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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2013

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

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

Commission file number 001-15757

**IMAGEWARE SYSTEMS, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**33-0224167**

(IRS Employer Identification No.)

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

**San Diego, CA 92127**

(Address of Principal Executive Offices)

**(858) 673-8600**

(Registrant's Telephone Number, Including Area Code)

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

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

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

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

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

The number of shares of common stock, with \$0.01 par value, outstanding on November 8, 2013 was 84,821,462.

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PART I

ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2013 (Unaudited)	December 31, 2012
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 3,468	\$ 4,225
Accounts receivable, net of allowance for doubtful accounts of \$3 at September 30, 2013 and December 31, 2012	314	328
Inventory, net	488	262
Other current assets	52	86
<b>Total Current Assets</b>	<b>4,322</b>	<b>4,901</b>
Property and equipment, net	187	150
Other assets	473	44
Intangible assets, net of accumulated amortization	179	200
Goodwill	3,416	3,416
<b>Total Assets</b>	<b>\$ 8,577</b>	<b>\$ 8,711</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 460	\$ 759
Deferred revenue	2,110	1,561
Accrued expenses	1,239	1,266
Derivative liabilities	406	—
Notes payable to related parties	65	65
<b>Total Current Liabilities</b>	<b>4,280</b>	<b>3,651</b>
Derivative liabilities	—	2,244
Pension obligation	442	401
Other long-term liabilities	—	72
<b>Total Liabilities</b>	<b>4,722</b>	<b>6,368</b>
Shareholders' equity:		
Preferred stock, authorized 4,000,000 shares:		
Series B Convertible Redeemable Preferred Stock, \$0.01 par value; designated 750,000 shares, 389,400 shares issued, and 239,400 shares outstanding at September 30, 2013 and December 31, 2012, respectively; liquidation preference \$620 and \$607 at September 30, 2013 and December 31, 2012, respectively.	2	2
Common stock, \$0.01 par value, 150,000,000 shares authorized; 84,713,786 and 76,646,553 shares issued at September 30, 2013 and December 31, 2012, respectively, and 84,707,082 and 76,639,849 shares outstanding at September 30, 2013 and December 31, 2012, respectively.	846	765
Additional paid-in capital	129,740	120,182
Treasury stock, at cost 6,704 shares	(64)	(64)
Accumulated other comprehensive loss	(186)	(139)
Accumulated deficit	(126,483)	(118,403)
<b>Total Shareholders' Equity</b>	<b>3,855</b>	<b>2,343</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 8,577</b>	<b>\$ 8,711</b>

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Product	\$ 1,842	\$ 257	\$ 2,413	\$ 898
Maintenance	654	681	1,962	2,127
	<u>2,496</u>	<u>938</u>	<u>4,375</u>	<u>3,025</u>
<b>Cost of revenues:</b>				
Product	90	49	249	184
Maintenance	209	207	585	748
Gross profit	<u>2,197</u>	<u>682</u>	<u>3,541</u>	<u>2,093</u>
<b>Operating expenses:</b>				
General and administrative	888	749	2,560	2,580
Sales and marketing	512	461	1,497	1,277
Research and development	946	798	2,861	2,291
Depreciation and amortization	29	17	77	44
	<u>2,375</u>	<u>2,025</u>	<u>6,995</u>	<u>6,192</u>
Loss from operations	(178)	(1,343)	(3,454)	(4,099)
Interest expense, net	73	5	148	14
Change in fair value of derivative liabilities	(470)	1,378	4,679	6,473
Other income, net	(123)	(2)	(231)	(327)
Income (loss) before income taxes	342	(2,724)	(8,050)	(10,259)
Income tax expense	3	2	5	6
Net income (loss)	339	(2,726)	(8,055)	(10,265)
Preferred dividends	(13)	(13)	(38)	(38)
Net income (loss) available to common shareholders	<u>\$ 326</u>	<u>\$ (2,739)</u>	<u>\$ (8,093)</u>	<u>\$ (10,303)</u>
<b>Basic income (loss) per common share - see Note 3:</b>				
Net income (loss) per share	\$ 0.00	\$ (0.04)	\$ (0.10)	\$ (0.15)
Preferred dividends	(0.00)	(0.00)	(0.00)	(0.00)
Basic income (loss) per share available to common shareholders	<u>\$ 0.00</u>	<u>\$ (0.04)</u>	<u>\$ (0.10)</u>	<u>\$ (0.15)</u>
Basic weighted-average shares	83,750,636	70,308,374	79,751,523	68,991,196
<b>Diluted income (loss) per common share - see Note 3:</b>				
Diluted income (loss) per share	\$ 0.00	\$ (0.04)	\$ (0.10)	\$ (0.15)
Diluted weighted-average shares	<u>93,352,192</u>	<u>70,308,374</u>	<u>79,751,523</u>	<u>68,991,196</u>

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

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net income (loss)	\$ 339	\$ (2,726)	\$ (8,055)	\$ (10,265)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(39)	(28)	(46)	(42)
Comprehensive income (loss)	<u>\$ 300</u>	<u>\$ (2,754)</u>	<u>\$ (8,101)</u>	<u>\$ (10,307)</u>

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

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

	Nine Months Ended September 30,	
	2013	2012
<b>Cash flows from operating activities</b>		
Net loss	\$ (8,055)	\$ (10,265)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	86	47
Amortization of debt issuance costs	145	15
Reduction in accounts payable and accrued expenses from the expiration of statute of limitations	(228)	(328)
Change in fair value of derivative liabilities	4,679	6,473
Warrants issued in lieu of cash paid for services	108	25
Stock-based compensation	411	454
Change in assets and liabilities		
Accounts receivable	15	(690)
Inventory	(226)	(135)
Other assets	41	(87)
Accounts payable	(212)	(106)
Deferred revenue	549	814
Accrued expenses	41	(749)
Pension obligation	41	15
Total adjustments	5,450	5,748
Net cash used in operating activities	(2,605)	(4,517)
<b>Cash flows from investing activities</b>		
Purchase of property and equipment	(103)	(159)
Net cash used in investing activities	(103)	(159)
<b>Cash flows from financing activities</b>		
Proceeds from exercised stock options	8	7
Proceeds from exercised warrants to purchase stock	2,014	3,502
Dividends paid	(25)	(203)
Repayment of notes payable	—	(45)
Net cash provided by financing activities	1,997	3,261
Effect of exchange rate changes on cash	(46)	(42)
Net decrease in cash and cash equivalents	(757)	(1,457)
Cash and cash equivalents at beginning of period	4,225	6,773
Cash and cash equivalents at end of period	\$ 3,468	\$ 5,316
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ —	\$ —
Cash paid for income taxes	\$ 1	\$ —
Summary of non-cash investing and financing activities:		
Reclassification of warrants previously classified as derivative liabilities to additional paid-in capital	\$ 6,276	\$ 13,588
Issuance of common stock warrants securing line of credit borrowing facility	\$ 580	\$ —
Issuance of common stock pursuant to cashless warrant exercises	\$ 43	\$ 704
Warrants issued for intangible asset purchases	\$ —	\$ 87
Contingent royalty payment	\$ —	\$ 72
Acquisition of intangible assets	\$ —	\$ (159)
Issuance of common stock pursuant to achievement of vesting conditions	\$ 1	\$ —

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

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

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

**Overview**

ImageWare Systems, Inc. (the “*Company*”) is incorporated in the state of Delaware. The Company is a leading developer of mobile and cloud-based identity management solutions, providing biometric, secure credential and law enforcement technologies. Scalable for worldwide deployment, ImageWare's biometric product line includes a multi-biometric engine that is hardware and algorithm independent, enabling the enrollment and management of unlimited population sizes. ImageWare's identification products are used to manage and issue secure credentials, including national IDs, passports, driver's licenses, smart cards and access control credentials. ImageWare's digital booking products provide law enforcement with integrated mug shot, fingerprint livescan and investigative capabilities. ImageWare is headquartered in San Diego, CA, with offices in Portland, OR and Ottawa, Ontario.

**Liquidity and Capital Resources**

For the nine months ended September 30, 2013, the Company issued 3,577,779 shares of its common stock and received net proceeds of approximately \$2,014,000 from the exercise of warrants for cash.

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. The credit line was extended by an existing shareholder and member of our Board of Directors. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015 (the “*Maturity Date*”). At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company's common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company's request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company's common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

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.

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

### **Basis of Presentation**

The accompanying condensed consolidated balance sheet as of December 31, 2012, 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, 2012, which are included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC on April 1, 2013.

Operating results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ended December 31, 2013, 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 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*

Inventories are stated at the lower of cost, determined using the average cost method, or market.

### *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*, Securities and Exchange Commission Staff Accounting Bulletin 104, and ASC 605-25, *Revenue Recognition, Multiple Element Arrangements*. Accordingly, the Company recognizes revenue when all of the following criteria are met: (i) persuasive evidence that an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the fee is fixed or determinable and (iv) collectability is reasonably assured.

