# EDGAR Submission Header Summary

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| Shell Company | No |
| Voluntary Filer | No |
| Well-Known Seasoned Issuer | No |
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| Emails | filingdesk@secconnect.com |

## Documents

| | |
|---|---|
| 10-K | iwsy10k_dec312014.htm |
| | Form 10-K |
| EX-23.1 | ex23-1.htm |
| EX-23.2 | ex23-2.htm |
| EX-31.1 | ex31-1.htm |
| EX-31.2 | ex31-2.htm |
| EX-32.1 | ex32-1.htm |
| GRAPHIC | stockperformance.jpg |
| EX-101.INS | iwsy-20141231.xml |
| EX-101.SCH | iwsy-20141231.xsd |
| EX-101.CAL | iwsy-20141231_cal.xml |
| EX-101.DEF | iwsy-20141231_def.xml |
| EX-101.LAB | iwsy-20141231_lab.xml |
| EX-101.PRE | iwsy-20141231_pre.xml |

## Module and Segment References

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

**FORM 10-K**

**(Mark One)**

| | |
|---|---|
| **[X]** | **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the fiscal year ended December 31, 2014** |
| **[ ]** | **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the transition period from ______ to ______** |

**Commission file number 001-15757**

# IMAGEWARE SYSTEMS INCORPORATED

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **33-0224167** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**10815 Rancho Bernardo Road, Suite 310,**
**San Diego, CA 92127**
(Address of principal executive offices)

**(858) 673-8600**
(Registrant's Telephone Number, Including Area Code)

**Securities registered pursuant to Section 12(b) of the Act: Common Stock, par value $0.01 per share**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large accelerated filer | [ ] | Accelerated filer | [X] |
| Non-accelerated filer<br>(Do not check if smaller reporting company) | [ ] | Smaller Reporting Company | [ ] |

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes [ ] No [X]

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant as of June 30, 2014, the last business day of the registrant's most recently completed second fiscal quarter, as reported on the OTCQB marketplace was $87,655,831. This number excludes shares of common stock held by affiliates, executive officers and directors.

As of March 12, 2015, there were 93,515,065 shares of the registrant's common stock outstanding.

**IMAGEWARE SYSTEMS, INC.**
**Form 10-K**
**For the Year Ended December 31, 2014**
**Table of Contents**

**CAUTIONARY STATEMENT**

*This Annual Report contains forward-looking statements regarding our business, financial condition, results of operations and prospects. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates" and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Annual Report. Additionally, statements concerning future matters such as the development of new products, sales levels, expense levels and other statements regarding matters that are not historical are forward-looking statements.*

*Although forward-looking statements in this Annual Report reflect the good faith judgment of our management, such statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties and actual results and outcomes may differ materially from the results and outcomes discussed in or anticipated by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include without limitation those discussed under the heading "Risk Factors" in Item 1A, as well as those discussed elsewhere in this Annual Report. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report. We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report. Readers are urged to carefully review and consider the various disclosures made in this Annual Report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects.*

In this Annual Report, "ImageWare," the "Company," "we," "our," and "us" refer to ImageWare Systems Incorporated and its subsidiaries, unless the context requires otherwise.

# PART I

## ITEM 1. BUSINESS

As used in this Annual Report, “we,” “us,” “our,” “ImageWare,” “ImageWare Systems,” “Company” or “our Company” refers to ImageWare Systems, Inc. and all of its subsidiaries.

### Overview

The Company is a pioneer and leader in the emerging market for biometrically enabled software-based identity management solutions. Using those human characteristics that are unique to us all, we create software that provides a highly reliable indication of a person’s identity. Our “flagship” product is our patented IWS Biometric Engine®. Scalable for small city business or worldwide deployment, our IWS Biometric Engine is a multi-biometric software platform that is hardware and algorithm independent, enabling the enrollment and management of unlimited population sizes. It allows a user to utilize one or more biometrics on a seamlessly integrated platform. Our products are used to manage and issue secure credentials, including national IDs, passports, driver licenses and access control credentials. Our products also provide law enforcement with integrated mug shot, LiveScan fingerprint and investigative capabilities. We also provide comprehensive authentication security software using biometrics to secure physical and logical access to facilities or computer networks or Internet sites. Biometric technology is now an integral part of all markets we address and all of our products are integrated into the IWS Biometric Engine.

Historically, we have marketed our products to government entities at the federal, state and local levels, however, the emergence of cloud based computing - a mobile market that demands increased security and interoperable systems, and the proven success of our products in the government markets, has enabled us to enlarge our target market focus to include the emerging consumer and non-government enterprise marketplace.

