$5,441,000, net of non-cash costs including a \$5,148,000 unrealized loss related to the change in value of our derivative liabilities, \$270,000 in stock based compensation, \$72,000 in debt issuance cost amortization and \$55,000 in depreciation and amortization offset by \$104,000 of non-cash income primarily from the write-off of certain accounts payable due to the expiration of the statute of limitations. During the six months ended June 30, 2013, we used cash of \$316,000 to fund increases in current assets and used cash of \$349,000 through decreases in current liabilities and deferred revenues, excluding debt.

### ***Investing Activities***

Net cash used in investing activities was \$70,000 for the six months ended June 30, 2014, compared to \$74,000 used in the six months ended June 30, 2013. For the six months ended June 30, 2014, we used cash to fund capital expenditures of computer equipment, software and furniture and fixtures of approximately \$70,000. This level of equipment purchases resulted primarily from the replacement of older equipment. For the six months ended June 30, 2013, we used \$74,000 to fund capital expenditures of computer equipment, software and furniture and fixtures.

### ***Financing Activities***

We generated cash of \$2,828,000 from financing activities for the six months ended June 30, 2014, as compared to the \$506,000 generated during the same period in 2013. We generated cash of \$2,798,000 from the exercise of 4,642,632 common stock warrants and \$55,000 from the exercise of 83,745 common stock options. During the six months ended June 30, 2013, we generated cash of \$528,000 from the exercise of 606,539 common stock warrants and \$3,000 from the exercise of 20,000 common stock options.

### ***Debt***

At June 30, 2014, we had approximately \$0 in outstanding debt, exclusive of any debt discounts, and \$0 in related accrued interest.

### ***7% Convertible Promissory Notes to Related Parties***

On November 14, 2008, the Company entered into Related-Party Convertible Notes in the principal aggregate amount of \$110,000, with certain officers and members of the Company's Board of Directors. The Related-Party Convertible Notes bear interest at 7.0% per annum and were due February 14, 2009. The principal amount of the Related-Party Convertible Notes plus accrued but unpaid interest is convertible at the option of the holder into common stock of the Company. The number of shares into which the Related-Party Convertible Notes are convertible shall be calculated by dividing the outstanding principal and accrued but unpaid interest by \$0.50 (the "Conversion Price").

In conjunction with the issuance of the Related-Party Convertible Notes, the Company issued an aggregate of 149,996 warrants to the note holders to purchase common stock of the Company which were exercised in their entirety, on a cashless basis, between October and November 2013 resulting in the issuance of 111,783 shares of the Company's common stock.

The Company, in 2008, initially recorded the convertible notes net of a discount equal to the fair value allocated to the warrants of approximately \$13,000. The Company estimated the fair value of the warrants using the Black-Scholes option pricing model using the following assumptions: term of 5 years, a risk free interest rate of 2.53%, a dividend yield of 0%, and volatility of 96%. The convertible notes also contained a beneficial conversion feature, resulting in an additional debt discount of \$12,000. The beneficial conversion amount was measured using the accounting intrinsic value, i.e. the excess of the aggregate fair value of the common stock into which the debt is convertible over the proceeds allocated to the security. The Company has accreted the beneficial conversion feature over the life of the Related-Party Convertible Notes.

The Company did not repay the Related-Party Convertible Notes on the due date. In August 2009, the Company received from the Related-Party Convertible Note holders a waiver of default and extension of the Maturity Date to January 31, 2010. As consideration for the waiver and note extension, the Company issued to the Related-Party Convertible Note holders warrants to purchase an aggregate of 150,000 shares of the Company's common stock. The warrants have an exercise price of \$0.50 per share and expire on August 25, 2014. In December 2013, 13,636 warrants were exercised, on a cashless basis, resulting in the issuance of 9,969 shares of the Company's common stock.

The Company did not repay the notes on January 31, 2010. During the year ended December 31, 2012, the Company repaid \$45,000 in principal to certain holders of the Related-Party Convertible Notes. On January 21, 2013, the holders of the Related-Party Convertible Notes agreed to extend the due date on their respective convertible notes to be due and payable no later than June 30, 2014 however, the Related-Party Convertible Notes will be callable at any time, at the option of the note holder, prior to June 30, 2014. In December 2013, a holder converted \$10,000 of the Related-Party Convertible Notes into 18,182 shares of common stock of the Company.

In June 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of \$55,000 into 100,000 shares of common stock of the Company. The holders also elected to convert approximately \$30,000 in accrued interest into 54,607 shares of the Company's common stock.

#### *Lines of Credit*

In March 2013, the Company entered into the Line of Credit with available borrowings of up to \$2,500,000, and in March 2014, the Line of Credit was amended to increase available borrowings to an aggregate total of \$3,500,000. Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to \$2.5 million of the outstanding balance of the Line of Credit into shares of the Company's common stock for \$0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's common stock for \$2.25 per share.

As consideration for the initial Line of Credit, the Company issued to the Holder the Line of Credit Warrant, exercisable for 1,052,632 shares of the Company's common stock. The Line of Credit Warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share. As consideration for entering into the Amendment, the Company issued to the Holder the Amendment Warrant, exercisable for 177,778 shares of the Company's common stock. The Amendment Warrant expires on March 27, 2015 and has an exercise price of \$2.25 per share.