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

### **Customer Concentration**

For the three months ended September 30, 2013, one customer accounted for approximately 69% or \$1,733,000 of total revenues and had trade receivables at September 30, 2013 of \$0. For the nine months ended September 30, 2013, one customer accounted for approximately 47% or \$2,037,000 of total revenues and had trade receivables at September 30, 2013 of \$0. For the three and nine months ended September 30, 2012, one customer accounted for approximately 16% and 15% or \$152,000 and \$459,000, respectively, of total revenues and had trade receivables at September 30, 2012 of \$608,000.

### **Recently Issued Accounting Standards**

From time to time, new accounting pronouncements are issued by 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 that the impact of recently issued standards that are not yet effective will not have a material impact on the Company's condensed consolidated financial statements upon adoption.

*FASB ASU 2012-02*. In July 2012, the FASB issued ASU 2012-02, *Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*. This new accounting standard allows companies to perform a qualitative assessment to determine whether further impairment testing of indefinite-lived intangible assets is necessary. Under the guidance in ASU 2012-02, an entity has the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The adoption of this ASU did not have a material effect on the Company's condensed consolidated financial statements.

**FASB ASU 2013-05.** In March 2013, the FASB issued ASU 2013-05, *Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (a consensus of the FASB Emerging Issues Task Force)*. ASU 2013-05 requires that when a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity, the parent is required to release any related cumulative translation adjustment into net income. The provisions of ASU 2013-05 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. When adopted, ASU 2013-05 is not expected to materially impact our condensed consolidated financial statements.

**FASB ASU 2013-11.** In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. This guidance requires netting unrecognized tax benefits against deferred tax assets for a loss or other carryforward that would apply in settlement of uncertain tax positions. This guidance will be effective for annual reporting periods beginning after December 15, 2013. We do not believe that adoption of this guidance will have a material impact on our financial statements or disclosures.

**NOTE 3. NET INCOME (LOSS) PER COMMON SHARE**

Basic income (loss) per common share is calculated by dividing net income (loss) available to common shareholders for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income (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 earnings (loss) per share:

(Amounts in thousands except share and per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Numerator for basic earnings (loss) per share:				
Net income (loss)	\$ 339	\$ (2,726)	\$ (8,055)	\$ (10,265)
Preferred dividends	(13)	(13)	(38)	(38)
Net income (loss) available to common shareholders	<u>326</u>	<u>(2,739)</u>	<u>(8,093)</u>	<u>(10,303)</u>
Numerator for diluted earnings (loss) per share:				
Net income (loss) available to common shareholders	\$ 326	\$ (2,739)	\$ (8,093)	\$ (10,303)
Preferred dividends	13	-	-	-
Interest expense on convertible debt	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net income (loss) for diluted earnings (loss) per share	<u>\$ 340</u>	<u>\$ (2,739)</u>	<u>\$ (8,093)</u>	<u>\$ (10,303)</u>
Denominator for basic earnings (loss) per share – weighted-average shares outstanding				
	83,750,636	70,308,374	79,751,523	68,991,196
Effect of dilutive securities	<u>9,601,556</u>	<u>-</u>	<u>-</u>	<u>-</u>
Denominator for diluted earnings (loss) per share – weighted-average shares outstanding	<u>93,352,192</u>	<u>70,308,374</u>	<u>79,751,523</u>	<u>68,991,196</u>
Basic income (loss) per share:				
Net income (loss) per share	\$ 0.00	\$ (0.04)	\$ (0.10)	\$ (0.15)
referred dividends	<u>(0.00)</u>	<u>(0.00)</u>	<u>(0.00)</u>	<u>(0.00)</u>
Net income (loss) per share available to common shareholders	<u>\$ 0.00</u>	<u>\$ (0.04)</u>	<u>\$ (0.10)</u>	<u>\$ (0.15)</u>
Diluted income (loss) per share:				
Net income (loss) per share	<u>\$ 0.00</u>	<u>\$ (0.04)</u>	<u>\$ (0.10)</u>	<u>\$ (0.15)</u>

The Company has excluded the following weighted-average securities from the calculation of diluted loss per share, as their effect would have been antidilutive:

Dilutive securities	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Restricted stock grants	-	280,000	-	346,642
Convertible notes payable	-	68,088	-	58,217
Convertible preferred stock	45,393	46,972	46,179	48,039
Stock options	103,315	1,137,780	102,095	1,145,604
Warrants	-	9,387,233	135,505	13,299,925
Total dilutive securities	148,708	10,920,073	283,779	14,898,427

#### NOTE 4. SELECT BALANCE SHEET DETAILS

##### Inventory

Inventories of \$488,000 as of September 30, 2013 were comprised of work in process of \$481,000, representing direct labor costs on in-process projects and finished goods of \$7,000 net of reserves for obsolete and slow-moving items of \$3,000. Inventories of \$262,000 as of December 31, 2012 were comprised of work in process of \$254,000, representing direct labor costs on in-process projects and finished goods of \$8,000 net of reserves for obsolete and slow-moving items of \$3,000. Appropriate consideration is given to obsolescence, excessive levels, deterioration and other factors in evaluating net realizable value and required reserve levels.

##### Intangible Assets

The Company has intangible assets in the form of trademarks, trade names and patents. The carrying amounts of the Company's acquired trademark and trade name intangible assets were \$35,000 and \$47,000 as of September 30, 2013 and December 31, 2012, respectively, which include accumulated amortization of \$312,000 and \$300,000 as of September 30, 2013 and December 31, 2012, respectively. Amortization expense related to trademark and trade name intangible assets was \$4,000 for the three months ended September 30, 2013 and 2012. Amortization expense for trademark and trade name intangible assets was \$12,000 for the nine months ended September 30, 2013 and 2012. 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 350, *Intangibles – Goodwill and Other*, for proper treatment.

In June 2012, the Company entered into an asset purchase agreement with Vocel, Inc., a Delaware corporation, whereby the Company purchased certain assets, consisting primarily of certain patents and trademarks. The Company evaluated this transaction under ASC 805, *Business Combinations*, and determined that this transaction constituted an asset purchase. The Company determined the aggregate fair value of the consideration issued to be approximately \$159,000 and has allocated this amount to the relative fair value of the assets acquired resulting in \$159,000 being allocated to patents. The Company began amortization of the acquired patents in the third quarter of 2012 on a straight-line basis over their weighted-average remaining life of approximately 13.5 years. Amortization expense related to the patents was \$3,000 for the three months ended September 30, 2013 and 2012, respectively and \$9,000 and \$3,000 for the nine months ended September 30, 2013 and 2012, respectively.

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)
2013 (3 months)	\$ 7
2014	28
2015	27
2016	12
2017	12
Thereafter	93
Totals	\$ 179

**Goodwill**

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

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

Notes payable consist of the following:

(\$ in thousands)	<u>September 30, 2013</u>	<u>December 31, 2012</u>
Notes payable to related parties:		
7% convertible promissory notes. Face value of notes \$65 at September 30, 2013 and December 31, 2012. Discount on notes is \$0 at September 30, 2013 and December 31, 2012. In January 2013, the Company received an extension to June 30, 2014. Notes callable at any time at option of holder.	\$ 65	\$ 65
Total notes payable to related parties	<u>\$ 65</u>	<u>\$ 65</u>
Total notes payable	65	65
Less current portion	<u>(65)</u>	<u>(65)</u>
Long-term notes payable	<u>\$ -</u>	<u>\$ -</u>

*7% Convertible Promissory Notes to Related Parties*

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

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

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

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

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

#### *Line of Credit*

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. The credit line was extended by an existing shareholder and member of our Board of Directors. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015. At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company's common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company's request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company's common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

The Company estimated the fair value of the warrants 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 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 and nine months ended September 30, 2013, the Company recorded approximately \$72,000 and \$145,000, respectively, in deferred financing fee amortization expense. Such expense is recorded as a component of interest expense in the Company's condensed consolidated statement of operations for the period ended September 30, 2013.

The Company evaluated the line of credit agreement and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the 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 exercise price and trading value of the Company's common stock at the date the line of credit agreement was issued (commitment date). Such amounts could range from \$0 to approximately \$474,000 depending on the amount borrowed by the Company under the line of credit agreement.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

#### **NOTE 6. EQUITY**

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

##### **Series B Convertible Redeemable Preferred Stock**

The Company had 239,400 shares of Series B Convertible Redeemable Preferred ("*Series B Preferred*") outstanding as of September 30, 2013 and December 31, 2012. At September 30, 2013 and December 31, 2012, 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 nine months ended September 30, 2013 or 2012. In June 2013, the Company paid approximately \$25,000 in dividends to Series B Preferred holders of record as of April 30, 2013.

