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Smaller Reporting Company	off
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Documents

10-Q	iwsy10q_mar312015.htm
	Form 10-Q
EX-31.1	ex31-1.htm
	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a)
EX-31.2	ex31-2.htm
	Certification of the Principal Financial and Accounting Officer pursuant to Rule 13a-14 (a) and 15d-14(a)
EX-32.1	ex32-1.htm
	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
EX-101.INS	iwsy-20150331.xml
EX-101.SCH	iwsy-20150331.xsd
EX-101.CAL	iwsy-20150331_cal.xml
EX-101.DEF	iwsy-20150331_def.xml
EX-101.LAB	iwsy-20150331_lab.xml
EX-101.PRE	iwsy-20150331_pre.xml

Module and Segment References

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 March 31, 2015

[ ] **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 May 11, 2015 was 93,658,649.

IMAGEWARE SYSTEMS, INC.
INDEX

			Page
PART I.	FINANCIAL INFORMATION		
	ITEM 1.	Financial Statements	1
		Condensed Consolidated Balance Sheets as of March 31, 2015 (unaudited) and December 31, 2014	1
		Condensed Consolidated Statements of Operations for the three months ended March 31, 2015 and 2014 (unaudited)	2
		Condensed Consolidated Statements of Comprehensive Loss for the three months ended March 31, 2015 and 2014 (unaudited)	3
		Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2015 and 2014 (unaudited)	4
		Notes to unaudited Condensed Consolidated Financial Statements	5
	ITEM 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	18
	ITEM 3.	Quantitative and Qualitative Disclosures About Market Risk	26
	ITEM 4.	Controls and Procedures	26
PART II.	OTHER INFORMATION		
	ITEM 1.	Legal Proceedings	27
	ITEM1A.	Risk Factors	27
	ITEM 2.	Unregistered Sales of Equity Securities	27
	ITEM 3.	Defaults Upon Senior Securities	27
	ITEM 4.	Mine Safety Disclosures	27
	ITEM 5.	Other Information	27
	ITEM 6.	Exhibits	27
SIGNATURES			28

PART I

ITEM 1. FINANCIAL STATEMENTS

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

	March 31, 2015 (Unaudited)	December 31, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 8,393	$ 218
Accounts receivable, net of allowance for doubtful accounts of $3 at March 31, 2015 and December 31, 2014	435	266
Inventory, net	1,005	916
Other current assets	124	86
Total Current Assets	9,957	1,486
Property and equipment, net	215	211
Other assets	112	153
Intangible assets, net of accumulated amortization	137	144
Goodwill	3,416	3,416
Total Assets	**$ 13,837**	**$ 5,410**
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current Liabilities:		
Accounts payable	$ 264	$ 459
Deferred revenue	1,694	1,827
Accrued expenses	1,009	1,013
Total Current Liabilities	2,967	3,299
Convertible line of credit to related party, net of discount	-	1,311
Pension obligation	1,807	1,834
Total Liabilities	4,774	6,444
Shareholders' Equity (Deficit):		
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 March 31, 2015 and December 31, 2014, respectively; liquidation preference $620 and $607 at March 31, 2015 and December 31, 2014, respectively.	2	2
Series E Convertible Redeemable Preferred Stock, $0.01 par value; designated 12,000 shares, 12,000 and 0 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively; liquidation preference $12,000 and $0 at March 31, 2015 and December 31, 2014, respectively.	-	-
Common stock, $0.01 par value, 150,000,000 shares authorized; 93,665,353 and 93,513,854 shares issued at March 31, 2015 and December 31, 2014, respectively, and 93,658,649 and 93,507,150 shares outstanding at March 31, 2015 and December 31, 2014, respectively.	935	934
Additional paid-in capital	148,519	135,982
Treasury stock, at cost 6,704 shares	(64)	(64)
Accumulated other comprehensive loss	(1,515)	(1,594)
Accumulated deficit	(138,814)	(136,294)
Total Shareholders' Equity (Deficit)	9,063	(1,034)
Total Liabilities and Shareholders' Equity (Deficit)	**$ 13,837**	**$ 5,410**

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 March 31,	
	2015	2014
Revenues:		
Product	$ 378	$ 434
Maintenance	613	629
	991	1,063
Cost of revenues:		
Product	74	70
Maintenance	212	181
Gross profit	705	812
Operating expenses:		
General and administrative	916	1,016
Sales and marketing	650	618
Research and development	1,033	1,030
Depreciation and amortization	42	42
	2,641	2,706
Loss from operations	(1,936)	(1,894)
Interest expense	437	79
Other income	(46)	(283)
Loss before income taxes	(2,327)	(1,690)
Income tax expense	3	—
Net loss	$ (2,330)	$ (1,690)
Preferred dividends	(204)	(13)
Net loss available to common shareholders	$ (2,534)	$ (1,703)
Basic and diluted loss per common share – see Note 3:		
Net loss	$ (0.03)	$ (0.02)
Preferred dividends	(0.00)	(0.00)
Basic and diluted loss per share available to common shareholders	$ (0.03)	$ (0.02)
Basic and diluted weighted-average shares outstanding	93,515,640	88,604,221

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 March 31,	
	2015	**2014**
Net loss	$ (2,330)	$ (1,690)
Other comprehensive income (loss):		
Foreign currency translation adjustment	(80)	(9)
Comprehensive loss	$ (2,410)	$ (1,699)

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)

