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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 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	**33-0224167**
(State or Other Jurisdiction of Incorporation or Organization)	(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 [X] 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 [X] 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	[ ]	Accelerated filer	[X]
Non-accelerated filer	[ ]	Smaller reporting company	[ ]

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

The number of shares of common stock, with $0.01 par value, outstanding on November 7, 2014 was 93,402,908.

IMAGEWARE SYSTEMS, INC.
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PART I

ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2014	December 31, 2013
	(Unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 488	$ 2,363
Accounts receivable, net of allowance for doubtful accounts of $3 at September 30, 2014 and December 31, 2013	261	302
Inventory, net	780	505
Other current assets	318	148
Total Current Assets	1,847	3,318
Property and equipment, net	232	245
Other assets	31	395
Intangible assets, net of accumulated amortization	151	172
Goodwill	3,416	3,416
Total Assets	**$ 5,677**	**$ 7,546**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 470	$ 486
Deferred revenue	1,995	1,662
Accrued expenses	1,013	924
Derivative liabilities	—	57
Notes payable to related parties	—	55
Total Current Liabilities	3,478	3,184
Pension obligation	1,040	1,031
Total Liabilities	4,518	4,215
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 September 30, 2014 and December 31, 2013, respectively; liquidation preference $620 and $607 at September 30, 2014 and December 31, 2013, respectively.	2	2
Common stock, $0.01 par value, 150,000,000 shares authorized; 93,309,612 and 87,555,317 shares issued at September 30, 2014 and December 31, 2013, respectively, and 93,302,908 and 87,548,613 shares outstanding at September 30, 2014 and December 31, 2013, respectively.	932	874
Additional paid-in capital	135,408	131,652
Treasury stock, at cost 6,704 shares	(64)	(64)
Accumulated other comprehensive loss	(799)	(830)
Accumulated deficit	(134,320)	(128,303)
Total Shareholders' Equity	1,159	3,331
Total Liabilities and Shareholders' Equity	**$ 5,677**	**$ 7,546**

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 September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Revenues:				
Product	$ 362	$ 1,842	$ 1,077	$ 2,413
Maintenance	557	654	1,842	1,962
	919	2,496	2,919	4,375
Cost of revenues:				
Product	77	90	195	249
Maintenance	171	209	536	585
Gross profit	671	2,197	2,188	3,541
Operating expenses:				
General and administrative	971	888	2,861	2,560
Sales and marketing	567	512	1,781	1,497
Research and development	1,210	946	3,391	2,861
Depreciation and amortization	45	29	134	77
	2,793	2,375	8,167	6,995
Loss from operations	(2,122)	(178)	(5,979)	(3,454)
Interest expense, net	104	73	288	148
Change in fair value of derivative liabilities	—	(470)	—	4,679
Other income, net	(1)	(123)	(289)	(231)
Income (loss) before income taxes	(2,225)	342	(5,978)	(8,050)
Income tax expense	3	3	15	5
Net income (loss)	(2,228)	339	(5,993)	(8,055)
Preferred dividends	(13)	(13)	(38)	(38)
Net income (loss) available to common shareholders	$ (2,241)	$ 326	$ (6,031)	$ (8,093)
Basic income (loss) per common share - see Note 3:				
Net income (loss) per share	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)
Preferred dividends	(0.00)	(0.00)	(0.00)	(0.00)
Basic income (loss) per share available to common shareholders	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)
Basic weighted-average shares	93,162,548	83,750,636	91,260,530	79,751,523
Diluted income (loss) per common share - see Note 3:				
Diluted income (loss) per share	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)
Diluted weighted-average shares	93,162,548	93,352,192	91,260,530	79,751,523

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)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income (loss)	$ (2,228)	$ 339	$ (5,993)	$ (8,055)
Other comprehensive income (loss):				
Foreign currency translation adjustment	48	(39)	32	(46)
Comprehensive income (loss)	$ (2,180)	$ 300	$ (5,961)	$ (8,101)

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)

	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Cash flows from operating activities		
Net loss	$ (5,993)	$ (8,055)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	134	86
Amortization of debt issuance costs	286	145
Reduction in accounts payable and accrued expenses from the expiration of statute of limitations	(216)	(228)
Change in fair value of derivative liabilities	—	4,679
Warrants issued in lieu of cash paid for services	53	108
Stock-based compensation	634	411
Change in assets and liabilities		
Accounts receivable	41	15
Inventory	(275)	(226)
Other assets	36	41
Accounts payable	190	(212)
Deferred revenue	333	549
Accrued expenses	128	41
Pension obligation	10	41
Total adjustments	1,354	5,450
Net cash used in operating activities	(4,639)	(2,605)
Cash flows from investing activities		
Purchase of property and equipment	(100)	(103)
Net cash used in investing activities	(100)	(103)
Cash flows from financing activities		
Proceeds from exercised stock options	59	8
Proceeds from exercised warrants to purchase stock	2,798	2,014
Dividends paid	(25)	(25)
Net cash provided by financing activities	2,832	1,997
Effect of exchange rate changes on cash	32	(46)
Net decrease in cash and cash equivalents	(1,875)	(757)
Cash and cash equivalents at beginning of period	2,363	4,225
Cash and cash equivalents at end of period	$ 488	$ 3,468
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 2	$ —
Cash paid for income taxes	$ 1	$ 1
Summary of non-cash investing and financing activities:		
Reclassification of warrants previously classified as derivative liabilities to additional paid-in capital	$ 57	$ 6,276
Issuance of common stock warrants securing line of credit borrowing facility	$ 127	$ 580
Issuance of common stock pursuant to cashless warrant exercises	$ 9	$ 43
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 mug shots, fingerprint live scans, 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

Amendment to 1999 Stock Option Plan

On July 1, 2014, the Company solicited 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.