## Common Stock

The following table summarizes common stock activity for the nine months ended September 30, 2013:

	<b>Common Stock</b>
Shares outstanding at December 31, 2012	<u>76,639,849</u>
Shares issued pursuant to options exercised for cash	32,713
Shares issued pursuant to cashless warrants exercised	4,336,741
Shares issued pursuant to achievement of vesting provisions	120,000
Shares issued pursuant to warrants exercised for cash	<u>3,577,779</u>
Shares outstanding at September 30, 2013	<u><u>84,707,082</u></u>

During the nine months ended September 30, 2013, the Company issued 32,713 shares of common stock pursuant to the exercise of 32,713 options for cash proceeds of approximately \$8,000. During the nine months ended September 30, 2013, the Company issued 3,577,779 shares of common stock pursuant to the exercise of 3,577,779 warrants resulting in cash proceeds of approximately \$2,014,000. Also during the nine months ended September 30, 2013, the Company issued 4,336,741 shares of common stock pursuant to the cashless exercise of 6,437,541 warrants.

During the nine months ended September 30, 2013, the Company issued 120,000 shares of common stock pursuant to the achievement of certain contractual vesting conditions contained in previously issued restricted stock grants to non-affiliated consultants.

## Warrants

The following table summarizes warrant activity for the following periods:

	<b>Warrants</b>	<b>Weighted- Average Exercise Price</b>
Balance at December 31, 2012	18,788,485	\$ 0.56
Granted	1,232,632	\$ 1.01
Expired / Canceled	(688,749)	\$ 1.49
Exercised	(10,015,320)	\$ 0.52
Balance at September 30, 2013	<u>9,317,048</u>	\$ 0.59

During the nine months ended September 30, 2013, the Company issued to certain consultants warrants to purchase an aggregate of 110,000 shares of the Company's common stock. Such warrants have exercise prices ranging from \$1.08 to \$1.15 per share and have terms ranging from one to three years from the date of issuance. An aggregate of 80,000 of these warrants become exercisable only upon the attainment of specified events. No such events were obtained during the nine months ended September 30, 2013.

During the nine months ended September 30, 2013, the Company issued to an existing shareholder and member of our Board of Directors warrants to purchase 1,052,632 shares of the Company's common stock. Such warrants have an exercise price of \$0.95 per share and a term of two years from the date of issuance.

During the nine months ended September 30, 2013, the Company issued to certain members of a newly established advisory board, warrants to purchase an aggregate of 70,000 shares of the Company's common stock. Such warrants have an exercise price of \$1.72 per share and have a two year term. The Company recorded the estimated grant date fair value of these warrants using the Black-Scholes option valuation model as a component of general and administrative expense.

During the nine months ended September 30, 2013, there were 6,437,541 warrants exercised pursuant to cashless transactions resulting in the issuance of 4,336,741 shares of common stock, 3,577,779 warrants exercised for cash resulting in the issuance of 3,577,779 shares of common stock and proceeds to the Company of approximately \$2,014,000 and 688,749 warrants that expired.

As of September 30, 2013, warrants to purchase 9,317,048 shares of common stock at prices ranging from \$0.50 to \$1.72 were outstanding. All warrants are exercisable as of September 30, 2013, and expire at various dates through December 2016, with the exception of an aggregate of 330,000 warrants, which become exercisable only upon the attainment of specified events.

#### *Stock-Based Compensation*

As of September 30, 2013, 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.

The Company estimates the fair value of its stock options using a Black-Scholes option-pricing model, consistent with the provisions of ASC 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 \$142,000 and \$411,000 for the three and nine months ended September 30, 2013, respectively. Stock-based compensation expense related to equity options was approximately \$145,000 and \$426,000 for the three and nine months ended September 30, 2012, respectively.

In January of 2010, the Company issued 847,258 shares of restricted stock to members of management and the Board. These shares vest quarterly over a three-year period. The restricted shares were issued as compensation for the cancellation of 1,412,096 options held by members of management and the Board. The Company evaluated the exchange in accordance with ASC 718 and determined there was no incremental cost to be recorded in conjunction with the exchange as the fair value of the options surrendered at the modification date exceeded the fair value of the restricted shares issued at the modification date. Stock-based compensation expense related to these restricted stock grants was \$0 for the three and nine months ended September 30, 2013. Stock-based compensation expense related to these restricted stock grants was approximately \$9,000 and \$28,000 for the three and nine months ended September 30, 2012, respectively.

During March 2011, the Company granted 880,000 performance units to certain key employees that grant the holder the right to receive compensation based on the appreciation in the Company's common stock in the event of transfer of control of the Company ("*Performance Units*"). As the vesting of the Performance Units is contingent upon the sale of the Company, the expense associated with the granting of the Performance Units was not material. The Performance Units issued to such key employees were terminated, and exchanged for options to purchase a total of 435,000 shares of common stock during the three months ended March 31, 2012.

ASC 718 requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the Black-Scholes option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The Company is required to make various assumptions in the application of the Black-Scholes option-pricing model. The Company has determined that the best measure of expected volatility is based on the historical weekly volatility of the Company's common stock. Historical volatility factors utilized in the Company's Black-Scholes computations for the nine months ended September 30, 2013 and 2012 ranged from 78% to 144%. The Company has elected to estimate the expected life of an award based upon the SEC approved "simplified method" noted under the provisions of Staff Accounting Bulletin No. 110. The expected term used by the Company during the nine months ended September 30, 2013 and 2012 was 5.9 years. The difference between the actual historical expected life and the simplified method was immaterial. The interest rate used is the risk free interest rate and is based upon U.S. Treasury rates appropriate for the expected term. Interest rates used in the Company's Black-Scholes calculations for the nine months ended September 30, 2013 and 2012 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.

In March 2013, the Company issued 410,000 options under existing stock-based compensation plans to certain members of senior management, certain members of the Board of Directors and certain employees. Such options have an exercise price of \$0.93 per share. In May and July 2013, the Company issued 42,500 and 35,000 options, respectively, under existing stock-based compensation plans to certain employees. The exercise price of the May 2013 grant was \$1.00 per share and the exercise price of the July 2013 grant was \$2.30 per share.

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

	<b>Options</b>	<b>Weighted-Average Exercise Price</b>
Balance at December 31, 2012	3,031,221	\$ 0.82
Granted	487,500	\$ 1.03
Expired/Cancelled	(27,500)	\$ 1.00
Exercised	(32,713)	\$ 0.27
Balance at September 30, 2013	<u>3,458,508</u>	<u>\$ 0.85</u>

The per share weighted-average grant date fair value of options granted during the nine months ended September 30, 2013 was \$0.74.

#### **NOTE 7. DERIVATIVE LIABILITIES**

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

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

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

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

As of December 31, 2012, the Company had 5,211,229 outstanding warrants to purchase shares of the Company's common stock that qualified for derivative liability treatment. The recorded fair market value of those warrants at December 31, 2012 was approximately \$2,244,000, which is reflected as a non-current liability in the consolidated balance sheet as of December 31, 2012.

As of September 30, 2013, the Company had 369,996 outstanding warrants to purchase shares of the Company's common stock that qualified for derivative liability treatment. The recorded fair market value of those warrants at September 30, 2013 was approximately \$406,000. During the nine months ended September 30, 2013, 4,714,993 warrants qualifying for derivative liability treatment were exercised on a cashless basis resulting in the issuance of 3,379,796 shares of common stock with an aggregate fair value of approximately \$6,276,000. Also during the nine months ended September 30, 2013, 126,240 warrants qualifying for derivative liability treatment were exercised for cash, resulting in the issuance of 126,240 shares of common stock with an aggregate fair value of approximately \$304,000 and cash proceeds of approximately \$63,000.

**NOTE 8. FAIR VALUE ACCOUNTING**

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

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

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

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

(\$ in thousands)	Fair Value at September 30, 2013			
	Total	Level 1	Level 2	Level 3
<b>Assets:</b>				
Pension assets	\$ 1,663	\$ 1,663	\$ —	\$ —
Totals	\$ 1,663	\$ 1,663	\$ —	\$ —
<b>Liabilities:</b>				
Derivative liabilities	\$ 406	\$ —	\$ —	\$ 406
Totals	\$ 406	\$ —	\$ —	\$ 406

(\$ in thousands)	Fair Value at December 31, 2012			
	Total	Level 1	Level 2	Level 3
<b>Assets:</b>				
Pension assets	\$ 1,630	\$ 1,630	\$ —	\$ —
Totals	\$ 1,630	\$ 1,630	\$ —	\$ —
<b>Liabilities:</b>				
Derivative liabilities	\$ 2,244	\$ —	\$ —	\$ 2,244
Totals	\$ 2,244	\$ —	\$ —	\$ 2,244

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

As of September 30, 2013, the Company had outstanding warrants to purchase 369,996 shares of the Company's common stock that qualified for derivative liability treatment. The recorded fair market value of those warrants at September 30, 2013 was approximately \$406,000 which is reflected as a current liability in the condensed consolidated balance sheet as of September 30, 2013 due to the remaining warrants having a remaining life of less than one year. The fair value of the Company's derivative liabilities are classified within Level 3 of the fair value hierarchy because they are valued using pricing models that incorporate management assumptions that cannot be corroborated with observable market data. The Company uses Black-Scholes or Monte-Carlo simulation methodologies in the determination of the fair value of the derivative liabilities.