	Three Months Ended March 31,	
	2015	**2014**
Cash flows from operating activities		
Net loss	$ (2,330)	$ (1,690)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	42	42
Reduction in accounts payable and accrued expenses from the expiration of statute of limitations	—	(211)
Amortization of debt issuance costs and beneficial conversion feature	426	78
Warrants issued in lieu of cash paid for services	80	—
Stock-based compensation	182	217
Change in assets and liabilities		
Accounts receivable	(169)	(189)
Inventory	(89)	(63)
Other assets	(38)	21
Accounts payable	(195)	(45)
Deferred revenue	(133)	(46)
Accrued expenses	23	121
Pension obligation	(27)	15
Total adjustments	102	(60)
Net cash used by operating activities	(2,228)	(1,750)
Cash flows from investing activities		
Purchase of property and equipment	(39)	(17)
Net cash used by investing activities	(39)	(17)
Cash flows from financing activities		
Proceeds from exercised stock options	7	24
Proceeds from issuance of preferred stock, net of issuance costs	9,955	—
Proceeds from line of credit	750	—
Repayment of line of credit borrowings	(350)	—
Proceeds from exercised warrants to purchase stock	—	1,548
Net cash provided by financing activities	10,362	1,572
Effect of exchange rate changes on cash	80	(9)
Net increase (decrease) in cash and cash equivalents	8,175	(204)
Cash and cash equivalents at beginning of period	218	2,363
Cash and cash equivalents at end of period	$ 8,393	$ 2,159
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 1	$ —
Cash paid for income taxes	$ —	$ —
Summary of non-cash investing and financing activities:		
Reclassification of warrants previously classified as derivative liabilities to additional paid-in capital	$ —	$ 57
Issuance of common stock warrants securing line of credit borrowing facility	$ —	$ 127
Beneficial conversion feature of convertible debt	$ 146	$ —
Conversion of related party notes into Series E Preferred	$ 1,978	$ —
Stock dividend on Series E Preferred	$ 191	$ —

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

Series E Preferred Financing and Line of Credit

On January 29, 2015, the Company filed the Certificate of Designations, Preferences, and Rights of the Series E Convertible Preferred Stock ("*Certificate of Designations*") with the Delaware Secretary of State, designating 12,000 shares of the Company's preferred stock, par value $0.01 per share, as Series E Convertible Preferred Stock ("*Series E Preferred*"). Shares of Series E Preferred accrue dividends at a rate of 8% per annum if the Company chooses to pay accrued dividends in cash, and 10% per annum if the Company chooses to pay accrued dividends in shares of Common Stock. Each share of Series E Preferred has a liquidation preference of $1,000 per share and is convertible, at the option of the holder, into that number of shares of the Company's Common Stock, par value $0.01 per share ("*Common Stock*"), equal to the Liquidation Preference, divided by $1.90.

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*"). The Company issued 1,978 shares of Series E Preferred in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowings plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below in Note 5, was reduced to $3,050,000, and the $500K Line of Credit was terminated.

The Series E Financing resulted in gross proceeds to the Company of $10,022,000, with net proceeds of approximately $9,955,000 after deducting offering expenses of approximately $67,000.

Liquidity, Capital Resources

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

Management believes that the Company's current cash and cash equivalents will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing and that we will have sufficient liquidity to fund our business and meet our contractual obligations over a period beyond the next 12 months.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION

Basis of Presentation

The accompanying condensed consolidated balance sheet as of December 31, 2014, 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, 2014, which are included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 that was filed with the SEC on March 16, 2015.

Operating results for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ended December 31, 2015, 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 March 31, 2015, two customers accounted for approximately 29% or $288,000 of our total revenue and had trade receivables at March 31, 2015 of $43,000. For the three months ended March 31, 2014, two customers accounted for approximately 30% or $314,000 of total revenues and had trade receivables at March 31, 2014 of approximately $142,000.

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. In April 2015, the FASB proposed a one-year deferral of the effective date of the new standard. If approved, the new standard will be effective for the Company in fiscal 2018, with early adoption not permitted to public companies. 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 consolidated financial statements.

FASB ASU No. 2014-16. In November 2014, the FASB issued ASU No. 2014-16 ("ASU 2014-16"), "*Derivatives and Hedging (Topic 815) - Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity*". ASU 2014-16 was issued to clarify how current U.S. GAAP should be interpreted in evaluating the economic characteristics and risk of a host contract in a hybrid financial instrument that is issued in the form of a share. In addition, ASU 2014-16 was issued to clarify that in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. ASU 2014-16 is effective with fiscal year beginning after December 15, 2015. Early adoption in an interim period is permitted. The Company is currently evaluating the impact of the adoption of ASU 2014-16 on its consolidated financial statements.

FASB ASU No. 2015-02. In February 2015, the FASB issued ASU No. 2015-02, which amends ASC Subtopic 810, "*Consolidations*." This amendment affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. Specifically, the amendments modify the evaluation of whether limited partnerships and similar legal entities are VIEs or voting interest entities; eliminate the presumption that a general partner should consolidate a limited partnership; affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships. The standard is effective for interim and annual reporting periods beginning after December 15, 2015. The standard may be applied retrospectively or through a cumulative effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is still evaluating what impact, if any, the adoption of this guidance will have on its consolidated financial statements.

FASB ASU No. 2015-03. In April 2015, the FASB issued ASU 2015-03, "*Simplifying the Presentation of Debt Issuance Costs.*" The standard requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected. The standard will become effective for the Company beginning January 1, 2016. The implementation of this standard is not expected to have a significant impact on our consolidated financial statements.

FASB ASU No. 2015-04. In April 2015, the FASB issued ASU 2015-04, "*Compensation - Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets.*" The amendments in ASU 2015-04 permit an entity with a fiscal year-end that does not coincide with a month-end a practical expedient that permits the entity to measure defined benefit plan assets and obligations using the month-end that is closest to the entity's fiscal year-end and apply that practical expedient consistently from year to year. The practical expedient should be applied consistently to all plans if an entity has more than one plan. Employee benefit plans are not within the scope of the amendments. We do not expect adoption of ASU No. 2015-04 to have a significant impact on our consolidated financial statements.