Settlement of Blue Spike Matter

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") 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 four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

Liquidity, Capital Resources and Going Concern Uncertainty

These unaudited condensed consolidated financial statements have been prepared and presented on a basis assuming we will continue as a going concern. We do not currently believe that our existing cash resources are sufficient to meet our anticipated needs over the next twelve months.

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 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 as a slower rate and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

At September 30, 2014, our principal sources of liquidity consisted of cash and cash equivalents of $488,000 and accounts receivable, net of $261,000. As of September 30, 2014, we had negative working capital of $1,631,000, which included $1,995,000 of deferred revenue. We have a history of recurring losses, and as of September 30, 2014, we have incurred a cumulative net loss of approximately $134,320,000. These factors raise substantial doubt about our ability to continue as a going concern. The financial statements do not include any adjustments that might be necessary from the outcome of this uncertainty.

In October and November of 2014, we borrowed an aggregate of $1,000,000 under one of the existing Lines of Credit, as defined in Note 5, "*Notes Payable and Lines of Credit*" below, for working capital purposes. We currently have remaining available borrowing capacity under the Lines of Credit aggregating $2,500,000. The Lines of Credit expire on March 27, 2015, and all amounts due and payable thereunder are required to be repaid at that time, unless the maturity date is extended or the outstanding balance is converted into shares of common stock at the option of the holder.

We do not anticipate that we can generate sufficient cash from operations to repay the amount due under the Lines of Credit before expiration on March 27, 2015. We will therefore need to either extend the maturity date of the Lines of Credit, or raise substantial additional capital through debt or equity financing to continue to execute our business plan. No assurances can be given that any such financing will be available on favorable terms, if at all. The inability to obtain debt or equity financing in a timely manner and in amounts sufficient to fund our operations, or the inability to extend the maturity date of the Lines of Credit would have an immediate and substantial adverse impact on our business, financial condition and results of operations. It also may require us to significantly modify our plan of operations to reduce spending to a sustainable level, which may include delaying, scaling back or eliminating some or all of our ongoing and planned investments in corporate infrastructure, research and development projects, regulatory submissions, business development initiatives, and sales and marketing activities.

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 nine months ended September 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 September 30, 2014, two customers accounted for approximately 38% or $346,000 of our total revenue and had trade receivables at September 30, 2014 of $43,000. For the nine months ended September 30, 2014, two customers accounted for approximately 30% or $879,000 of our total revenue and had trade receivables at September 30, 2014 of $43,000. For the three months ended September 30, 2013, one customer accounted for approximately 69% or $1,733,000 of our total revenue and had trade receivables at September 30, 2013 of $0. For the nine months ended September 30, 2013, one customer accounted for approximately 47% or $2,037,000 of our total revenue and had no trade receivables at September 30, 2013.

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.

FASB ASU No. 2014-15. In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, which provides guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 will be effective in the fourth quarter of 2016, with early adoption permitted. The Company is currently evaluating the impact of its pending adoption of ASU 2014-15 on its condensed 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 September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator for basic earnings (loss) per share:				
Net income (loss)	$ (2,228)	$ 339	$ (5,993)	$ (8,055)
Preferred dividends	(13)	(13)	(38)	(38)
Net income (loss) available to common shareholders	(2,241)	326	$ (6,031)	$ (8,093)
Numerator for diluted earnings (loss) per share:				
Net income (loss) available to common shareholders	$ (2,241)	$ 326	$ (6,031)	$ (8,093)
Preferred dividends	—	13	—	—
Interest expense on convertible debt	$ —	$ 1	$ —	$ —
Net income (loss) for diluted earnings (loss) per share	$ (2,241)	$ 340	$ (6,031)	$ (8,093)
Denominator for basic earnings (loss) per share – weighted-average shares outstanding	93,162,548	83,750,636	91,260,530	79,751,523
Effect of dilutive securities	—	9,601,556	—	—
Denominator for diluted earnings (loss) per share – weighted-average shares outstanding	93,162,548	93,352,192	91,260,530	79,751,523
Basic income (loss) per share:				
Net income (loss) per share	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)
Preferred dividends	(0.00)	(0.00)	(0.00)	(0.00)
Net income (loss) per share available to common shareholders	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)
Diluted income (loss) per share:				
Net income (loss) per share	$ (0.02)	$ 0.00	$ (0.07)	$ (0.10)

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Restricted stock grants	—	—	—	—
Convertible notes payable	—	—	—	—
Convertible preferred stock	46,991	45,393	46,991	46,179
Stock options	3,663,670	103,315	3,663,670	102,095
Warrants	1,057,778	—	1,057,778	135,505
Total dilutive securities	4,768,439	148,708	4,768,439	283,779

NOTE 4. SELECT BALANCE SHEET DETAILS

Inventory

Inventories of $780,000 as of September 30, 2014 were comprised of work in process of $773,000, representing direct labor costs of approximately $762,000 on in-process projects, approximately $11,000 of equipment related to in-process projects and finished goods of $7,000 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 $19,000 and $31,000 as of September 30, 2014 and December 31, 2013, respectively, which include accumulated amortization of $328,000 and $316,000 as of September 30, 2014 and December 31, 2013, respectively. Amortization expense for the intangible assets was $4,000 and $12,000 for the three and nine months ended September 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 $132,000 and $141,000 as of September 30, 2014 and December 31, 2013, respectively, which include accumulated amortization of $527,000 and $518,000 as of September 30, 2014 and December 31, 2013, respectively. Amortization expense for patent intangible assets was $3,000 and $9,000 for the three and nine months ended September 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:

Fiscal Year Ended December 31,	Estimated Amortization Expense ($ in thousands)
2014 (3 months)	$ 7
2015	27
2016	12
2017	12
2018	12
Thereafter	81
Totals	$ 151

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 September 30, 2014 and December 31, 2013.