In April 2014, the Company and Holder entered into the Second Amendment to the Line of Credit to decrease the available borrowings to \$3.0 million. Contemporaneous with the execution of the Second Amendment, the Company entered into a new unsecured line of credit with available borrowings of up to \$500,000 with the Second Holder, which amount is convertible into shares of the Company's common stock for \$2.25 per share. As a result of these amendments, total available borrowings under aggregate Lines of Credit available to the Company remain unchanged at a total of \$3,500,000. In connection with the Second Amendment, the Holder assigned and transferred to the Second Holder one-half of the 177,778 Amendment Warrants issued by the Company to the Holder to purchase shares of the Company's common stock, originally granted to the Holder upon execution of the Amendment.

Borrowings under the Lines of Credit accrue interest at a rate of 8% per annum and are due in March 2015. Advances under the credit facilities are made at the Company's request. The Lines of Credit will terminate, and no further advances will be made, upon the earlier of March 2015 or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$3.5 million. In the event of such financing, the outstanding balance under the terms of the Lines of Credit shall be due and payable upon demand.

The Company estimated the fair value of the Line of Credit Warrant and the Amendment Warrants using the Black-Scholes option pricing model using the following assumptions: term of two years for the Line of Credit Warrants issued March 2013 and a term of one year for the Amendment Warrants issued in March 2014, a risk free interest rate of 2.58%, a dividend yield of 0%, and volatility of 79% for the Line of Credit Warrant and 74% for the Amendment Warrant. The Company recorded the fair value of the Line of Credit Warrant and the Amendment Warrants as deferred financing fees of approximately \$707,000 to be amortized over the life of the Lines of Credit.

The Company evaluated the Lines of Credit and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the Lines of Credit). The Company has considered the accounting for this contingent beneficial conversion feature using the guidance in ASC 470, *Debt*. The guidance in ASC 470 states that a contingent beneficial conversion feature in an instrument shall not be recognized in earnings until the contingency is resolved. The beneficial conversion features of future borrowings under the Lines of Credit will be measured using the intrinsic value calculated at the date the contingency is resolved using the exercise price and trading value of the Company's common stock at the date the Lines of Credit were issued (commitment date). Such amounts could range from \$0 to approximately \$500,000 depending on the amount borrowed by the Company under the Lines of Credit.

As of June 30, 2014, no advances were made under the Lines of Credit.

### ***Contractual Obligations***

Total contractual obligations and commercial commitments as of June 30, 2014 are summarized in the following table (in thousands):

	<b>Payment Due by Year</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 Years</b>
7% related party promissory notes	\$ —	\$ —	\$ —	\$ —	\$ —
Operating lease obligations	1,633	214	1,252	167	—
<b>Total</b>	<b>\$ 1,633</b>	<b>\$ 214</b>	<b>\$ 1,252</b>	<b>\$ 167</b>	<b>\$ —</b>

### ***Real Property Leases***

In December 2010, we relocated our corporate headquarters to Rancho Bernardo Road in San Diego, California and entered into a three-year lease agreement. In August 2013, we entered into an amendment effective November 2013, whereby the Company consolidated its existing leases. The Company leased an additional 4,793 square feet of space in the same location while simultaneously vacating 2,560 square feet of space resulting in total rented square feet of 9,927. The lease term commenced on November 1, 2013 and ends on October 31, 2017. Future minimum rent payments under the amended lease will be approximately \$105,000 in 2014 (6 months), \$216,000 in 2015, \$222,000 in 2016 and \$190,000 in 2017.

In July 2014, we amended our Portland, Oregon office lease by increasing our leased square footage by 1,499 square feet resulting in 8,045 total leased square footage and extended our lease for 36 months to October 31, 2018. Future minimum rent payments will be approximately \$73,000 in 2014 (6 months), \$148,000 in 2015, \$152,000 in 2016, \$157,000 in 2017 and \$134,000 in 2018.

In addition to the corporate headquarters lease in San Diego, California, we also lease space in Ottawa, Province of Ontario, Canada; and Mexico City, Mexico.

### ***Stock-based Compensation***

Stock-based compensation has been classified as follows in the accompanying condensed consolidated statements of operations (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Cost of revenues	\$ 3	\$ 3	\$ 6	\$ 5
General and administrative	140	78	285	145
Sales and marketing	34	33	70	62
Research and development	31	30	64	57
Total	<u>\$ 208</u>	<u>\$ 144</u>	<u>\$ 425</u>	<u>\$ 269</u>

### ***Off-Balance Sheet Arrangements***

At June 30, 2014, 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 relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed elsewhere in this Annual Report.