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

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

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

(\$ in thousands)	<u>Derivative Liabilities</u>
Balance at December 31, 2012	\$ 2,244
Total unrealized gains	
Included in earnings	4,679
Settlements	(6,517)
Issuances	—
Transfers in and/or out of Level 3	—
Balance at September 30, 2013	<u>\$ 406</u>

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

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

## NOTE 9. RELATED PARTY TRANSACTIONS

### Related-Party Convertible Notes

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

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

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

The Company did not repay the notes on January 31, 2010. During the year ended December 31, 2012, the Company repaid \$45,000 in principal to certain holders of the Related-Party Convertible Notes.

On January 21, 2013, the holders of the Related-Party Convertible Notes agreed to extend the due date on their respective convertible notes to be due and payable no later than June 30, 2014, however, the Related-Party Convertible Notes are callable at any time, at the option of the note holder, prior to June 30, 2014.

### **Professional Service Contract**

During the year ended December 31, 2012 the Company entered into a series of professional service contracts with an entity that John Cronin, a member of the Company's Board of Directors, has an ownership interest in. The aggregate contract value was \$370,000. The Company did not pay the professional services firm any monies during the nine months ended September 30, 2013.

### **Line of Credit**

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. Neal Goldman, an existing shareholder and member of our Board of Directors, extended the credit line. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015. At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company's common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company's request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company's common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

The Company estimated the fair value of the warrants 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 warrants as a deferred financing fee of approximately \$580,000 to be amortized over the life of the line of credit agreement.

The Company evaluated the line of credit agreement and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the 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 exercise price and trading value of the Company's common stock at the date the line of credit agreement was issued (commitment date). Such amounts could range from \$0 to approximately \$474,000 depending on the amount borrowed by the Company under the line of credit agreement.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

## NOTE 10. CONTINGENT LIABILITIES

During the nine months ended September 30, 2013, the Company wrote off certain accounts payable and accrued liabilities totaling approximately \$228,000, which is included in "Other income, net" 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 and Senior Vice President of Administration and Chief Financial Officer. 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: (i) a lump sum cash payment equal to between six months and twenty-four months of base salary, based upon specific agreements; (ii) continuation of the executive's fringe benefits and medical insurance for a period of three years; and (iii) immediate vesting of 50% of each executive's outstanding restricted stock awards and stock options. In the event that the executive's employment is terminated within the six months prior to or the thirteen months following a change of control (as defined in the employment agreements), the executive is entitled to the severance benefits described above, except that 100% of each executive's restricted stock awards outstanding and stock options will immediately vest. Each executive's eligibility to receive any severance payments or other benefits upon his termination is conditioned upon him executing a general release of liability.

The Company also has a Change of Control and Severance Benefits Agreement with its Chief Technical Officer and Vice President of Business Development. 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 his employment without cause prior to the closing of any change of control transaction: (i) a lump sum cash payment equal to six months of base salary; and (ii) continuation of the executive's health insurance benefits until the earlier of six (6) months following the date of termination, the date on which he is no longer entitled to continuation coverage pursuant to COBRA or the date that he obtains comparable health insurance coverage. In the event that the executive's employment is terminated within the twelve months following a change of control, he is entitled to the severance benefits described above, plus his stock options will immediately vest and become exercisable. The executive's eligibility to receive severance payments or other benefits upon his termination is conditioned upon him executing a general release of liability.

### *Litigation*

On September 21, 2012, Blue Spike, LLC, a Texas limited liability company ("Blue Spike"), filed claims against the Company in the United States District Court for the Eastern District of Texas, alleging that the Company is impermissibly using Blue Spike's patented technologies in certain Company products, including its Biometric Engine. To date, Blue Spike has filed similar suits asserting claims of patent infringement against over 100 companies since August 9, 2012. The defendants span a wide range of industries, from Internet search engines to chip manufacturers, digital rights management, video streaming and digital watermarking. The Company has filed a motion to dismiss the complaint and a motion to transfer Blue Spike's case against the Company to San Diego. The Company's motion to dismiss Blue Spike's contributory and willful infringement allegations against the Company was granted by the Court. The Company's motion to transfer has not been ruled upon. Currently pending are approximately 19 other motions to dismiss and at least 9 motions filed by various other defendants to transfer the action to the Northern District of California, Central District of California, Northern District of West Virginia, District of Massachusetts, Southern District of New York, and District of New Jersey. None of the transfer motions has yet been ruled upon. Blue Spike is seeking to recover an unspecified amount of compensatory damages from the Company, and an injunction to enjoin the Company from further acts of alleged infringement. The Company believes Blue Spike's claim to be without merit and intends to vigorously defend itself. The Company is unable to estimate a possible range of loss at this time.

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

#### *Leases*

In December 2010, we relocated our corporate headquarters to Rancho Bernardo Road in San Diego, California and entered into a three-year lease agreement. In August 2013, we entered into an amendment effective November 2013, whereby the Company consolidated its existing leases. The Company will lease an additional 4,793 square feet of space in the same location while simultaneously vacating 2,560 square feet of space resulting in total rented square feet of 9,927. The lease term commenced on November 1, 2013 and ends on October 31, 2017. Future minimum rent payments under the amended lease will be approximately \$48,000 in 2013 (3 months), \$210,000 in 2014, \$216,000 in 2015, \$222,000 in 2016 and \$190,000 in 2017.

In April 2012, we entered into a lease extension of our Portland, Oregon offices whereby we extended the lease term for a period of 36 months commencing November 1, 2012 until October 31, 2015. Future minimum rent payments will be approximately \$36,000 (3 months) in 2013, \$146,000 in 2014 and \$124,000 in 2015.

In addition to the corporate headquarters lease in San Diego, California, we also lease space in Ottawa, Province of Ontario, Canada; and Mexico City, Mexico, which are included in the future minimum lease payments at September 30, 2013.

At September 30, 2013, future minimum lease payments are as follows:

(\$ in thousands)	
2013 (3 months)	\$ 102
2014	\$ 399
2015	\$ 384
2016	\$ 233
2017 and thereafter	\$ 190
	<u>\$ 1,308</u>

Rental expense incurred under operating leases for the nine months ended September 30, 2013 and 2012 was approximately \$321,000 and \$387,000, respectively.

#### **NOTE 11. SUBSEQUENT EVENTS**

Subsequent to September 30, 2013 and through November 8, 2013, the Company issued 111,783 shares of common stock pursuant to the cashless exercise of 149,996 warrants issued as additional consideration for the Related-Party Notes. Also during October 2013, the Company issued 2,597 shares of its common stock pursuant to the exercise of 2,597 options resulting in cash proceeds to the Company of approximately \$2,000.

In November 2013, the Company issued 290,000 options under existing stock-based compensation plans to certain members of the Board of Directors, senior management and certain employees. Such options have an exercise price of \$1.93 per share.

## 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, 2012, 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

ImageWare Systems, Inc. (the "Company") is incorporated in the state of Delaware. The Company is a leading developer of mobile and cloud-based identity management solutions, providing biometric, secure credential and law enforcement technologies. Scalable for worldwide deployment, ImageWare's biometric product line includes a multi-biometric engine that is hardware and algorithm independent, enabling the enrollment and management of unlimited population sizes. ImageWare's identification products are used to manage and issue secure credentials, including national IDs, passports, driver's licenses, smart cards and access control credentials. ImageWare's digital booking products provide law enforcement with integrated mug shot, fingerprint livescan and investigative capabilities. ImageWare is headquartered in San Diego, CA, with offices in Portland, OR and Ottawa, Ontario

### Recent Developments

#### *New Product Introductions*

In July 2013, the Company introduced its mobile biometric identity management platform, GoMobile Interactive™ ("GMI"). Based upon acquired patented messaging platform technology combined with the Company's patented Biometric Engine®, GMI allows global business, service and content providers to offer users biometric security for their products, services and content on the Android or iPhone operating systems. GMI includes a standalone application that can be used as a turnkey solution, as well as a software development kit, enabling integration with existing mobile applications for Android and iPhone. Targeted verticals for the product include mobile banking and value transfer, retail, healthcare and entertainment services. By supporting multi-modal biometrics on a mobile device, the Company is able to offer an out-of-band security solution that is far superior to traditional password or PIN protection, which are now failing and costing businesses billions of dollars. In addition, the GoMobile Interactive service supports dynamic information gathering, allowing clients to learn about their users through the use of interactive surveys that can be optionally secured using biometrics.

#### *Contracts*

In August 2013, the Company was awarded a \$2.2 million contract by its largest customer, the U.S. Department of Veteran Affairs (the "VA"), to expand its personal identity verification ("PIV") credentialing capabilities across federal, state and local facilities. The multi-biometric identity management solution was first implemented with the VA in 2007, whereby the Company has provided enrollment and on-going management of face, LiveScan fingerprint and fingerprint minutia. These services, which are in compliance with U.S. government standards, provide a greater level of security and drive the standards for commercial adoption. Under the terms of the agreement, the Company delivered software licenses during the third quarter of 2013 and received approximately \$1.5 million in revenue. Additionally, the Company will recognize maintenance related service revenues valued at approximately \$692,000 from this customer ratably over the next year.