Our biometric technology is a core software component of an organization’s security infrastructure and includes a multi-biometric identity management solution for enrolling, managing, identifying and verifying the identities of people by the physical characteristics of the human body. We develop, sell and support various identity management capabilities within government (federal, state and local), law enforcement, commercial enterprises, and transportation and aviation markets for identification and verification purposes. Our IWS Biometric Engine is a patented biometric identity management software platform for multi-biometric enrollment, management and authentication, managing population databases of virtually unlimited sizes. It is hardware agnostic and can utilize different types of biometric algorithms. It allows different types of biometrics to be operated at the same time on a seamlessly integrated platform. It is also offered as a Software Development Kit based search engine, enabling developers and system integrators to implement a biometric solution or integrate biometric capabilities into existing applications without having to derive biometric functionality from pre-existing applications. The IWS Biometric Engine combined with our secure credential platform, IWS EPI Builder, provides a comprehensive, integrated biometric and secure credential solution that can be leveraged for high-end applications such as passports, driver licenses, national IDs, and other secure documents.

Our law enforcement solutions enable agencies to quickly capture, archive, search, retrieve, and share digital images, fingerprints and other biometrics as well as criminal history records on a stand-alone, networked, wireless or Web-based platform. We develop, sell and support a suite of modular software products used by law enforcement and public safety agencies to create and manage criminal history records and to investigate crime. Our IWS Law Enforcement solution consists of five software modules: Capture and Investigative modules, which provide a criminal booking system with related databases as well as the ability to create and print mug photo/SMT image lineups and electronic mugbooks; a Facial Recognition module, which uses biometric facial recognition to identify suspects; a Web module, which provides access to centrally stored records over the Internet in a connected or wireless fashion; and a LiveScan module, which incorporates LiveScan capabilities into IWS Law Enforcement providing integrated fingerprint and palm print biometric management for civil and law enforcement use. The IWS Biometric Engine is also available to our law enforcement clients and allows them to capture and search using other biometrics such as iris or DNA.

Our secure credential solutions empower customers to create secure and smart digital identification documents with complete ID systems. We develop, sell and support software and design systems which utilize digital imaging and biometrics in the production of photo identification cards, credentials and identification systems. Our products in this market consist of IWS EPI Suite and IWS EPI Builder ("*SDK*"). These products allow for the production of digital identification cards and related databases and records and can be used by, among others, schools, airports, hospitals, corporations or governments. We have added the ability to incorporate multiple biometrics into the ID systems with the integration of IWS Biometric Engine to our secure credential product line.

Our enterprise authentication software includes the IWS Desktop Security product which is a comprehensive authentication management infrastructure solution providing added layers of security to workstations, networks and systems through advanced encryption and authentication technologies. IWS Desktop Security is optimized to enhance network security and usability, and uses multi-factor authentication methods to protect access, verify identity and help secure the computing environment without sacrificing ease-of-use features such as quick login. Additionally, IWS Desktop Security provides an easy integration with various smart card-based credentials including the Common Access Card ("*CAC*"), Homeland Security Presidential Directive 12 ("*HSPD-12*"), Personal Identity Verification ("*PIV*") credential, and Transportation Worker Identification Credential ("*TWIC*") with an organization's access control process. IWS Desktop Security provides the crucial end-point component of a Logical Access Control System ("*LACS*"), and when combined with a Physical Access Control System ("*PACS*"), organizations benefit from a complete door to desktop access control and security model.

**Recent Developments**

*Series E Preferred Stock Financing*

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

In February 2015 the Company completed a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*"). Approximately 2,000 shares were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit, as defined below, was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10.0 million, with net proceeds of approximately $9.925 million after deducting offering expenses of approximately $75,000.

*Amendment to 1999 Stock Option Plan*

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

*Settlement of Blue Spike Matter*

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") against the Company in the United States District Court for the Eastern District of Texas, entitled Blue Spike, LLC v. ImageWare Systems, Inc., Case No. 12-cv-688-LED. The four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

*Lines of Credit*

At December 31, 2014, the Company had two unsecured lines of credit, one with maximum available borrowings of up to $5.0 million that matures in March 2017 (the "*Line of Credit*") and another with maximum available borrowings of up to $500,000 that matures in March 2015 (the "*$500K Line of Credit*") (together, the "*Lines of Credit*"). The Lines of Credit were extended by two existing members of our Board of Directors (the "*Holders*") and, at the election of the Holders, are convertible into shares of the Company's Common Stock at prices ranging from $0.95 per share to $2.30 per share, in accordance with the terms and conditions of the Lines of Credit.

Advances under the Lines of Credit are made at the Company's request. Up to the date of the Series E Financing, the Company received $1.95 million in advances under the Line of Credit and no advances under the $500K Line of Credit. As a result of the Series E Financing, approximately 2,000 shares of Series E Preferred were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1.95 million in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

**Industry Background**

***Biometrics and Secure Credential Markets***

We believe the biometric identity management market will continue to grow as the role of biometrics becomes more widely adopted for enhancing security and complying with government regulations and initiatives and as biometric capture devices become increasingly mobile, robust and cost effective. Our biometric and secure credentialing solutions are meeting the requirements and standards for true multi-modal biometric identity management systems, as well as providing scalability to support evolving functionality.