FASB ASU No. 2015-05. In April 2015, the FASB issued ASU 2015-05, *'Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement"*. The amendments in ASU 2015-05 provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer's accounting for service contracts. For public business entities, ASU 2015-05 will be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. We do not expect adoption of ASU No. 2015-05 to have a significant impact on our consolidated financial statements.

NOTE 3. NET LOSS PER COMMON SHARE

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

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

(Amounts in thousands except share and per share amounts)	**Three Months Ended March 31,**	
	2015	**2014**
Numerator for basic and diluted loss per share:		
Net loss	$ (2,330)	$ (1,690)
Preferred dividends	(204)	(13)
Net loss available to common shareholders	$ (2,534)	$ (1,703)
Denominator for basic and dilutive loss per share — weighted-average shares outstanding	93,515,640	88,604,221
Net loss	$ (0.03)	$ (0.02)
Preferred dividends	(0.00)	(0.00)
Basic and diluted loss per share available to common shareholders	$ (0.03)	$ (0.02)

The following potential dilutive securities have been excluded from the computations of diluted weighted-average shares outstanding as their effect would have been antidilutive:

Potential Dilutive securities	**Three Months Ended March 31,**	
	2015	**2014**
Convertible notes payable	—	113,885
Convertible preferred stock	6,362,769	45,392
Stock options	4,159,718	2,102,673
Warrants	686,666	3,606,108
Total potential dilutive securities	11,209,153	5,868,058

NOTE 4. SELECT BALANCE SHEET DETAILS

Inventory

Inventories of $1,005,000 as of March 31, 2015 were comprised of work in process of $999,000, representing direct labor costs of approximately $970,000 on in-process projects, approximately $29,000 of equipment related to in-process projects and finished goods of $6,000 net of reserves for obsolete and slow-moving items of $3,000.

Inventories of $916,000 as of December 31, 2014 were comprised of work in process of $909,000, comprised of direct labor costs on in-process projects of $881,000 and equipment on in-process projects of $28,000. Finished goods inventories were $7,000 net of reserves for obsolete and slow-moving items of $3,000.

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 $11,000 and $15,000 as of March 31, 2015 and December 31, 2014, respectively, which include accumulated amortization of $336,000 and $332,000 as of March 31, 2015 and December 31, 2014, respectively. Amortization expense for the intangible assets was $4,000 for the three months ended March 31, 2015 and 2014. 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 $126,000 and $129,000 as of March 31, 2015 and December 31, 2014, respectively, which include accumulated amortization of $533,000 and $530,000 as of March 31, 2015 and December 31, 2014, respectively. Amortization expense for patent intangible assets was $3,000 for the three months ended March 31, 2015 and 2014. Patent intangible assets are being amortized on a straight-line basis over their weighted-average remaining life of approximately 11.3 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)**
2015 (9 months)	$ 20
2016	12
2017	12
2018	12
2019	12
Thereafter	69
Totals	$ 137

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 March 31, 2015 and December 31, 2014.

NOTE 5. LINES OF CREDIT

Outstanding line of credit consists of the following:

($ in thousands)	**March 31, 2015**	**December 31, 2014**
Line of Credit to a related party:		
8% convertible line of credit. Face value of advances under line of credit was $0 at March 31, 2015 and $1,550 at December 31, 2014. Discount on advances under line of credit was $0 at March 31, 2015 and $239 at December 31, 2014. Maturity date is March 27, 2017.	$ —	$ 1,311
Total line of credit to related parties	—	1,311
Less current portion	(—)	(—)
Line of credit to related parties	$ —	$ 1,311

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 had 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 expired on March 27, 2015 and had an exercise price of $2.25 per share.

The Company estimated the fair value of the Line of Credit Warrant using the Black-Scholes option pricing model using the following assumptions: term of two years, a risk free interest rate of 2.58%, a dividend yield of 0%, and volatility of 79%. The Company recorded the fair value of the Line of Credit Warrant as a deferred financing fee of approximately $580,000 to be amortized over the life of the line of credit agreement. The Company estimated the fair value of the Amendment Warrant using the Black-Scholes option pricing model using the following assumptions: term on one year, a risk free interest rate of 2.58%, a dividend yield of 0% and volatility of 74%. The Company recorded the fair value of the Amendment Warrant as an additional deferred financing fee of approximately $127,000 to be amortized over the life of the line of credit agreement.

During the three months ended March 31, 2015 and 2014, the Company recorded an aggregate of approximately $41,000 and $78,000, respectively in deferred financing fee amortization expense which is recorded as a component of interest expense in the Company's condensed consolidated statements of operations.

In April 2014, the Company and the Holder entered into a further amendment to the Line of Credit to decrease the available borrowings to $3,000,000 (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 (the "*500K Line of Credit*") 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.

In December 2014, the Company and the Holder entered into a further amendment to the Line of Credit to increase the available borrowing to $5,000,000 and extend the maturity date of the Line of Credit to March 27, 2017 (the "*Third Amendment*"). Also, as a result of the Third Amendment, the Holder has the right to convert up to $2,500,000 outstanding principal, plus any accrued but unpaid interest ("*Outstanding Balance*") into shares of the Company's Common Stock for $0.95 per share, the next $500,000 Outstanding Balance into shares of Common Stock for $2.25 per share and any remaining outstanding balance thereafter into shares of Common Stock for $2.30 per share. The Third Amendment also modified the definition of a "Qualified Financing" to mean a debt or equity financing resulting in gross proceeds to the Company of at least $5,000,000.

Advances under the credit facility are made at the Company's request.