### *New Pilot Programs*

On September 19, 2013, the Company announced that it had been awarded a contract for software and services in support of a paid pilot from an undisclosed United States federal agency to implement iris recognition throughout 20 state and local law enforcement agencies. As a subcontractor to Iris ID, the Company will supply its QuickCapture™ application to public safety agencies participating in the one-year iris recognition pilot. The Company's QuickCapture will be used to manage multiple types of Electronic Biometric Transmission Specification (EBTS) transactions, including enrollment, identity verification and investigative searches. During the course of the pilot, the Company's solution will be implemented in over 20 agencies to evaluate the use of iris recognition, primarily in correction facilities. Under the terms of the agreement, the Company will complete the delivery of its QuickCapture application in the fourth quarter of 2013.

### *Liquidity and Capital Resources*

For the nine months ended September 30, 2013, the Company issued 3,577,779 shares of its common stock and received net proceeds of approximately \$2,014,000 from the exercise of warrants for cash.

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. The credit line was extended by an existing shareholder and member of our Board of Directors. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015. At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company's common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company's request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company's common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

The Company estimated the fair value of the warrants 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 warrants as a deferred financing fee of approximately \$580,000 to be amortized over the life of the line of credit agreement.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

### **Critical Accounting Policies and Estimates**

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

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

Critical accounting policies are those that, in management's view, are most important in the portrayal of our financial condition and results of operations. Management believes there have been no material changes during the nine months ended September 30, 2013 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, 2012.

## Results of Operations

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

### *Comparison of the Three Months Ended September 30, 2013 to the Three Months Ended September 30, 2012.*

#### *Product Revenue*

Net Product Revenue (dollars in thousands)	Three Months Ended September 30,		\$ Change	% Change
	2013	2012		
Software and royalties	\$ 1,797	\$ 224	\$ 1,573	702%
Percentage of total net product revenue	98%	87%		
Hardware and consumables	\$ 3	\$ 12	\$ (9)	(75)%
Percentage of total net product revenue	0%	5%		
Services	\$ 42	\$ 21	\$ 21	100%
Percentage of total net product revenue	2%	8%		
Total net product revenue	\$ 1,842	\$ 257	\$ 1,585	617%

Software and royalty revenue increased 702% or approximately \$1,573,000 during the three months ended September 30, 2013 as compared to the corresponding period in 2012. This increase is due to higher identification software license revenue and royalties of approximately \$1,541,000, higher sales of boxed identity management software through our distribution channel of approximately \$37,000 offset by lower law enforcement project revenues of approximately \$5,000.

Revenue from the sale of hardware and consumables decreased 75% or approximately \$9,000 during the three months ended September 30, 2013 as compared to the corresponding period in 2012. The decrease resulted from lower law enforcement revenues related to 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 100% or approximately \$21,000 during the three months ended September 30, 2013 as compared to the corresponding period in 2012 due primarily to the completion of the service element in certain identification project solutions.

We believe that the period-to-period fluctuations of identity management software revenue in project-oriented solutions are largely due to the timing of government procurement with respect to the various programs we are pursuing. Based on management's current visibility into the timing of potential government procurements, we believe that we will see an increase in government procurement and implementations with respect to identity management initiatives; however, we cannot predict the timing of such initiatives. During the quarter ended September 30, 2013, we continued our efforts to move the Biometric Engine into cloud and mobile markets and expanding our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the next six months which should help us to begin to smooth out our period-to-period fluctuations in revenue and enable us to provide better visibility into the timing of future revenues.

**Maintenance Revenue**

<b>Maintenance Revenue (dollars in thousands)</b>	<b>Three Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Maintenance revenue	\$ 654	\$ 681	\$ (27)	(4)%

Maintenance revenue was \$654,000 for the three months ended September 30, 2013 as compared to \$681,000 for the corresponding period in 2012. Identity management maintenance revenues generated from identification project solutions were \$236,000 for the three months ended September 30, 2013 as compared to \$220,000 during the comparable period in 2012. Law enforcement maintenance revenues were \$418,000 for the three months ended September 30, 2013 as compared to \$461,000 during the comparable period in 2012. The decrease of approximately \$43,000 results primarily from the expiration of certain maintenance contracts.

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

**Cost of Product Revenue**

<b>Cost of Product Revenue: (dollars in thousands)</b>	<b>Three Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Software and royalties	\$ 67	\$ 23	\$ 44	191%
Percentage of software and royalty product revenue	4%	10%		
Hardware and consumables	\$ 6	\$ 10	\$ (4)	(40)%
Percentage of hardware and consumables product revenue	200%	83%		
Services	\$ 17	\$ 16	\$ 1	6%
Percentage of services product revenue	40%	76%		
Total product cost of revenue	\$ 90	\$ 49	\$ 41	84%
Percentage of total product revenue	5%	19%		

The cost of software and royalty product revenue increased 191% or approximately \$44,000 for the three months ended September 30, 2013 as compared to the corresponding period of 2012. The increase in software and royalty cost of product revenue of approximately \$44,000 is due primarily to higher third-party software content contained in project solutions for the three months ended September 30, 2013 as compared to the corresponding period in 2012. 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 \$4,000 or 40% for the three months ended September 30, 2013 as compared to the corresponding period in 2012 reflects the decrease in hardware and consumable revenue for the three months ended September 30, 2013 as compared to the corresponding period in 2012. The increase in the percentage of hardware and consumable costs as a percentage of hardware and consumable product revenue from 83% for the three months ended September 30, 2012 to 200% for the corresponding period in 2013 reflects an increase in the cost of replacement keys to certain distribution channel customers.

The cost of services revenue increased approximately \$1,000 during the three months ended September 30, 2013 as compared to the corresponding period in 2012 despite the cost of service revenues as a percentage of service revenues decreasing from 76% for the three months ended September 30, 2012 to 40% for the comparable period in 2013. The percentage decrease in 2013 reflects uncharacteristically low software costs incurred on certain identification projects.

**Cost of Maintenance Revenue**

<b>Maintenance cost of revenue (dollars in thousands)</b>	<b>Three Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Total maintenance cost of revenue	\$ 209	\$ 207	\$ 2	1%
Percentage of total maintenance revenue	32%	30%		

Cost of maintenance revenue as a percentage of maintenance revenues increased approximately 2% to 32% during the three months ended September 30, 2013 from 30% for the corresponding period in 2012 despite lower maintenance revenues due primarily to higher law enforcement maintenance costs incurred for digital camera replacements.

**Product Gross Profit**

<b>Product gross profit (dollars in thousands)</b>	<b>Three Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Software and royalties	\$ 1,730	\$ 201	\$ 1,529	761%
Percentage of software and royalty product revenue	96%	90%		
Hardware and consumables	\$ (3)	\$ 2	\$ (5)	(250)%
Percentage of hardware and consumables product revenue	(100)%	17%		
Services	\$ 25	\$ 5	\$ 20	400%
Percentage of services product revenue	60%	24%		
Total product gross profit	\$ 1,752	\$ 208	\$ 1,544	742%
Percentage of total product revenue	95%	81%		

Software and royalty gross profit increased 761% or approximately \$1,529,000 for the three months ended September 30, 2013 from the corresponding period in 2012, due, primarily, to higher software and royalty product revenues of approximately \$1,573,000. In addition to revenue level changes, costs of software products can vary as a percentage of product revenue from quarter to quarter depending upon product mix and third party software licenses included in software solutions.

Hardware and consumables gross profit decreased approximately \$5,000 for the three month period ended September 30, 2013 as compared to the corresponding period in 2012 due to lower hardware and consumables product revenue during the three month period ended September 30, 2013 as compared to the corresponding period in the 2012 year.

Services gross profit increased approximately \$20,000 due to higher professional services product revenues during the three months ended September 30, 2013 as compared to the corresponding period in 2012.

**Maintenance Gross Profit**

<b>Maintenance gross profit (dollars in thousands)</b>	<b>Three Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Total maintenance gross profit	\$ 445	\$ 474	\$ (29)	(6)%
Percentage of total maintenance revenue	68%	70%		

Gross profit related to maintenance revenue decreased 6% or approximately \$29,000 for the three months ended September 30, 2013, as compared to the same period ended September 30, 2012. That decrease is due to lower maintenance revenues of approximately \$27,000 combined with approximately \$2,000 in higher maintenance costs. The increase in maintenance costs despite lower maintenance revenues is reflective of digital camera replacements for certain law enforcement customers during the three months ended September 30, 2013.