NOTE 5. NOTES PAYABLE AND LINES OF CREDIT

Notes payable consist of the following:

($ in thousands)	**September 30, 2014**	**December 31, 2013**
Notes payable to related parties:		
7% convertible promissory notes. Face value of notes $0 at September 30, 2014 and $55 at December 31, 2013. Discount on notes is $0 at September 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	$ —	$ 55
Total notes payable	—	55
Less current portion	(—)	(55)
Long-term notes payable	$ —	$ —

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 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 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 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.

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 September 30, 2014, no advances were made under the Lines of Credit. For activity under the Lines of Credit subsequent to September 30, 2014, see Note 11, "*Subsequent Events*" below.

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 September 30, 2014 and December 31, 2013. At September 30, 2014 and December 31, 2013, the Company had cumulative undeclared dividends of approximately $21,000, respectively. There were no conversions of Series B Preferred into common stock during the nine months ended September 30, 2014 or 2013.

Common Stock

The following table summarizes common stock activity for the nine months ended September 30, 2014:

	Common Stock
Shares outstanding at December 31, 2013	87,548,613
Shares issued pursuant to options exercised for cash	88,491
Shares issued pursuant to Related-Party note payable conversion	154,607
Shares issued pursuant to cashless warrants exercised	868,565
Shares issued pursuant to warrants exercised for cash	4,642,632
Shares outstanding at September 30, 2014	93,302,908

During the nine months ended September 30, 2014, the Company issued 88,491 shares of common stock pursuant to the exercise of 88,491 options for cash proceeds of approximately $59,000. During the nine months ended September 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 nine months ended September 30, 2014, the Company issued 868,565 shares of common stock pursuant to the cashless exercise of 1,125,784 warrants.

Warrants

The following table summarizes warrant activity for the following periods:

	Warrants	Weighted-Average Exercise Price
Balance at December 31, 2013	6,598,416	$ 0.52
Granted	277,778	$ 2.10
Expired / Canceled	(50,000)	$ 1.08
Exercised	(5,768,416)	$ 0.58
Balance at September 30, 2014	1,057,778	$ 1.15

During the nine months ended September 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 nine months ended September 30, 2014.

During the nine months ended September 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 nine months ended September 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 nine months ended September 30, 2014, there were 1,125,784 warrants exercised on a cashless basis resulting in the issuance of 868,565 shares of the Company's common stock.

As of September 30, 2014, warrants to purchase 1,057,778 shares of common stock at prices ranging from $0.50 to $2.40 were outstanding. All warrants are exercisable as of September 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.

During September 2014, warrants to purchase 25,000 shares of the Company's common stock at an exercise price of $1.10 per share became issuable upon the attainment of certain specified performance criteria. The Company determined the fair value of the warrants to be approximately $53,000 using the Black-Scholes option-pricing model and has recorded the fair value as a component of general and administrative expense for the three and nine months ended September 30, 2014 in the accompanying condensed consolidated statement of operations.

Stock-Based Compensation

As of September 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 $150,000 and $456,000 for the three and nine months ended September 30, 2014, respectively. Stock-based compensation expense related to equity options was approximately $142,000 and $411,000 for the three and nine months ended September 30, 2013, respectively.

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 nine months ended September 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 nine months ended September 30, 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 nine months ended September 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	(88,491)	$ 0.78
Balance at September 30, 2014	3,663,670	$ 0.95

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 nine months ended September 30, 2014, the Company recorded $60,000 and $179,000, 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 nine months ended September 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)	Fair Value at September 30, 2014 Total	Level 1	Level 2	Level 3
Assets:				
Pension assets	$ 1,690	$ 1,690	$ —	$ —
Totals	$ 1,690	$ 1,690	$ —	$ —
Liabilities:				
Derivative liabilities	$ —	$ —	$ —	$ —
Totals	$ —	$ —	$ —	$ —

($ in thousands)	Fair Value at December 31, 2013 Total	Level 1	Level 2	Level 3
Assets:				
Pension assets	$ 1,790	$ 1,790	$ —	$ —
Totals	$ 1,790	$ 1,790	$ —	$ —
Liabilities:				
Derivative liabilities	$ 57	$ —	$ —	$ 57
Totals	$ 57	$ —	$ —	$ 57

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 nine months ended September 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)	**Derivative Liabilities**
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 September 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 nine months ended September 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 nine 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 nine months of base salary; (ii) continuation of their fringe benefits and medical insurance for a period of nine months; (iii) immediate vesting of 50% of their outstanding stock options and restricted stock awards. In the event that their employment is terminated within nine 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.