As of December 31, 2014, advances made under the Line of Credit agreement aggregated $1,550,000 and there were no borrowings under the 500K Line of Credit. During the three months ended March 31, 2015, the Company borrowed $750,000 under the Line of Credit and borrowed $0 under the $500K Line of Credit. During the three months ended March 31, 2015, the Company repaid $350,000 in principal borrowings under the Line of Credit.

In February 2015, as a result of the Series E Financing discussed under Note 1 above, the Company issued 1,978 shares of Series E Preferred to the Holder of the Line of Credit to satisfy $1,950,000 in principal borrowings under the Line of Credit plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

The Company evaluated the lines of credit agreements and determined that the instruments contain 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 line of credit agreement). 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 line of credit agreement will be measured using the intrinsic value calculated at the date the contingency is resolved using the conversion price and trading value of the Company's Common Stock at the date the line of credit agreement was issued (commitment date). As of December 31, 2014, the Company had recorded approximately $296,000 in beneficial conversion feature as a debt discount and had amortized approximately $56,000 of such debt discount as a component of interest expense. Pursuant to additional borrowings made during the three months ended March 31, 2015, the Company recognized an additional $146,000 in beneficial conversion feature as debt discount. As a result of the Series E financing and retirement of all amounts outstanding under the line of credit, the Company recognized all remaining unamortized debt discount of approximately $385,000 as a component of interest expense during the three months ended March 31, 2015.

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*"), redeemable at the option of the Company, outstanding as of March 31, 2015 and December 31, 2014. At March 31, 2015 and December 31, 2014, the Company had cumulative undeclared dividends of approximately $21,000 and $8,000, respectively. There were no conversions of Series B Preferred into Common Stock during the three months ended March 31, 2015 or 2014.

Series E Convertible Preferred Stock

On January 29, 2015, the Company filed the Certificate of Designations, Preferences, and Rights of the Series E Convertible Preferred Stock ("*Certificate of Designations*") with the Delaware Secretary of State, designating 12,000 shares of the Company's preferred stock, par value $0.01 per share, as Series E Convertible Preferred Stock ("*Series E Preferred*"). Shares of Series E Preferred accrue dividends at a rate of 8% per annum if the Company chooses to pay accrued dividends in cash, and 10% per annum if the Company chooses to pay accrued dividends in shares of Common Stock. Each share of Series E Preferred has a liquidation preference of $1,000 per share and is convertible, at the option of the holder, into that number of shares of the Company's Common Stock, par value $0.01 per share ("*Common Stock*"), equal to the Liquidation Preference, divided by $1.90.

Any time after the six-month period following the Issuance Date, the Company may redeem all or a portion of the Series E Preferred outstanding upon thirty (30) calendar days prior written notice (the "Company's Redemption Notice") in cash at a price per share of Series E Preferred equal to 110% of the Liquidation Preference Amount plus all accrued and unpaid dividends. Also, simultaneous with the occurrence of a Change of Control transaction, the Company, at its option, shall have the right to redeem all or a portion of the outstanding Series E Preferred in cash at a price per share of Series E Preferred equal to 110% of the Liquidation Preference Amount plus all accrued and unpaid dividends.

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*").

The Company had 12,000 and 0 shares of Series E Preferred outstanding as of March 31, 2015 and December 31, 2014. At March 31, 2015 and December 31, 2014, the Company had cumulative undeclared dividends of approximately $0 and $0, respectively. There were no conversions of Series E Preferred into Common Stock during the three months ended March 31, 2015. The Company issued the holders of Series E Preferred 106,916 shares of Common Stock on March 31, 2015 as payment of dividends due on this date.

Common Stock

The following table summarizes common stock activity for the three months ended March 31, 2015:

	Common Stock
Shares outstanding at December 31, 2014	93,507,150
Shares issued pursuant to payment of stock dividend on Series E Preferred	106,916
Shares issued pursuant to options exercised for cash	8,456
Shares issued pursuant to cashless warrants exercised	36,127
Shares outstanding at March 31, 2015	93,658,649

During the three months ended March 31, 2015, the Company issued 8,456 shares of Common Stock pursuant to the exercise of 8,456 options for cash proceeds of approximately $7,000 and issued 36,127 shares of Common Stock pursuant to the cashless exercise of 83,334 warrants. Also during the three months ended March 31, 2015, the Company issued 106,916 shares of Common Stock in payment of the accumulated Series E Preferred dividends due and payable as of March 31, 2015.

Warrants

The following table summarizes warrant activity for the following periods:

	Warrants	Weighted-Average Exercise Price
Balance at December 31, 2014	977,778	$ 1.22
Granted	—	$ 0.00
Expired / Canceled	(207,778)	$ 2.09
Exercised	(83,334)	$ 0.98
Balance at March 31, 2015	686,666	$ 0.98

During the three months ended March 31, 2015, there were 83,334 warrants exercised on a cashless basis resulting in the issuance of 36,127 shares of the Company's Common Stock. Also during the three months ended March 31, 2105, 207,778 warrants expired.

During the three months ended March 31, 2015, the Company modified 200,000 warrants previously issued to a consultant by eliminating certain performance condition requirements resulting in such warrants vesting pursuant to the passage of time. The Company determined the modification date fair value of the vested warrants using the Black-Scholes option valuation model and recorded approximately $80,000 in expense for the three months ended March 31, 2015. The Company used the following assumptions in the application of the Black-Scholes option valuation model: an exercise price of $1.72, a term of 0.77 years, a risk free interest rate of 2.58%, a dividend yield of 0%, and volatility of 64%. Such expense is recorded in the Company's Condensed Consolidated Statement of Operations as a component of sales and marketing expense.