### ***Recently Issued Accounting Standards***

Please refer to the section “Recently Issued Accounting Standards” in Note 2 of our Notes to the Condensed Consolidated Financial Statements.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Each of our contracts requires payment in U.S. dollars. We therefore do not engage in hedging transactions to reduce our exposure to changes in currency exchange rates, although in the event any future contracts are denominated in a foreign currency, we may do so in the future. As a result, our financial results are not affected by factors such as changes in foreign currency exchange rates.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### ***Evaluation of Disclosure Controls and Procedures.***

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operations of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of June 30, 2014. Based on this evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports submitted under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, including to ensure that information required to be disclosed by the Company is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.



## **Changes in Internal Controls Over Financial Reporting**

The Company's Chief Executive Officer and Chief Financial Officer have determined that there have been no changes, in the Company's internal control over financial reporting during the period covered by this report identified in connection with the evaluation described in the above paragraph that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II**

### **ITEM 1. LEGAL PROCEEDINGS**

On August 21, 2012, a complaint for patent infringement was filed against the Company in the United States District Court for the Eastern District of Texas, entitled *Blue Spike, LLC v. ImageWare Systems, Inc.*, Case No. 12-cv-688-LED. The case is one of approximately 80-plus lawsuits filed by Blue Spike, LLC. All cases have been consolidated for all pretrial purposes, other than venue, with the first-filed, lead action entitled *Blue Spike, LLC v. Texas Instruments, Inc.*, Case No. 12-cv-499-LED, filed on August 9, 2012. The four patents-in-suit are related to digital signal abstracting technology. On March 14, 2014, the Court granted the Company's motion to sever and transfer its case to the United States District Court for the Southern District of California. Accordingly, Blue Spike's case against the Company has been severed from the consolidated action and transferred to the Southern District of California. The Court also denied without prejudice the Company's motion to dismiss claims for indirect and willful infringement, without prejudice to re-filing the motion in the Southern District of California. The Company contends that the asserted patents are invalid, unenforceable and/or not infringed and intends to defend against the action vigorously.

Other than as specifically described above, we are currently not involved in any litigation that we believe could have a material adverse effect on our financial condition or results of operations. Other than described above, there is no action, suit, proceeding, inquiry or investigation before or by any court, public board, government agency, self-regulatory organization or body pending or, to the knowledge of the executive officers of the Company or any of our subsidiaries, threatened against or affecting the Company, our common stock, any of our subsidiaries or of the Company's or our subsidiaries' officers or directors in their capacities as such, in which an adverse decision could have a material adverse effect.

### **ITEM 1A. RISK FACTORS**

Our results of operations and financial condition are subject to numerous risks and uncertainties described in our Annual Report on Form 10-K for our fiscal year ended December 31, 2013, filed on March 17, 2014. You should carefully consider these risk factors in conjunction with the other information contained in this Quarterly Report. Should any of these risks materialize, our business, financial condition and future prospects could be negatively impacted. As of June 30, 2014, there have been no material changes to the disclosures made in the above-referenced Form 10-K.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

### **ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b>(a)</b>	<b>EXHIBITS</b>
31.1	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a)
31.2	Certification of the Principal Financial and Accounting Officer pursuant to Rule 13a-14(a) and 15d-14(a)
32.1	Certification by the Principal Executive Officer and Principal Financial and Accounting Officer pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 11, 2014

IMAGEWARE SYTEMS, INC

By: /s/ S. James Miller

S. James Miller

Chief Executive Officer, Chairman and Director

(Principal Executive Officer)

Date: August 11, 2014

By: /s/ Wayne Wetherell

Wayne Wetherell

Chief Financial Officer

(Principal Financial and Accounting Officer)

**Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and pursuant to Rule 13a-14(a) and Rule 15d-14 under the Securities Exchange Act of 1934**

I, S. James Miller, Jr., Chief Executive Officer of the Company, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ImageWare Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations: and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

ImageWare Systems, Inc.

By: /s/ S. James Miller, Jr.  
S. James Miller, Jr.  
Chief Executive Officer  
(Principal Executive Officer)

**Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and pursuant to Rule 13a-14(a) and Rule 15d-14 under the Securities Exchange Act of 1934**

I, Wayne Wetherell, Chief Financial Officer of the Company, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of ImageWare Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluations: and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

ImageWare Systems, Inc.

By: /s/ Wayne Wetherell  
Wayne Wetherell  
Chief Financial Officer (Principal Financial Officer)

**CERTIFICATION**

S. James Miller, Chief Executive Officer of ImageWare Systems, Inc. (the "Company"), and Wayne Wetherell, Chief Financial Officer of the Company, each hereby certifies pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. Section 1350) that, to the best of his knowledge:

1. The Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and

2. The information contained in the Quarterly Report on Form 10-Q of the Company for the quarter ended March 31, 2014 fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and the results of operations of the Company for the period covered by the Quarterly Report.

**IN WITNESS WHEREOF**, the undersigned have set their hands hereto as of the 11th day of August, 2014.

/s/ S. James Miller

**S. James Miller**  
**Chief Executive Officer**

/s/ Wayne Wetherell

**Wayne Wetherell**  
**Chief Financial Officer**  
**(Principal Financial and Accounting Officer)**

A signed original of this written statement required by Section 906 has been provided to ImageWare Systems, Inc. and will be retained by ImageWare Systems, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.