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 $53,000 in 2014 (3 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 $37,000 in 2014 (3 months), $176,000 in 2015, $190,000 in 2016, $196,000 in 2017 and $168,000 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 September 30, 2014, future minimum lease payments are as follows:

($ in thousands)		
2014 (3 months)	$	108
2015	$	450
2016	$	422
2017	$	386
2018 and thereafter	$	168
	$	1,534

Rental expense incurred under operating leases for the nine months ended September 30, 2014 and 2013 was approximately $316,000 and $321,000, respectively.

NOTE 11. SUBSEQUENT EVENTS

Settlement of Blue Spike Matter

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") 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 four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

Borrowings under Line of Credit

In October and November of 2014, we borrowed an aggregate of $1,000,000 under one of the existing Lines of Credit, as defined in Note 5, "*Notes Payable and Lines of Credit*", for working capital purposes. We currently have remaining available borrowing capacity under the Lines of Credit aggregating $2,500,000. The Lines of Credit expire on March 27, 2015, and all amounts due and payable thereunder are required to be repaid at that time, unless the maturity date is extended or the outstanding balance is converted into shares of common stock at the option of the holder.

Exercise of Warrants

In November 2014, the Company issued 100,000 shares of common stock pursuant to the exercise of 100,000 warrants resulting in proceeds to the Company of $50,000.

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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

Amendment to 1999 Stock Option Plan

On July 1, 2014, the Company solicited 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.

Borrowing under Lines of Credit

In October and November of 2014, we borrowed an aggregate of $1,000,000 under one of the existing Lines of Credit, as defined in Note 5 of the notes to our condensed consolidated financial statements, titled "*Notes Payable and Lines of Credit*", for working capital purposes. The Lines of Credit are set to expire on March 27, 2015, unless the maturity date is extended or, at the option of the holder, the outstanding balance is converted into shares of the our common stock

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 nine months ended September 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 September 30, 2014 to the Three Months Ended September 30, 2013.

Product Revenue

Net Product Revenue (dollars in thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	$ Change	% Change
Software and royalties	$ 206	$ 1,797	$ (1,591)	(89)%
Percentage of total net product revenue	57%	98%		
Hardware and consumables	$ 29	$ 3	$ 26	867%
Percentage of total net product revenue	8%	0%		
Services	$ 127	$ 42	$ 85	202%
Percentage of total net product revenue	35%	2%		
Total net product revenue	$ 362	$ 1,842	$ (1,480)	(80)%

Software and royalty revenue decreased 89% or approximately $1,591,000 during the three months ended September 30, 2014 as compared to the corresponding period in 2013. This decrease is due to lower identification software license revenue and royalties of approximately $1,542,000 and lower sales of boxed identity management software sold through our distribution channel of approximately $49,000 for the three months ended September 30, 2014 as compared to the corresponding period of 2013. The decrease in identification software license revenue received during the quarter ended September 30, 2014 compared to the corresponding period for the last fiscal year is principally due to the positive impact of non-recurring revenue received from one customer in the 2013 period.

Revenue from the sale of hardware and consumables increased approximately $26,000 during the three months ended September 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 approximately $85,000 during the three months ended September 30, 2014 as compared to the corresponding period in 2013, due to higher service revenue components in 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 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 September 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 first quarter of 2015, 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

Maintenance Revenue (dollars in thousands)	Three Months Ended September 30, 2014	2013	$ Change	% Change
Maintenance revenue	$ 557	$ 654	$ (97)	(15)%

Maintenance revenue was $557,000 for the three months ended September 30, 2014 as compared to $654,000 for the corresponding period in 2013. Identity management maintenance revenue generated from identification software solutions were $243,000 for the three months ended September 30, 2014 as compared to $236,000 during the comparable period in 2013. The increase of $7,000 results from the expansion of our installed base. Law enforcement maintenance revenues were $314,000 for the three months ended September 30, 2014 as compared to $418,000 during the comparable period in 2013. The decrease of $104,000 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

Cost of Product Revenue: (dollars in thousands)	Three Months Ended September 30, 2014	2013	$ Change	% Change
Software and royalties	$ 13	$ 67	$ (54)	(81)%
Percentage of software and royalty product revenue	6%	4%		
Hardware and consumables	$ 21	$ 6	$ 15	250%
Percentage of hardware and consumables product revenue	72%	200%		
Services	$ 43	$ 17	$ 26	153%
Percentage of services product revenue	34%	40%		
Total product cost of revenue	$ 77	$ 90	$ (13)	(14)%
Percentage of total product revenue	21%	5%		

The cost of software and royalty product revenue decreased 81% or approximately $54,000 for the three months ended September 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 $1,591,000 during the three months ended September 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 increase in the cost of product revenue for our hardware and consumable sales of 250% or approximately $15,000 for the three months ended September 30, 2014 as compared to the corresponding period in 2013 reflects the increase in hardware and consumable revenue for the three months ended September 30, 2014 as compared to the corresponding period of 2013.

The cost of services revenue increased approximately $26,000 during the three months ended September 30, 2014 as compared to the corresponding period in 2013. This increase reflects higher service revenues of approximately $85,000 during the three months ended September 30, 2014 as compared to the comparable three-month period of 2013.

Cost of Maintenance Revenue

Maintenance cost of revenue (dollars in thousands)	**Three Months Ended September 30, 2014**	**2013**	**$ Change**	**% Change**
Total maintenance cost of revenue	$ 171	$ 209	$ (38)	(18)%
Percentage of total maintenance revenue	31%	32%		

Cost of maintenance revenue decreased 18% or approximately $38,000 during the three months ended September 30, 2014 as compared to the corresponding period in 2013. This decrease results primarily from lower Law Enforcement maintenance labor costs due to the utilization of lower priced resources to fulfill maintenance requirements for the three months ended September 30, 2014 as compared to the comparable period of 2013.