As of March 31, 2015, warrants to purchase 686,666 shares of Common Stock at prices ranging from $0.50 to $1.83 were outstanding. All warrants are exercisable as of March 31, 2015, and expire at various dates through December 2016, with the exception of an aggregate of 150,000 warrants, which become exercisable only upon the attainment of specified events. The intrinsic value of warrants outstanding at March 31, 2015 was approximately $558,000.

Stock-Based Compensation

As of March 31, 2015, 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-valuation 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 $128,000 and $158,000 for the three months ended March 31, 2015 and 2014, respectively.

ASC No. 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-valuation 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-valuation 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 three months ended March 31, 2015 and 2014 ranged from 64% to 99%. 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 three months ended March 31, 2015 and 2014 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 three months ended March 31, 2015 and 2014 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, 2014	4,057,296	$ 1.06
Granted	141,000	$ 1.78
Expired/Cancelled	(30,122)	$ 1.67
Exercised	(8,456)	$ 0.83
Balance at March 31, 2015	4,159,718	$ 1.08

The intrinsic value of options exercised during the three months ended at March 31, 2015 was approximately $10,000. The intrinsic value of options exercisable at March 31, 2015 was approximately $3,019,000. The aggregate intrinsic value for all options outstanding as of March 31, 2015 was $3,176,000. The weighted-average grant-date per share fair value of options granted during the three months ended March 31, 2015 was $1.06. At March 31, 2015, the total remaining unrecognized compensation cost related to unvested stock options amounted to approximately $1,002,000 which will be recognized over a weighted-average period of 2.3 years.

In December 2014, the Company issued 94,116 shares of its Common Stock to certain members of the Company's Board of Directors as compensation to be rendered through December 2015. Such shares are forfeitable should the Board members' services be terminated. 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 to be rendered through December 2014. Pursuant to these issuances, the Company recorded approximately $54,000 and $59,000 as compensation expense for the three months ended March 31, 2015 and 2014, respectively.

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

	Three Months Ended March 31,	
	2015	2014
Cost of revenues	$ 3	$ 3
General and administrative	123	145
Sales and marketing	29	36
Research and development	27	33
Total	$ 182	$ 217

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.

	Fair Value at March 31, 2015			
($ in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Pension assets	$ 1,472	$ 1,472	$ —	$ —
Totals	$ 1,472	$ 1,472	$ —	$ —

	Fair Value at December 31, 2014			
($ in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Pension assets	$ 1,654	$ 1,654	$ —	$ —
Totals	$ 1,654	$ 1,654	$ —	$ —

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.

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 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 had 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 expired on March 27, 2015 and had an exercise price of $2.25 per share.

The Company estimated the fair value of the warrants using the Black-Scholes option valuation model using the following assumptions: term of two years, a risk free interest rate of 2.58%, a dividend yield of 0%, and volatility of 79%. The Company recorded the fair value of the warrants as a deferred financing fee of approximately $580,000 to be amortized over the life of the line of credit agreement. During the three months ended March 31, 2015 and 2014, the Company recorded approximately $41,000 and $78,000, respectively in deferred financing fee amortization expense which is recorded as a component of interest expense in the Company's condensed consolidated statements of operations.

In April 2014, the Company and the Holder entered into a further amendment to the Line of Credit to decrease the available borrowings to $3,000,000 (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 (the "*500K Line of Credit*") 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.

In December 2014, the Company and the Holder entered into a further amendment to the Line of Credit to increase the available borrowing to $5,000,000 and extend the maturity date of the Line of Credit to March 27, 2017 (the "*Third Amendment*"). Also, as a result of the Third Amendment, the Holder has the right to convert up to $2,500,000 outstanding principal, plus any accrued but unpaid interest ("*Outstanding Balance*") into shares of the Company's Common Stock for $0.95 per share, the next $500,000 Outstanding Balance into shares of Common Stock for $2.25 per share and any remaining outstanding balance thereafter into shares of Common Stock for $2.30 per share. The Third Amendment also modified the definition of a "Qualified Financing" to mean a debt or equity financing resulting in gross proceeds to the Company of at least $5,000,000.

Advances under the credit facility are made at the Company's request.

As of December 31, 2014, advances made under the Line of Credit agreement aggregated $1,550,000 and there were no borrowings under the 500K Line of Credit. During the three months ended March 31, 2015, the Company borrowed $750,000 under the Line of Credit and borrowed $0 under the $500K Line of Credit. During the three months ended March 31, 2015, the Company repaid $350,000 in principal borrowings under the Line of Credit.

In February 2015, as a result of the Series E Financing discussed under Note 1 above, the Company issued 1,978 shares of Series E Preferred to the Holder of the Line of Credit to satisfy $1,950,000 in principal borrowings under the Line of Credit plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

The Company evaluated the lines of credit agreements and determined that the instruments contain 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 line of credit agreement). 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 line of credit agreement will be measured using the intrinsic value calculated at the date the contingency is resolved using the conversion price and trading value of the Company's Common Stock at the date the line of credit agreement was issued (commitment date). As of December 31, 2014, the Company had recorded approximately $296,000 in beneficial conversion feature as a debt discount and had amortized approximately $56,000 of such debt discount as a component of interest expense. Pursuant to additional borrowings made during the three months ended March 31, 2015, the Company recognized an additional $146,000 in beneficial conversion feature as debt discount. As a result of the Series E financing and retirement of all amounts outstanding under the line of credit, the Company recognized all remaining unamortized debt discount of approximately $385,000 as a component of interest expense during the three months ended March 31, 2015.