**Operating Expense**

Operating expenses (dollars in thousands)	Three Months Ended September 30,		\$ Change	% Change
	2013	2012		
General and administrative	\$ 888	\$ 749	\$ 139	19%
Percentage of total net revenue	36%	80%		
Sales and marketing	\$ 512	\$ 461	\$ 51	11%
Percentage of total net revenue	21%	49%		
Research and development	\$ 946	\$ 798	\$ 148	19%
Percentage of total net revenue	38%	85%		
Depreciation and amortization	\$ 29	\$ 17	\$ 12	71%
Percentage of total net revenue	1%	2%		

**General and Administrative Expense**

General and administrative expense is comprised primarily of salaries and other employee-related costs for executive, financial, and other infrastructure personnel. General legal, accounting and consulting services, insurance, occupancy and communication costs are also included with general and administrative expense. The dollar increase of approximately \$139,000 is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately \$73,000 due primarily to increases in investor and public relations expenses of approximately \$82,000, increases in legal and auditing fees of approximately \$18,000 and increases in Board of Director fees of approximately \$63,000 offset by decreases in contractor fees and contract services of approximately \$75,000 and decreases in patent related expenses of approximately \$15,000.
- Increase in personnel related expense of approximately \$79,000 due to headcount increases and quarterly discretionary 401(k) employer match contributions of approximately \$27,000.
- Decrease in stock-based compensation expense of approximately \$8,000.
- Decrease in travel, insurances, licenses, dues, rent, and office related costs of approximately \$5,000.

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, business development and product management functions. The dollar increase of approximately \$51,000 during the three months ended September 30, 2013 as compared to the corresponding period in 2012 is primarily comprised of the following major components:

- Increase in personnel related expenses including sales commissions and fringe benefits of approximately \$20,000.
- Decrease in travel and trade show expense of approximately \$6,000.
- Decrease in professional services of approximately \$7,000.
- Increase in contract services, office related expenses and miscellaneous other selling expenses of approximately \$35,000.
- Increase in our Mexico sales offices expenses of approximately \$9,000.

### ***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 \$148,000 for the three months ended September 30, 2013 as compared to the corresponding period in 2012 due primarily to the following major components:

- Increase in personnel expenditures of approximately \$106,000 due primarily to headcount increases.
- Increase in contractor fees and contract services of approximately \$27,000.
- Increase in rent, office related costs and travel expenses of approximately \$15,000.

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

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

During the three months ended September 30, 2013, depreciation and amortization expense increased approximately \$12,000 as compared to the corresponding period in 2012. 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 September 30, 2013, we recognized interest income of \$0 and interest expense of approximately \$73,000. For the three months ended September 30, 2012, we recognized interest income of \$1,000 and interest expense of \$6,000. Interest expense for the three months ended September 30, 2013 is comprised of approximately \$72,000 of amortization expense of deferred financing fees related to our unsecured line of credit and \$1,000 related to coupon interest on our 7% related party convertible notes.

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

For the three months ended September 30, 2013, we recognized non-cash income of \$470,000 compared to non-cash expense of \$1,378,000 for the corresponding period of 2012. This income and expense is related to the change in fair value of the Company's derivative liabilities associated with the anti-dilution provisions in certain warrants to purchase shares of our common stock. The derivative liabilities were revalued using available market information and commonly accepted valuation methodologies.

### ***Other Income, Net***

For the three months ended September 30, 2013, we recognized other income of \$124,000 and other expense of \$1,000. For the three months ended September 30, 2012, we recognized other income of \$17,000 and other expense of \$15,000. Other income for the three months ended September 30, 2013 is comprised of approximately \$124,000 from the write-off of certain accounts payable and accrued expenses due to the expiration of the legal statute of limitations on such liabilities. Other income for the three months ended September 30, 2012 is comprised of approximately \$12,000 from the write-off of certain accounts payable due to the expiration of the legal statute of limitations on such payables and \$5,000 in miscellaneous other income. Other expense for the three months ended September 30, 2012 is related to the write-off of certain deferred financing fees.

**Comparison of the Nine Months Ended September 30, 2013 to the Nine Months Ended September 30, 2012.**

**Product Revenue**

Net Product Revenue (dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2013	2012		
Software and royalties	\$ 2,246	\$ 715	\$ 1,531	214%
Percentage of total net product revenue	93%	80%		
Hardware and consumables	\$ 67	\$ 132	\$ (65)	(49)%
Percentage of total net product revenue	3%	15%		
Services	\$ 100	\$ 51	\$ 49	96%
Percentage of total net product revenue	4%	5%		
Total net product revenue	\$ 2,413	\$ 898	\$ 1,515	169%

Software and royalty revenue increased 214% or approximately \$1,531,000 during the nine months ended September 30, 2013 as compared to the corresponding period in 2012. This increase is due to higher sales of identification software license revenue and royalties of approximately \$1,527,000, higher sales of our boxed identity management software sold through our distribution channel of approximately \$1,000 and higher law enforcement project related revenues of approximately \$3,000.

Revenue from the sale of hardware and consumables decreased 49% or approximately \$65,000 during the nine months ended September 30, 2013 as compared to the corresponding period in 2012. The decrease resulted from lower revenues from project solutions containing hardware and consumable components.

Services revenue is comprised primarily of software integration services, system installation services and customer training. Such revenue increased 96% or approximately \$49,000 during the nine months ended September 30, 2013 as compared to the corresponding period in 2012 due primarily to the completion of the service element in certain law enforcement and identification project solutions.

We believe that the period-to-period fluctuations of identity management software revenue in project-oriented solutions are largely due to the timing of government procurement with respect to the various programs we are pursuing. Based on management's current visibility into the timing of potential government procurements, we believe that we will see an increase in government procurement and implementations with respect to identity management initiatives; however, we cannot predict the timing of such initiatives. During the quarter ended September 30, 2013, we accelerated our efforts to move the Biometric Engine into cloud and mobile markets and expanding our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the next six months which should help us to begin to smooth out our period-to-period fluctuations in revenue and enable us to provide better visibility into the timing of future revenues.

**Maintenance Revenue**

Maintenance Revenue (dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2013	2012		
Maintenance revenue	\$ 1,962	\$ 2,127	\$ (165)	(8)%

Maintenance revenue was \$1,962,000 for the nine months ended September 30, 2013 as compared to \$2,127,000 for the corresponding period in 2012. Identity management maintenance revenues generated from identification project solutions were \$680,000 for the nine months ended September 30, 2013 as compared to \$679,000 during the comparable period in 2012. Law enforcement maintenance revenues were \$1,282,000 for the nine months ended September 30, 2013 as compared to \$1,448,000 during the comparable period in 2012. The decrease of \$165,000 results from the expiration of certain law enforcement maintenance contracts.

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

**Cost of Product Revenue**

<b>Cost of Product Revenue:</b> (dollars in thousands)	<b>Nine Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
Software and royalties	\$ 123	\$ 88	\$ 35	40%
Percentage of software and royalty product revenue	5%	12%		
Hardware and consumables	\$ 61	\$ 62	\$ (1)	(2)%
Percentage of hardware and consumables product revenue	91%	47%		
Services	\$ 65	\$ 34	\$ 31	91%
Percentage of services product revenue	65%	67%		
<b>Total product cost of revenue</b>	<b>\$ 249</b>	<b>\$ 184</b>	<b>\$ 65</b>	<b>35%</b>
Percentage of total product revenue	10%	20%		

The cost of software and royalty product revenue increased 40% or approximately \$35,000 for the nine months ended September 30, 2013 as compared to the corresponding period of 2012. The increase in software and royalty cost of product revenue of approximately \$35,000 is due to higher software product sales of approximately \$1,531,000 and contain certain third-party software elements. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

The increase in the cost of product revenue for our hardware and consumable sales as a percentage of hardware and consumable product revenues from 47% for the nine months ended September 30, 2012 to 91% for the nine months ended September 30, 2013 is due to the 2012 period containing the sale of certain hardware which contained uncharacteristically low costs.

The cost of services revenue increased 91% or approximately \$31,000 during the nine months ended September 30, 2013 as compared to the corresponding period in 2012. This increase reflects higher services revenues of approximately \$49,000 related to project-oriented work during the nine months ended September 30, 2013.

**Cost of Maintenance Revenue**

<b>Maintenance cost of revenue</b> (dollars in thousands)	<b>Nine Months Ended September 30,</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2013</b>	<b>2012</b>		
<b>Total maintenance cost of revenue</b>	<b>\$ 585</b>	<b>\$ 748</b>	<b>\$ (163)</b>	<b>(22)%</b>
Percentage of total maintenance revenue	30%	35%		

Cost of maintenance revenues decreased approximately \$163,000 for the nine months ended September 30, 2013 as compared to the corresponding period in 2012 due to lower maintenance revenues of approximately \$165,000 combined with cost savings realized from the movement of technical support functions from our Canadian office to our San Diego office in May of 2012. The decrease in the cost of maintenance revenues as a percentage of maintenance revenues from 35% for the twelve months ended September 30, 2012 to 30% for the corresponding period of 2013 reflect the cost saving realized by the movement of the technical support functions to our San Diego office.