Product Gross Profit

Product gross profit (dollars in thousands)	**Three Months Ended September 30, 2014**	**2013**	**$ Change**	**% Change**
Software and royalties	$ 193	$ 1,730	$ (1,537)	(89)%
Percentage of software and royalty product revenue	94%	96%		
Hardware and consumables	$ 8	$ (3)	$ 11	367%
Percentage of hardware and consumables product revenue	28%	(100%)		
Services	$ 84	$ 25	$ 59	236%
Percentage of services product revenue	66%	60%		
Total product gross profit	$ 285	$ 1,752	$ (1,467)	(84)%
Percentage of total product revenue	79%	95%		

Software and royalty gross profit decreased 89% or approximately $1,537,000 for the three months ended September 30, 2014 from the corresponding period in 2013 due primarily to lower software and royalty product revenue of approximately $1,591,000. 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 increased approximately $11,000 for the three-month period ended September 30, 2014 as compared to the corresponding period in 2013. This increase was primarily due to higher hardware and consumables revenue of approximately $26,000 in the three-month period ended September 30, 2014 as compared to the corresponding period in the 2013 year.

Services gross profit increased approximately $59,000 for the nine months ended September 30, 2014 as compared to the corresponding period in 2013 due primarily to higher services revenues during the nine months ended September 30, 2014 than the comparable 2013 period.

Maintenance Gross Profit

Maintenance gross profit (dollars in thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	$ Change	% Change
Total maintenance gross profit	$ 386	$ 445	$ (59)	(13)%
Percentage of total maintenance revenue	69%	68%		

Gross profit related to maintenance revenue decreased 13% or approximately $59,000 for the three months ended September 30, 2014 as compared to the same period ended September 30, 2013. That decrease is due to lower maintenance revenue of approximately $97,000 offset with lower maintenance cost of revenues of approximately $38,000.

Operating Expense

Operating expenses (dollars in thousands)	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	$ Change	% Change
General and administrative	$ 971	$ 888	$ 83	9%
Percentage of total net revenue	106%	36%		
Sales and marketing	$ 567	$ 512	$ 55	11%
Percentage of total net revenue	62%	21%		
Research and development	$ 1,210	$ 946	$ 264	28%
Percentage of total net revenue	132%	38%		
Depreciation and amortization	$ 45	$ 29	$ 16	55%
Percentage of total net revenue	5%	1%		

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 $83,000 is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately $95,000 due primarily to increases in professional services and investor relation fees of approximately $30,000, increases in legal fees of approximately $18,000, patent infringement settlement fees of $40,000 and increases in patent related expenses of approximately $26,000, offset by decreases in various consulting and contract services of approximately $19,000.

- Decrease in personnel related expense of approximately $13,000.

- Increase in stock-based compensation expense of approximately $4,000.

- Decrease in travel, insurances, licenses, dues, rent, and office related costs of approximately $3,000.

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 $55,000 during the three months ended September 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 $37,000 due primarily to headcount increases.
- Increase in professional services of approximately $27,000.
- Decrease in contract services, travel and trade show expenses and office related expenses of approximately $11,000.
- Increase in stock-based compensation expense of approximately $2,000.

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 $264,000 for the three months ended September 30, 2014 as compared to the corresponding period in 2013 due primarily to the following major components:

- Increase in personnel expenditures of approximately $8,000 due to headcount increases.
- Increase in contractor fees and contract services of approximately $245,000.
- Increase in stock-based compensation of approximately $2,000.
- Increase in office related expenses of approximately $9,000.

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 September 30, 2014, depreciation and amortization expense increased approximately $16,000 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 $16,000 reflects the replacement of fully depreciated equipment.

Interest Expense

For the three months ended September 30, 2014, we recognized interest expense of approximately $104,000. For the three months ended September 30, 2013, we recognized interest expense of approximately $73,000. Interest expense for the three months ended September 30, 2014 is comprised of approximately $104,000 of amortization expense of deferred financing fees related to our unsecured line of credit. Interest expense for the three months ended September 30, 2013 is comprised of approximately $72,000 of amortization expense of deferred financing fees related to our unsecured line of credit and $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 September 30, 2014, we recognized non-cash expense of $0 compared to non-cash income of approximately $470,000 for the corresponding period of 2013. This non-cash expense/income 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, net

For the three months ended September 30, 2014, we recognized other income of approximately $1,000. For the three months ended September 30, 2013, we recognized other income of approximately $124,000 and other expenses of $1,000. Other income for the three months ended September 30, 2014 is comprised of approximately $1,000 related to miscellaneous receipts. Other income for the three months ended September 2013 is comprised of approximately $124,000 from the write-off of certain accounts payable and accrued expenses due to the expiration of the statute of limitations on such liabilities.

Comparison of the Nine Months Ended September 30, 2014 to the Nine Months Ended September 30, 2013.