NOTE 10. CONTINGENT LIABILITIES

During the three months ended March 31, 2015 and 2014, the Company wrote off certain accounts payable and accrued expenses totaling approximately $0 and $211,000, 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

Our corporate headquarters are located in San Diego, California where we occupy 9,927 square feet of office space. This facility is leased through October 2017 at a cost of approximately $18,000 per month. In addition to our corporate headquarters, we also occupied the following spaces at March 31, 2015:

- 1,508 square feet in Ottawa, Province of Ontario, Canada, at a cost of approximately $3,000 per month until the expiration of the lease on March 31, 2016;
- 8,045 square feet in Portland, Oregon, at a cost of approximately $16,000 per month until the expiration of the lease on October 31, 2018 and
- 425 square feet of office space in Mexico City, Mexico, at a cost of approximately $3,000 per month until the expiration of the lease on July 31, 2015.

At March 31, 2015, future minimum lease payments are as follows:

($ in thousands)		
2015 (9 months)	$	335
2016	$	421
2017	$	386
2018	$	168
2019 and thereafter	$	—
	$	1,310

Rental expense incurred under operating leases for the three months ended March 31, 2015 and 2014 was approximately $108,000 and $104,000, respectively.

NOTE 11. SUBSEQUENT EVENTS

Management has reviewed and evaluated subsequent events and transactions occurring after the balance sheet date through the filing of this Quarterly Report on Form 10-Q and determined that no subsequent events occurred.

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, 2014, 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

Series E Preferred Financing

On January 29, 2015, the Company filed the Certificate of Designations, Preferences, and Rights of the Series E Convertible Preferred Stock ("*Certificate of Designations*") with the Delaware Secretary of State, designating 12,000 shares of the Company's preferred stock, par value $0.01 per share, as Series E Convertible Preferred Stock ("*Series E Preferred*"). Shares of Series E Preferred accrue dividends at a rate of 8% per annum if the Company chooses to pay accrued dividends in cash, and 10% per annum if the Company chooses to pay accrued dividends in shares of Common Stock. Each share of Series E Preferred has a liquidation preference of $1,000 per share and is convertible, at the option of the holder, into that number of shares of the Company's Common Stock, par value $0.01 per share ("*Common Stock*"), equal to the Liquidation Preference, divided by $1.90.

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*").

The Company issued 1,978 shares of Series E Preferred in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10,022,000, with net proceeds of approximately $9,955,000 after deducting offering expenses of approximately $67,000.

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 three months ended March 31, 2015 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, 2014.

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 March 31, 2015 to the Three Months Ended March 31, 2014

Product Revenue

Net Product Revenue (dollars in thousands)	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Software and royalties	$ 305	$ 339	$ (34)	(10)%
Percentage of total net product revenue	81%	78%		
Hardware and consumables	$ —	$ 53	$ (53)	(100)%
Percentage of total net product revenue	0%	12%		
Services	$ 73	$ 42	$ 31	74%
Percentage of total net product revenue	19%	10%		
Total net product revenue	$ 378	$ 434	$ (56)	(13)%

Software and royalty revenue decreased 10% or approximately $34,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014. This decrease is due to lower identification project revenues of approximately $29,000, lower sales of our boxed identity management software sold through our distribution channel of approximately $43,000 offset by higher royalty revenues of approximately $34,000 and higher sales of our law enforcement software of approximately $4,000 for the three months ended March 31, 2015 as compared to the corresponding period of 2014.

Revenue from the sale of hardware and consumables decreased approximately $53,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014. This decrease resulted from lower revenues from project solutions containing hardware and consumable components.

Services revenue is comprised primarily of software integration services, system installation services and customer training. Such revenue increased approximately $31,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014, due primarily to the completion of the service elements 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 March 31, 2015, we continued to accelerate our efforts to move the Biometric Engine into cloud and mobile markets and expanding our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the second 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 March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Total maintenance revenue	$ 613	$ 629	$ (16)	(3)%

Maintenance revenue was approximately $613,000 for the three months ended March 31, 2015 as compared to approximately $629,000 for the corresponding period in 2014. Identity management maintenance revenue generated from identification software solutions were approximately $241,000 for the three months ended March 31, 2015 as compared to approximately $242,000 during the comparable period in 2014. Law enforcement maintenance revenue was approximately $372,000 for the three months ended March 31, 2015 as compared to approximately $387,000 during the comparable period in 2014. The decrease of $15,000 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 March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Software and royalties	$ 21	$ 22	$ (1)	(5)%
Percentage of software and royalty product revenue	7%	6%		
Hardware and consumables	$ —	$ 33	$ (33)	(100)%
Percentage of hardware and consumables product revenue	—%	62%		
Services	$ 53	$ 15	$ 38	253%
Percentage of services product revenue	73%	36%		
Total product cost of revenue	$ 74	$ 70	$ 4	6%
Percentage of total product revenue	20%	16%		

The cost of software and royalty product revenue decreased 5% or approximately $1,000 for the three months ended March 31, 2015 as compared to the corresponding period of 2014. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

The decrease in the cost of product revenue for our hardware and consumable sales of approximately $33,000 for the three months ended March 31, 2015 as compared to the corresponding period in 2014 reflects the lack of revenues generated from the sale of hardware and consumables.

The cost of services revenue increased approximately $38,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014. This increase reflects higher professional service revenues of approximately $31,000 combined with higher level more costly service resources utilized during the three months ended March 31, 2015 as compared to the corresponding period in 2014.

Cost of Maintenance Revenue

Maintenance cost of revenue (dollars in thousands)	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Total maintenance cost of revenue	$ 212	$ 181	$ 31	17%
Percentage of total maintenance revenue	35%	29%		

Cost of maintenance revenue increased 17% or approximately $31,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014. This increase results from higher departmental expenses driven primarily by headcount increases for the three months ended March 31, 2015 as compared to the corresponding period in 2014.