**Product Gross Profit**

Product gross profit (dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2013	2012		
Software and royalties	\$ 2,123	\$ 627	\$ 1,496	239%
Percentage of software and royalty product revenue	95%	88%		
Hardware and consumables	\$ 6	\$ 70	\$ (64)	(91)%
Percentage of hardware and consumables product revenue	9%	53%		
Services	\$ 35	\$ 17	\$ 18	106%
Percentage of services product revenue	35%	33%		
Total product gross profit	\$ 2,164	\$ 714	\$ 1,450	203%
Percentage of total product revenue	90%	80%		

Software and royalty gross profit increased 239% or approximately \$1,496,000 for the nine months ended September 30, 2013 from the corresponding period in 2012 due primarily to higher software and royalty product revenues of approximately \$1,531,000. Costs of software products can vary as a percentage of product revenue from quarter to quarter depending upon product mix and third party software licenses included in software solutions.

Hardware and consumables gross profit decreased 91% or approximately \$64,000 for the nine month period ended September 30, 2013 as compared to the corresponding period in 2012. This decrease was primarily due to the lower hardware and consumable product revenues of approximately \$65,000 for the nine months ended September 30, 2013 as compared to the comparable period of 2012 combined with the 2012 period containing uncharacteristically low cost of hardware revenues related to the sale of certain hardware.

Services gross profit increased 106% or approximately \$18,000 due to higher professional services revenue of approximately \$49,000 offset by higher cost of professional service revenues of approximately \$31,000 during the nine months ended September 30, 2013 to the corresponding period in 2012.

**Maintenance Gross Profit**

Maintenance gross profit (dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2013	2012		
Total maintenance gross profit	\$ 1,377	\$ 1,379	\$ (2)	0%
Percentage of total maintenance revenue	70%	65%		

Gross margins related to maintenance revenue increased to 70% for the nine months ended September 30, 2013 from 65% for the same period ended September 30, 2012. That increase is due to lower maintenance cost of revenues of approximately \$163,000 due to the movement of certain technical support functions from the our Canadian office to our San Diego office.

**Operating Expense**

Operating expenses (dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2013	2012		
General and administrative	\$ 2,560	\$ 2,580	\$ (20)	(1)%
Percentage of total net revenue	59%	85%		
Sales and marketing	\$ 1,497	\$ 1,277	\$ 220	17%
Percentage of total net revenue	34%	42%		
Research and development	\$ 2,861	\$ 2,291	\$ 570	25%
Percentage of total net revenue	65%	76%		
Depreciation and amortization	\$ 77	\$ 44	\$ 33	75%
Percentage of total net revenue	2%	1%		

### ***General and Administrative Expense***

General and administrative expense is comprised primarily of salaries and other employee-related costs for executive, financial, and other infrastructure personnel. General legal, accounting and consulting services, insurance, occupancy and communication costs are also included with general and administrative expense. The dollar decrease of approximately \$20,000 is comprised of the following major components:

- Decrease in professional fees including consulting services and contract services of approximately \$238,000 due primarily to decreases in audit related fees of \$126,000, decreases in various consulting and contract services of approximately \$124,000, decreases in patent expenses of approximately \$78,000 offset by increases in Board of Director fees of approximately \$90,000.
- Increase in personnel related expense of approximately \$198,000 due to headcount increases and discretionary 401(k) employer match contributions of approximately \$79,000.
- Decrease in stock-based compensation expense of approximately \$26,000.
- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately \$46,000.

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, business development and product management functions. The dollar increase of \$220,000 during the nine months ended September 30, 2013 as compared to the corresponding period in 2012 is primarily comprised of the following major components:

- Increase in personnel related expense of approximately \$113,000.
- Decrease in stock-based compensation expense of approximately \$8,000.
- Increase in professional services of approximately \$100,000.
- Increase in contract services, travel and trade show expenses and office related expenses of approximately \$30,000.
- Decrease in our Canadian and Mexico sales offices expenses of approximately \$15,000.

### ***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 \$570,000 for the nine months ended September 30, 2013 as compared to the corresponding period in 2012 due primarily to the following major components:

- Increase in personnel expenditures of approximately \$341,000 due to headcount increases.
- Increase in contractor and contract services of \$195,000 due to greater utilization of these resources.
- Increase in rent, office related costs and travel and trade show expenses of approximately \$42,000.
- Decrease in stock-based compensation of approximately \$8,000.

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

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

During the nine months ended September 30, 2013, depreciation and amortization expense increased approximately \$33,000 as compared to the corresponding period in 2012. The relatively small amount of depreciation and amortization is a reflection of the relatively small property and equipment carrying value. The increase of \$33,000 reflects higher depreciation expense on recent equipment purchases needed to replace older, obsolete equipment.

### ***Interest Expense, Net***

For the nine months ended September 30, 2013, we recognized interest income of \$1,000 and interest expense of \$149,000. For the nine months ended September 30, 2012, we recognized interest income of \$3,000 and interest expense of \$17,000. Interest expense for the nine months ended September 30, 2013 is comprised of approximately \$145,000 of amortization expense of deferred financing fees related to our unsecured line of credit and \$4,000 is related to coupon interest on our 7% related party convertible notes.

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

For the nine months ended September 30, 2013, we recognized non-cash expense of \$4,679,000 compared to \$6,473,000 for the corresponding period of 2012. This expense is related to the change in fair value of the Company's derivative liabilities associated with the anti-dilution provisions in certain warrants to purchase shares of our common stock. The derivative liabilities were revalued using available market information and commonly accepted valuation methodologies.

### ***Other Income, Net***

For the nine months ended September 30, 2013, we recognized other income of \$232,000 and other expense of \$1,000. For the nine months ended September 30, 2012, we recognized other income of \$342,000 and other expense of \$15,000. Other income for the nine months ended September 30, 2013 is comprised of approximately \$228,000 from the write-off of certain accounts payable and accrued expenses due the expiration of the legal statute of limitation on such payables and accrued liabilities and \$4,000 of miscellaneous other income. Other income for the nine months ended September 30, 2012 is comprised of approximately \$328,000 from the write-off of certain accounts payable due to the expiration of the legal statute of limitations on such payables and \$14,000 in miscellaneous other income. Other expense for the nine months ended September 30, 2012 is comprised of approximately \$15,000 from the write off of certain deferred financing fees.

## **LIQUIDITY AND CAPITAL RESOURCES**

At September 30, 2013, our principal sources of liquidity consisted of cash and cash equivalents of \$3,468,000 and accounts receivable, net of \$314,000. As of September 30, 2013, we had positive working capital of \$42,000 which included \$2,110,000 of deferred revenue and \$406,000 in derivative liabilities. Historically, our principal sources of cash have included customer payments from the sale of our products, proceeds from the issuance of common and preferred stock and proceeds from the issuance of debt. Our principal uses of cash have included cash used in operations, payments relating to purchases of property and equipment and repayments of borrowings. We expect that our principal uses of cash in the future will be for product development including customization of identity management products for enterprise and consumer applications, further development of intellectual property, development of our Software as a Service ("SaaS") capabilities for existing products as well as general working capital and capital expenditure requirements. We expect that, as our revenues grow, our sales and marketing and research and development expenses will continue to grow, albeit to a lesser extent and, as a result, we will need to generate significant net revenues to achieve and sustain income from operations.

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. The credit line was extended by an existing shareholder and member of our Board of Directors. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015. At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company's common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company's request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company's common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

The Company estimated the fair value of the warrants 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 warrants as a deferred financing fee of approximately \$580,000 to be amortized over the life of the line of credit agreement.

The Company evaluated the line of credit agreement and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the 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 exercise price and trading value of the Company's common stock at the date the line of credit agreement was issued (commitment date). Such amounts could range from \$0 to approximately \$474,000 depending on the amount borrowed by the Company under the line of credit agreement.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

For the nine months ended September 30, 2013, the Company issued 3,577,779 shares of its common stock and received net proceeds of approximately \$2,014,000 from the exercise of warrants for cash.

Management believes that the Company's current cash and cash equivalents combined with the line of credit availability and cash raised subsequent to September 30, 2013 will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing.

### ***Operating Activities***

We used net cash of \$2,605,000 in operating activities for the nine months ended September 30, 2013 as compared to net cash used of \$4,517,000 during the comparable period in 2012. During the nine months ended September 30, 2013, net cash used in operating activities consisted of net loss of \$8,055,000 and a decrease in working capital and other assets and liabilities of \$249,000. Those amounts were offset by \$5,201,000, net of non-cash costs including a \$4,679,000 unrealized loss related to the change in value of our derivative liabilities, \$519,000 in stock based compensation, \$145,000 in debt issuance cost amortization and \$86,000 in depreciation and intangible asset amortization offset by \$228,000 of non-cash income primarily from the write-off of certain accounts payable and accrued liabilities due to the expiration of the statute of limitations. During the nine months ended September 30, 2013, we used cash of \$170,000 to fund increases in current assets and generated cash of \$419,000 through increases in current liabilities and deferred revenues, excluding debt.