Product Revenue

Net Product Revenue (dollars in thousands)	**Nine Months Ended September 30, 2014**	**2013**	**$ Change**	**% Change**
Software and royalties	$ 787	$ 2,246	$ (1,459)	(65)%
Percentage of total net product revenue	73%	93%		
Hardware and consumables	$ 107	$ 67	$ 40	60%
Percentage of total net product revenue	10%	3%		
Services	$ 183	$ 100	$ 83	83%
Percentage of total net product revenue	17%	4%		
Total net product revenue	$ 1,077	$ 2,413	$ (1,336)	(55)%

Software and royalty revenue decreased 65% or approximately $1,459,000 during the nine months ended September 30, 2014 as compared to the corresponding period in 2013. This decrease is due to lower sales of identification software licenses of approximately $1,377,000, lower sales of boxed identity management software through our distribution channel of approximately $32,000, and lower law enforcement project related revenues of approximately $90,000, offset by higher identification software royalties of approximately $40,000. The decrease in identification software license revenue received during the quarter ended September 30, 2014 compared to the corresponding period for the last fiscal year is principally due to the positive impact of non-recurring revenue received from one customer in the 2013 period.

Revenue from the sale of hardware and consumables increased 60% or approximately $40,000 during the nine months ended September 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 83% or approximately $83,000 during the nine months ended September 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 September 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 first quarter of 2015, 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

Maintenance Revenue (dollars in thousands)	Nine Months Ended September 30, 2014	2013	$ Change	% Change
Maintenance revenue	$ 1,842	$ 1,962	$ (120)	(6)%

Maintenance revenue was $1,842,000 for the nine months ended September 30, 2014 as compared to $1,962,000 for the corresponding period in 2013. Identity management maintenance revenues were $729,000 for the nine months ended September 30, 2014 as compared to $680,000 during the comparable period in 2013. The increase of $49,000 results from the expansion of our installed base. Law enforcement maintenance revenues were $1,113,000 for the nine months ended September 30, 2014 as compared to $1,282,000 during the comparable period in 2013. The decrease of $169,000 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

Cost of Product Revenue: (dollars in thousands)	Nine Months Ended September 30, 2014	2013	$ Change	% Change
Software and royalties	$ 51	$ 123	$ (72)	(59)%
Percentage of software and royalty product revenue	6%	5%		
Hardware and consumables	$ 76	$ 61	$ 15	25%
Percentage of hardware and consumables product revenue	71%	91%		
Services	$ 68	$ 65	$ 3	5%
Percentage of services product revenue	37%	65%		
Total product cost of revenue	$ 195	$ 249	$ (54)	(22)%
Percentage of total product revenue	18%	10%		

The cost of software and royalty product revenue decreased 59% or approximately $72,000 for the nine months ended September 30, 2014 as compared to the corresponding period of 2013. This decrease in software and royalty cost of product revenue of approximately $72,000 is due to lower sales of software licenses and royalties. 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 increase in the cost of product revenue for our hardware and consumable sales of 25% or approximately $15,000 for the nine months ended September 30, 2014 as compared to the corresponding period in 2013 reflects the increase in hardware and consumable revenue for the three months ended September 30, 2014 as compared to the corresponding period in 2013.

The cost of services revenue increased 5% or approximately $3,000 during the nine months ended September 30, 2014 as compared to the corresponding period in 2013. The increase reflects higher services revenues during the nine months ended September 30, 2014 as compared to the comparable period of 2013.

Cost of Maintenance Revenue

Maintenance cost of revenue (dollars in thousands)	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	$ Change	% Change
Total maintenance cost of revenue	$ 536	$ 585	$ (49)	(8)%
Percentage of total maintenance revenue	29%	30%		

Cost of maintenance revenue decreased approximately $49,000 during the nine months ended September 30, 2014 as compared to the corresponding period in 2013 due primarily to lower maintenance revenues of approximately $120,000 combined with lower non-labor related maintenance costs.

Product Gross Profit

Product gross profit (dollars in thousands)	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	$ Change	% Change
Software and royalties	$ 736	$ 2,123	$ (1,387)	(65)%
Percentage of software and royalty product revenue	94%	95%		
Hardware and consumables	$ 31	$ 6	$ 25	417%
Percentage of hardware and consumables product revenue	29%	9%		
Services	$ 115	$ 35	$ 80	229%
Percentage of services product revenue	63%	35%		
Total product gross profit	$ 882	$ 2,164	$ (1,282)	(59)%
Percentage of total product revenue	82%	90%		

Software and royalty gross profit decreased 65% or approximately $1,387,000 for the nine months ended September 30, 2014 from the corresponding period in 2013 due primarily to lower software and royalty product revenues of approximately $1,459,000 offset by lower cost of software and royalty product revenues of approximately $72,000. In addition to changes caused by revenue volume fluctuations, 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 approximately $25,000 for the nine-month period ended September 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 nine months ended September 30, 2014 as compared to the comparable period in 2013.

Services gross profit increased approximately $80,000 for the nine months ended September 30, 2014 as compared to the corresponding period in 2013 due primarily to higher services revenues during the nine months ended September 30, 2014 than the comparable 2013 period.

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Maintenance Gross Profit

Maintenance gross profit (dollars in thousands)	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	$ Change	% Change
Total maintenance gross profit	$ 1,306	$ 1,377	$ (71)	(5)%
Percentage of total maintenance revenue	71%	70%		

Gross profit related to maintenance revenue decreased approximately $71,000 for the nine months ended September 30, 2014 as compared to the same period ended September 30, 2013. That decrease is due to lower maintenance revenues of approximately $120,000 offset by lower maintenance costs of approximately $49,000.