Product Gross Profit

Product gross profit (dollars in thousands)	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Software and royalties	$ 284	$ 317	$ (33)	(10)%
Percentage of software and royalty product revenue	93%	94%		
Hardware and consumables	$ —	$ 20	$ (20)	(100)%
Percentage of hardware and consumables product revenue	—%	38%		
Services	$ 20	$ 27	$ (7)	(26)%
Percentage of services product revenue	27%	64%		
Total product gross profit	$ 304	$ 364	$ (60)	(16)%
Percentage of total product revenue	80%	84%		

Software and royalty gross profit decreased 10% or approximately $33,000 for the three months ended March 31, 2015 from the corresponding period in 2014 due primarily to lower software and royalty product revenues. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

Hardware and consumables gross profit decreased approximately $20,000 for the three-month period ended March 31, 2015 as compared to the corresponding period in 2014 as there were no sales of these products during the three months ended March 31, 2015.

Services gross profit decreased approximately $7,000 for the three months ended March 31, 2015 as compared to the corresponding period in 2014 due primarily to higher service revenues of approximately $30,000 offset by higher cost of service revenues of approximately $38,000 for the three months ended March 31, 2015 as compared to the corresponding period in 2014.

Maintenance Gross Profit

Maintenance gross profit (dollars in thousands)	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
Total maintenance gross profit	$ 402	$ 448	$ (46)	(10)%
Percentage of total maintenance revenue	66%	71%		

Gross profit related to maintenance revenue decreased 10% or approximately $46,000 for the three months ended March 31, 2015 as compared to the same period ended March 31, 2014. This decrease is due to lower maintenance revenues of approximately $16,000 combined with higher cost of maintenance revenues of approximately $31,000. Lower maintenance revenues results primarily from the expiration of certain maintenance contracts and the increase in cost of maintenance revenues results from headcount increases.

Operating Expense

Operating expenses (dollars in thousands)	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014	$ Change	% Change
General and administrative	$ 916	$ 1,016	$ (100)	(10)%
Percentage of total net revenue	87%	96%		
Sales and marketing	$ 650	$ 618	$ 32	5%
Percentage of total net revenue	66%	58%		
Research and development	$ 1,033	$ 1,030	$ 3	0%
Percentage of total net revenue	104%	97%		
Depreciation and amortization	$ 42	$ 42	$ —	0%
Percentage of total net revenue	4%	4%		

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 decrease of approximately $100,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014 is comprised of the following major components:

- Decrease in professional fees including consulting services and contract services of approximately $56,000 due primarily to decreases in professional services and investor relation fees of approximately $13,000, decreases in legal fees of approximately $39,000, decrease in audit related fees of approximately $2,000 and decreases in patent related expenses of approximately $13,000, offset by increases in various consulting and contract services of approximately $11,000.
- Decrease in personnel related expense of approximately $38,000 due to headcount decreases.
- Decrease in stock-based compensation expense of approximately $16,000.
- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately $10,000.

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 $32,000 during the three months ended March 31, 2015 as compared to the corresponding period in 2014 is primarily comprised of the following major components:

- Increase in personnel related expense of approximately $4,000.
- Increase in professional services of approximately $61,000 resulting primarily from the modification of certain warrants issued to sales consultants.
- Decrease in contract services, travel and trade show expenses and office related expenses of approximately $26,000.
- Decrease in stock-based compensation expense 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 $3,000 for the three months ended March 31, 2015 as compared to the corresponding period in 2014 due primarily to the following major components:

- Decrease in personnel expenditures of approximately $42,000 due to headcount decreases.
- Increase in contractor fees and contract services of approximately $49,000.
- Decrease in stock-based compensation of approximately $6,000.
- Increase in office related expenses and travel of approximately $2,000.

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 March 31, 2015 and 2014, depreciation and amortization expense was approximately $42,000. The relatively small amount of depreciation and amortization is a reflection of the relatively small property and equipment carrying value.

Interest Expense, Net

For the three months ended March 31, 2015, we recognized interest expense of approximately $438,000 and interest income of approximately $1,000. For the three months ended March 31, 2014, we recognized interest expense of approximately $79,000. Interest expense for the three months ended March 31, 2015 is comprised of approximately $12,000 of coupon interest on debt outstanding under our Line of Credit, approximately $41,000 in deferred financing fee amortization related to our Line of Credit, approximately $385,000 related to the recognition of beneficial conversion feature related to our Line of Credit. Interest expense for the three months ended March 31, 2014 is comprised of approximately $78,000 in deferred financing fee amortization related to our Line of Credit and approximately $1,000 related to certain related party notes payable.

Other Income

For the three months ended March 31, 2015, we recognized other income of approximately $46,000. For the three months ended March 31, 2014, we recognized other income of approximately $283,000. Other income for the three months ended March 31, 2015 is comprised of approximately $45,000 from the settlement of certain patent infringement matters in favor of the Company and $1,000 from miscellaneous receipts. Other income for the three months ended March 31, 2014 was comprised of approximately $211,000 from the write-off of certain accounts payable and accrued expenses due to the legal statute of limitations on such payables and accrued expenses and 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.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2015, our principal sources of liquidity consisted of cash and cash equivalents of $8,393,000 and accounts receivable, net of $435,000. As of March 31, 2015, we had positive working capital of $6,990,000, which included $1,694,000 of deferred revenue. We have a history of recurring losses, and as of March 31, 2015, we have incurred a cumulative net loss of approximately $138,814,000.