During the nine months ended September 30, 2012, we used net cash of \$4,517,000 in operating activities. During the nine months ended September 30, 2012, net cash used in operating activities primarily consisted of net loss of \$10,265,000 and an increase in working capital and other assets and liabilities of \$938,000. Those amounts were offset by \$6,686,000, net of non-cash costs including a \$6,473,000 unrealized loss related to the change in value of our derivative liabilities, \$479,000 in stock-based compensation and \$47,000 in depreciation and amortization, \$15,000 in deferred financing fee expense offset by \$328,000 of non-cash income from the write off of certain accounts payable due to the expiration of the statute of limitations. During the nine months ended September 30, 2012, we used cash of \$912,000 from increases in current assets and used cash of \$26,000 through decreases in current liabilities and deferred revenues, excluding debt.

### ***Investing Activities***

Net cash used in investing activities was \$103,000 for the nine months ended September 30, 2013, compared to \$159,000 used in the nine months ended September 30, 2012. For the nine months ended September 30, 2013, we used cash to fund capital expenditures of computer equipment, software and furniture and fixtures of approximately \$103,000. This level of equipment purchases resulted primarily from the replacement of older equipment. For the nine months ended September 30, 2012, we used \$159,000 to replace older equipment and software.

### ***Financing Activities***

We generated cash of \$1,997,000 from financing activities for the nine months ended September 30, 2013 as compared to the \$3,261,000 generated during the same period in 2012. We generated cash of \$2,014,000 from the exercise of 3,577,779 common stock warrants and \$8,000 from the exercise of 32,713 common stock options. During the nine months ended September 30, 2013, we used cash of \$25,000 to pay dividends on our Series B Preferred Stock.

We generated cash of \$3,261,000 from financing activities for the nine months ended September 30, 2012. We generated cash of \$3,502,000 from the exercise of 7,003,947 common stock warrants and \$7,000 from the exercise of 24,924 common stock options. We used cash of \$203,000 for the payment of dividends on our Series B Preferred Stock and \$45,000 for the repayment of notes payable.

### ***Debt***

At September 30, 2013, we had approximately \$65,000 in outstanding debt, exclusive of any debt discounts, and another \$33,000 in related accrued interest.

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

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

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

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

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

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

**Line of Credit**

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowing of up to \$2.5 million. The credit line was extended by an existing shareholder and member of our Board of Directors. Borrowings under the credit facility bear interest of 8% per annum and are due in March 2015. At any time prior to the Maturity Date, the holder shall have the right to convert the outstanding balance owed into shares of the Company’s common stock by dividing the outstanding balance by \$0.95.

Advances under the credit facility are made at the Company’s request. The line of credit shall terminate, and no further advances shall be made, upon the earlier of the Maturity Date or such date that the Company consummates a debt and/or equity financing resulting in net proceeds to the Company of at least \$2.5 million. In the event of such financing, the outstanding balance under the terms of this note shall be due and payable upon demand.

As additional consideration for the unsecured line of credit agreement, the Company issued to the holder a warrant exercisable for 1,052,632 shares of the Company’s common stock. The warrant has a term of two years from the date of issuance and an exercise price of \$0.95 per share.

The Company estimated the fair value of the warrants 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 warrants as a deferred financing fee of approximately \$580,000 to be amortized over the life of the line of credit agreement.

The Company evaluated the line of credit agreement and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying common stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the 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 exercise price and trading value of the Company’s common stock at the date the line of credit agreement was issued (commitment date). Such amounts could range from \$0 to approximately \$474,000 depending on the amount borrowed by the Company under the line of credit agreement.

As of September 30, 2013, no advances were made under the unsecured line of credit agreement.

***Contractual Obligations***

Total contractual obligations and commercial commitments as of September 30, 2013 are summarized in the following table (in thousands):

	Total	Payment Due by Year					
		2013 (3 months)	2014	2015	2016	2017	Thereafter
7% related party promissory notes	\$ 65	\$ —	\$ 65	\$ —	\$ —	\$ —	\$ —
Operating lease obligations	1,308	102	399	384	233	190	—
<b>Total</b>	<b>\$ 1,373</b>	<b>\$ 102</b>	<b>\$ 464</b>	<b>\$ 384</b>	<b>\$ 233</b>	<b>\$ 190</b>	<b>\$ —</b>

**Real Property Leases**

In December 2010, we relocated our corporate headquarters to Rancho Bernardo Road in San Diego, California and entered into a three-year lease agreement. In August 2013, we entered into an amendment effective November 2013, whereby the Company consolidated its existing leases. The Company will lease an additional 4,793 square feet of space in the same location while simultaneously vacating 2,560 square feet of space resulting in total rented square feet of 9,927. The lease term commenced on November 1, 2013 and ends on October 31, 2017. Future minimum rent payments under the amended lease will be approximately \$48,000 in 2013 (3 months), \$210,000 in 2014, \$216,000 in 2015, \$222,000 in 2016 and \$190,000 in 2017.

In April 2012, we entered into a lease extension of our Portland, Oregon offices whereby we extended the lease term for a period of 36 months commencing November 1, 2012 until October 31, 2015. Future minimum rent payments will be approximately \$36,000 (3 months) in 2013, \$146,000 in 2014 and \$124,000 in 2015.

In addition to the corporate headquarters lease in San Diego, California, we also lease space in Ottawa, Province of Ontario, Canada; and Mexico City, Mexico, which are included in the future minimum lease payments at September 30, 2013.

**Stock-based Compensation**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Cost of revenues	\$ 3	\$ 3	\$ 8	\$ 8
General and administrative	76	84	222	248
Sales and marketing	33	35	95	103
Research and development	30	33	86	95
Total	<u>\$ 142</u>	<u>\$ 155</u>	<u>\$ 411</u>	<u>\$ 454</u>

**Recently Issued Accounting Standards**

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

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

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

**ITEM 4. CONTROLS AND PROCEDURES**

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

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operations of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of September 30, 2013. Based on this evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports submitted under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, including to ensure that information required to be disclosed by the Company is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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

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

## **PART II**

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

On September 21, 2012, Blue Spike, LLC, a Texas limited liability company ("*Blue Spike*"), filed claims against the Company in the United States District Court for the Eastern District of Texas, alleging that the Company is impermissibly using Blue Spike's patented technologies in certain Company products, including its Biometric Engine. To date, Blue Spike has filed similar suits asserting claims of patent infringement against over 100 companies since August 9, 2012. The defendants span a wide range of industries, from Internet search engines to chip manufacturers, digital rights management, video streaming and digital watermarking. The Company has filed a motion to dismiss the complaint and a motion to transfer Blue Spike's case against the Company to San Diego. The Company's motion to dismiss Blue Spike's contributory and willful infringement allegations against the Company was granted by the Court. The Company's motion to transfer has not been ruled upon. Currently pending are approximately 19 other motions to dismiss and at least 9 motions filed by various other defendants to transfer the action to the Northern District of California, Central District of California, Northern District of West Virginia, District of Massachusetts, Southern District of New York, and District of New Jersey. None of the transfer motions has yet been ruled upon. Blue Spike is seeking to recover an unspecified amount of compensatory damages from the Company, and an injunction to enjoin the Company from further acts of alleged infringement. The Company believes Blue Spike's claim to be without merit and intends to vigorously defend itself. The Company is unable to estimate a possible range of loss at this time.

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

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

Our results of operations and financial condition are subject to numerous risks and uncertainties described in our Annual Report on Form 10-K for our fiscal year ended December 31, 2012, filed on April 1, 2013. 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 September 30, 2013, there have been no material changes to the disclosures made in the above-referenced Form 10-K.

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

None.

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

None.

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

Not applicable.

### **ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b>(a)</b>	<b>EXHIBITS</b>
23.1	Consent of Independent Valuation Firm
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

\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed note filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

**SIGNATURES**

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

Date: November 14, 2013

IMAGEWARE SYTEMS, INC

By: /s/ S. James Miller

S. James Miller

Chief Executive Officer, Chairman and Director  
(Principal Executive Officer)

Date: November 14, 2013

By: /s/ Wayne Wetherell

Wayne Wetherell

Chief Financial Officer  
(Principal Financial and Accounting Officer)

CONSENT OF INDEPENDENT VALUATION FIRM

As independent valuation consultants, Vantage Point Advisors, Inc. hereby consents to the use of the name Vantage Point Advisors, Inc. and to references to our report entitled "Valuation Analysis of ImageWare Systems, Inc." prepared for ImageWare Systems, Inc., or information contained therein, for inclusion in the Quarterly Report on Form 10-Q of ImageWare Systems, Inc. for the quarter ended September 30, 2013.

/s/ Vantage Point Advisors, Inc.

Vantage Point Advisors, Inc.

San Diego, California

November 8, 2013

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

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

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

Date: November 14, 2013

ImageWare Systems, Inc.

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

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

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

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

Date: November 14, 2013

ImageWare Systems, Inc.

By: /s/ Wayne Wetherell

Wayne Wetherell

Chief Financial Officer (Principal Financial Officer)

## CERTIFICATION

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

1. The Quarterly Report on Form 10-Q of the Company for the period ended September 30, 2013 fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and

2. The information contained in the Quarterly Report on Form 10-Q of the Company for the quarter ended September 30, 2013 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 14th day of November, 2013.

/s/ S. James Miller

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

/s/ Wayne Wetherell

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**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.