Operating Expense

Operating expenses (dollars in thousands)	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	$ Change	% Change
General and administrative	$ 2,861	$ 2,560	$ 301	12%
Percentage of total net revenue	98%	59%		
Sales and marketing	$ 1,781	$ 1,497	$ 284	19%
Percentage of total net revenue	61%	34%		
Research and development	$ 3,391	$ 2,861	$ 530	19%
Percentage of total net revenue	116%	65%		
Depreciation and amortization	$ 134	$ 77	$ 57	74%
Percentage of total net revenue	5%	2%		

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 $301,000 is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately $190,000 due primarily to increases in audit related fees of approximately $31,000, increases in various consulting and contract services of approximately $65,000, increases in legal fees of approximately $79,000, patent infringement settlement fees of $40,000, increases in patent related expenses of approximately $25,000 and decreases in Board of Director fees of approximately $50,000,

- Increase in personnel related expense of approximately $33,000 due to headcount increases and higher fringe benefit costs.

- Increase in stock-based compensation expense of approximately $24,000.

- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately $54,000.

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 $284,000 during the nine months ended September 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 $149,000 due primarily to headcount increases.
- Increase in stock-based compensation expense of approximately $10,000.
- Increase in professional services of approximately $24,000.
- Increase in contract services, travel and trade show expenses and office related expenses of approximately $94,000.
- Increase in our Mexico sales offices expenses of approximately $7,000.

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 $530,000 for the nine months ended September 30, 2014 as compared to the corresponding period in 2013 due primarily to the following major components:

- Increase in personnel expenditures of approximately $251,000 due to headcount increases.
- Increase in contractor fees of approximately $239,000 due to the accelerated development of our mobile applications.
- Increase in rent, office related costs, contract services and travel and trade show expenses of approximately $31,000.
- Increase in stock-based compensation of approximately $9,000.

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 nine months ended September 30, 2014, depreciation and amortization expense increased approximately $57,000 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 $57,000 reflects the replacement of fully depreciated equipment.

Interest Expense, Net

For the nine months ended September 30, 2014, we recognized interest income of approximately $1,000 and interest expense of approximately $289,000. For the nine months ended September 30, 2013, we recognized interest income of $1,000 and interest expense of $149,000. Interest expense for the nine months ended September 30, 2014 is comprised of approximately $286,000 of amortization expense of deferred financing fees related to our unsecured line of credit, approximately $2,000 related to coupon interest on our 7% related party convertible notes and approximately $1,000 related to miscellaneous interest charges. Interest expense for the nine months ended September 30, 2013 is comprised of approximately $145,000 of amortization expense of deferred financing fees related to our unsecured line of credit and $4,000 is related to coupon interest on our 7% related party convertible notes.

Change in Fair Value of Derivative Liabilities

For the nine months ended September 30, 2014, we recognized non-cash expense of $0 compared to approximately $4,679,000 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, net

For the nine months ended September 30, 2014, we recognized other income of approximately $289,000. For the nine months ended September 30, 2013, we recognized other income of approximately $232,000 and other expense of approximately $1,000. Other income for the nine months ended September 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 nine months ended September 30, 2013 is comprised of approximately $228,000 from the write-off of certain accounts payable due to the expiration of the legal statute of limitations on such payables and approximately $4,000 in miscellaneous other income.

LIQUIDITY AND CAPITAL RESOURCES

The unaudited condensed consolidated financial statements contained in this Quarterly Report on Form 10-Q have been prepared and presented on a basis assuming we will continue as a going concern. We do not currently believe that our existing cash resources are sufficient to meet our anticipated needs over the next twelve months.

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 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 as a slower rate and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

At September 30, 2014, our principal sources of liquidity consisted of cash and cash equivalents of $488,000 and accounts receivable, net of $261,000. As of September 30, 2014, we had negative working capital of $1,631,000, which included $1,995,000 of deferred revenue. We have a history of recurring losses, and as of September 30, 2014, we have incurred a cumulative net loss of approximately $134,320,000. These factors raise substantial doubt about our ability to continue as a going concern. The financial statements contained in this Quarterly Report on Form 10-Q do not include any adjustments that might be necessary from the outcome of this uncertainty.

In October and November of 2014, we borrowed an aggregate of $1,000,000 under one of the existing Lines of Credit, as defined in Note 5, "*Notes Payable and Lines of Credit*", for working capital purposes. We currently have remaining available borrowing capacity under the Lines of Credit aggregating $2,500,000. The Lines of Credit expire on March 27, 2015, and all amounts due thereunder are required to be repaid at such time, unless the maturity date is extended or the outstanding balance is converted into shares of common stock at the option of the holder.

We do not anticipate that we can generate sufficient cash from operations to repay the amount due under the Lines of Credit before expiration on March 27, 2015. We will therefore need to either extend the maturity date of the Lines of Credit, or raise substantial additional capital through debt or equity financing to continue to execute our business plan. No assurances can be given that any such financing will be available on favorable terms, if at all. The inability to obtain debt or equity financing in a timely manner and in amounts sufficient to fund our operations, or the inability to extend the maturity date of the Lines of Credit would have an immediate and substantial adverse impact on our business, financial condition and results of operations. It also may require us to significantly modify our plan of operations to reduce spending to a sustainable level, which may include delaying, scaling back or eliminating some or all of our ongoing and planned investments in corporate infrastructure, research and development projects, regulatory submissions, business development initiatives, and sales and marketing activities.

Operating Activities

We used net cash of $4,639,000 in operating activities for the nine months ended September 30, 2014 as compared to net cash used of $2,605,000 during the comparable period in 2013. During the nine months ended September 30, 2014, net cash used in operating activities consisted of net loss of $5,993,000 and a decrease in working capital and other assets and liabilities of $463,000. Those amounts were offset by $891,000, net of non-cash costs including $687,000 in stock based compensation, $286,000 in debt issuance cost amortization and $134,000 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 nine months ended September 30, 2014, we used cash of $198,000 to fund increases in current assets and generated cash of $661,000 through increases in current liabilities and deferred revenues, excluding debt.