On January 29, 2015, the Company filed the Certificate of Designations, Preferences, and Rights of the Series E Convertible Preferred Stock ("*Certificate of Designations*") with the Delaware Secretary of State, designating 12,000 shares of the Company's preferred stock, par value $0.01 per share, as Series E Convertible Preferred Stock ("*Series E Preferred*"). Shares of Series E Preferred accrue dividends at a rate of 8% per annum if the Company chooses to pay accrued dividends in cash, and 10% per annum if the Company chooses to pay accrued dividends in shares of Common Stock. Each share of Series E Preferred has a liquidation preference of $1,000 per share and is convertible, at the option of the holder, into that number of shares of the Company's Common Stock, par value $0.01 per share ("*Common Stock*"), equal to the Liquidation Preference, divided by $1.90.

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*"). The Company issued 1,978 of Series E Preferred in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit, as defined below, was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10,022,000, with net proceeds of approximately $9,955,000 million after deducting offering expenses of approximately $67,000.

As a result of the Series E Financing, we currently have remaining available borrowing capacity aggregating $3,050,000. Any outstanding balance under the Line of Credit is currently set to mature in March 2017, 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.

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

Management believes that the Company's current cash and cash equivalents will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing and that we will have sufficient liquidity to fund our business and meet our contractual obligations over a period beyond the next 12 months.

Operating Activities

We used net cash of $2,228,000 in operating activities for the three months ended March 31, 2015 as compared to net cash used of $1,750,000 during the comparable period in 2014. During the three months ended March 31, 2015, net cash used in operating activities consisted of net loss of $2,330,000 and an increase in working capital and other assets and liabilities of $628,000. Those amounts were offset by $730,000 of non-cash costs including $182,000 in stock based compensation, $426,000 in debt issuance cost and beneficial conversion feature amortization, $80,000 in warrant compensation expense and $42,000 in depreciation and amortization. During the three months ended March 31, 2015, we used cash of $296,000 to fund increases in current assets and used cash of $332,000 through reductions in current liabilities and deferred revenues, excluding debt.

We used net cash of $1,750,000 in operating activities for the three months ended March 31, 2014. During the three months ended March 31, 2014, net cash used in operating activities consisted of net loss of $1,690,000 and an increase in working capital and other assets and liabilities of $186,000. Those amounts were offset by $126,000, net of non-cash costs including $217,000 in stock based compensation, $78,000 in debt issuance cost amortization and $42,000 in depreciation and amortization offset by $211,000 of non-cash income primarily from the write-off of certain accounts payable due to the expiration of the statute of limitations. During the three months ended March 31, 2014, we used cash of $231,000 to fund increases in current assets and generated cash of $45,000 through increases in current liabilities and deferred revenues, excluding debt.

Investing Activities

Net cash used in investing activities was $39,000 for the three months ended March 31, 2015 as compared to $17,000 used in the three months ended March 31, 2014. For the three months ended March 31, 2015, we used cash to fund capital expenditures of computer equipment, software and furniture and fixtures of approximately $39,000. This level of equipment purchases resulted primarily from the replacement of older equipment. For the three months ended March 31, 2014, we used approximately $17,000 to fund capital expenditures of computer equipment, software and furniture and fixtures.

Financing Activities

We generated cash of $10,362,000 from financing activities for the three months ended March 31, 2015 as compared to the $1,572,000 generated during the same period in 2014. During the three months ended March 31, 2015, we generated cash of $10,022,000 from the Series E Financing offset by $67,000 in offering costs, $7,000 from the exercise of 8,456 Common Stock options and $750,000 from borrowings under the Line of Credit offset by the repayment of $350,000 under the Line of Credit. During the three months ended March 31, 2014, we generated cash of $1,548,000 from the exercise of 3,090,000 Common Stock warrants and $24,000 from the exercise of 33,920 Common Stock options.

Debt

At March 31, 2015, the Company had no outstanding debt and no related accrued interest.

Contractual Obligations

Total contractual obligations and commercial commitments as of March 31, 2015 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	1,310	335	975	—	—
Total	$ 1,310	$ 335	$ 975	$ —	$ —

Real Property Leases

Our corporate headquarters are located in San Diego, California where we occupy 9,927 square feet of office space. This facility is leased through October 2017 at a cost of approximately $18,000 per month. In addition to our corporate headquarters, we also occupied the following spaces at March 31, 2015:

- 1,508 square feet in Ottawa, Province of Ontario, Canada, at a cost of approximately $3,000 per month until the expiration of the lease on March 31, 2016;
- 8,045 square feet in Portland, Oregon, at a cost of approximately $16,000 per month until the expiration of the lease on October 31, 2018 and
- 425 square feet of office space in Mexico City, Mexico, at a cost of approximately $3,000 per month until the expiration of the lease on July 31, 2015.

At March 31, 2015, future minimum lease payments are as follows:

($ in thousands)	
2015 (9 months)	$ 335
2016	$ 421
2017	$ 386
2018	$ 168
2019 and thereafter	$ —
	$ 1,310

Off-Balance Sheet Arrangements

At March 31, 2015, 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 Quarterly 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 March 31, 2015. 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

None.

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, 2014, filed on March 16, 2015. You should carefully consider these risk factors in conjunction with the other information contained in this Quarterly Report. Should any of these risks materialize, our business, financial condition and future prospects could be negatively impacted. As of March 31, 2015, there have been no material changes to the disclosures made in the above-referenced Form 10-K.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

(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: May 11, 2015	IMAGEWARE SYTEMS, INC
	By: /s/ S. James Miller S. James Miller Chief Executive Officer, Chairman and Director (Principal Executive Officer)
Date: May 11, 2015	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: May 11, 2015

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: May 11, 2015

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 March 31, 2015 fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and

2. The information contained in the Quarterly Report on Form 10-Q of the Company for the quarter ended March 31, 2015 fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and the results of operations of the Company for the period covered by the Quarterly Report.

IN WITNESS WHEREOF, the undersigned have set their hands hereto as of the 11th day of May, 2015.

/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.