We used net cash of $2,605,000 in operating activities for the nine months ended September 30, 2013. During the nine months ended September 30, 2013, net cash used in operating activities consisted of net loss of $8,055,000 and a decrease in working capital and other assets and liabilities of $249,000. Those amounts were offset by $5,201,000, net of non-cash costs including a $4,679,000 unrealized loss related to the change in value of our derivative liabilities, $519,000 in stock based compensation, $145,000 in debt issuance cost amortization and $86,000 in depreciation and amortization offset by $228,000 of non-cash income primarily from the write-off of certain accounts payable due to the expiration of the statute of limitations. During the nine months ended September 30, 2013, we used cash of $170,000 to fund increases in current assets and generated cash of $419,000 through increases in current liabilities and deferred revenues, excluding debt.

Investing Activities

Net cash used in investing activities was $100,000 for the nine months ended September 30, 2014 as compared to $103,000 used in the nine months ended September 30, 2013. For the nine months ended September 30, 2014, we used cash to fund capital expenditures of computer equipment, software and furniture and fixtures of approximately $100,000. This level of equipment purchases resulted primarily from the replacement of older equipment. For the nine months ended September 30, 2013, we used approximately $103,000 to fund capital expenditures of computer equipment, software and furniture and fixtures.

Financing Activities

We generated cash of $2,832,000 from financing activities for the nine months ended September 30, 2014 as compared to the $1,997,000 generated during the same period in 2013. During the nine months ended September 30, 2014, we generated cash of $2,798,000 from the exercise of 4,642,632 common stock warrants and $59,000 from the exercise of 88,491 common stock options. During the nine months ended September 30, 2014, we used cash of $25,000 to pay dividends on our Series B Preferred Stock. During the nine months ended September 30, 2013, we generated cash of $2,014,000 from the exercise of 3,577,779 common stock warrants and $8,000 from the exercise of 32,713 common stock options and used cash of $25,000 to pay dividends on our Series Preferred Stock.

Debt

At September 30, 2014, we had approximately $0 in outstanding debt, exclusive of any debt discounts, and $0 in related accrued interest. However, as indicated under "Recent Developments" above, subsequent to September 30, 2014, we borrowed $1,000,000 under the Lines of Credit for working capital purposes.

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 September 30, 2014, no advances were made under the Lines of Credit. However, as indicated under "Recent Developments" above, subsequent to September 30, 2014, we borrowed $1,000,000 under the Lines of Credit for working capital purposes.

Contractual Obligations

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

	Payment Due by Year				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease obligations	1,534	447	851	236	—
Total	$ 1,534	$ 447	$ 851	$ 236	$ —

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 $53,000 during the remainder of 2014, $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 $37,000 during the remainder of 2014, $176,000 in 2015, $190,000 in 2016, $196,000 in 2017 and $168,000 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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Cost of revenues	$ 3	$ 3	$ 9	$ 8
General and administrative	140	76	425	222
Sales and marketing	34	33	105	95
Research and development	32	30	95	86
Total	$ 209	$ 142	$ 634	$ 411

Off-Balance Sheet Arrangements

At September 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 September 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 by Blue Spike, LLC ("*Blue Spike*") 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 four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

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.

We have identified the following risk factor in addition to the risk factors previously disclosed in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013:

Most of our outstanding indebtedness is due and payable on March 27, 2015 and if not extended on or before its maturity date, we expect to be unable to pay such indebtedness when due. If we are unable to extend the maturity date, or otherwise restructure such indebtedness, we will be in default and will need to raise additional capital to continue operations.

Subsequent to September 30, 2014, we incurred borrowings under the Line of Credit of approximately $1,000,000, due and payable on March 27, 2015, and we anticipate needing to increase our borrowings under the Line of Credit to continue to fund our working capital needs, thereby increasing the aggregate amount of indebtedness due and payable on or before March 2015.

We do not anticipate generating sufficient revenue and profit to repay these borrowings in full when due. Therefore, unless the holders of the notes issued under the Line of Credit convert any outstanding balance into shares of common stock, we will need to seek an extension of the maturity date of the Line of Credit on or before March 27, 2015. If we are unable to extend the maturity date of the Line of Credit, we will be required to raise additional capital through debt and/or equity financing to continue our operations. No assurances can be given that any such financing will be available to us on favorable terms, if at all. At this time, we do not have any commitments for alternative financing or for an extension of the maturity date of the Lines of Credit. The inability to obtain debt or equity financing in a timely manner and in amounts sufficient to fund our operations, if necessary, would have an immediate and substantial adverse impact on our business, financial condition or results of operations.

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

(a)	EXHIBITS
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: November 17, 2014	IMAGEWARE SYTEMS, INC
	By: /s/ S. James Miller S. James Miller Chief Executive Officer, Chairman and Director (Principal Executive Officer)
Date: November 17, 2014	By: /s/ Wayne Wetherell Wayne Wetherell Chief Financial Officer (Principal Financial and Accounting Officer)

Exhibit 31.1

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: November 17, 2014

ImageWare Systems, Inc.

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

Exhibit 31.2

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: November 17, 2014

ImageWare Systems, Inc.

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

Exhibit 32.1

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 September 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 September 30, 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 17th day of November, 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.