As a result of HSPD-12, government organizations are required to adopt new processes for verifying the identity of employees and contractors as well as controlling access to secure facilities and information systems. In response to the strict requirements set forth by the Federal government, ImageWare enhanced its IWS Biometric Engine and secure credentialing product suite by adding card management and card printing modules which enable the offering of end-to-end support for PIV-I and PIV-II business processes, technical requirements, as well as the ability to partner with leading physical and logical access control vendors for logistics and deployment considerations. We believe that the HSPD-12 standards as well as the product enhancements created to meet those standards will, in large part, be adopted by the commercial market and that the Company's products will transition into those market spaces without significant customization.

Organizations concerned with security can use our technology to create secure “smart” identification cards that can be instantly checked against a database of applicable biometrics to prevent unauthorized access to secure facilities or computer networks. We believe potential customers in these markets include, among others, large corporations, border crossings (land, air and sea), airports, hospitals, universities and government agencies.

Identification systems have historically been sold based upon the cost-savings digital systems offer over traditional non-digital systems. We believe that the ability to easily capture images and data in a digital database and to enable immediate and widespread access to that database for remote identification/verification will be a functionality that both public and private sector customers will require in the future and that such functionality will be one of the primary drivers for future growth within this market. We are able to provide field-proven identification products with high quality reference accounts across the board in terms of size and complexity of systems and user requirements. When combined with our proven biometric, cloud and interactive mobile messaging capabilities, we believe we can provide a leading product offering into the biometrically enabled secure identity management market.

***Law Enforcement and Public Safety Markets***

The United States law enforcement and public safety markets are composed of federal, state and local law enforcement agencies. Our target customers include local police and sheriff’s departments, primary state law enforcement agencies, prisons, special police agencies, county constable offices, and federal agencies such as the Department of Homeland Security, FBI, DEA and ICE. In addition, police agencies in foreign countries have shown interest in using the full range of IWS Law Enforcement products to meet the growing need for a flexible yet robust booking/investigative solution that includes the routine use of IWS Facial Recognition as well as the ability to use other biometrics. We continue to target agencies in foreign countries for our biometric and law enforcement solutions.

Law enforcement customers require demanding end-to-end solutions that incorporate robust features and functionalities such as biometric and secure credentialing capabilities, as well as instant access to centrally maintained records for real time verification of identity and privileges. Law enforcement has long used the multiple biometrics of fingerprint and face in establishing an individual’s identity record. More recently, law enforcement is seeking capability to utilize additional biometrics such as iris and DNA. The Company’s multi-biometric platform product, the IWS Biometric Engine, allows company customers to use as many and different biometrics as desired all on a single, integrated platform.

Agencies are also moving toward a more shared experience where specific pieces of suspect/arrest data may be viewed by outside agencies allowing a suspect’s identity to be quickly defined with the end goal being the swift apprehension of the subject.

**Products and Services**

Our identity management solutions are primarily focused around biometrics and secure credentials providing complete, cross-functional and interoperable systems. Our biometric and secure credentialing products provide complete and interoperable solutions with features and functions required throughout the entire identity management life cycle, enabling users the flexibility to make use of any desired options, such as identity proofing and enrollment, card issuance, maintenance and access control. Our solutions offer a significant benefit that one vendor’s solution is used throughout the various stages, from establishing an applicant’s verified identity, to issuance of smart card based credentials, to the usage and integration to physical and logical access control systems.

These solutions improve global communication, the integrity and authenticity of access control to facilities and information systems, as well as enhance security, increase efficiency, reduce identity fraud, and protect personal privacy.

We categorize our identity management products and services into three basic markets: (i) Biometrics, (ii) Secure Credential, and (iii) Law Enforcement and Public Safety. We offer a series of modular products that can be seamlessly integrated into an end-to-end solution or licensed as individual components.

***Biometrics***

Our biometric product line consists of the following:

*GoMobile InteractiveTM*

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 IWS 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 GMI service supports dynamic information gathering, allowing clients to learn about their users through the use of interactive surveys that can be secured using biometrics.

*IWS Biometric Engine*

This is a biometric identity management platform for multi-biometric enrollment, management and authentication, managing population databases of unlimited sizes without regard to hardware or algorithm. Searches can be 1:1 (verification), 1:N (identification), X:N (investigative) and N:N (database integrity). IWS Biometric Engine is technology and biometric agnostic, enabling the use of biometric devices and algorithms from any vendor, and the support of the following biometric types: finger, face, iris, hand geometry, palm, signature, DNA, voice, 3D face and retina. IWS Biometric Engine is a second-generation solution from the Company that is based on field-proven ImageWare technology solutions that have been used to manage millions of biometric records since 1997 and is ideal for a variety of applications including: criminal booking, background checks (civil and criminal), watch list, visa/passport and border control (air, land and sea), physical and logical access control, and other highly-secure identity management environments. The Company believes that this product will be very attractive to the emerging commercial and consumer markets as they deploy biometric identity management systems.

Our IWS Biometric Engine is scalable, and biometric images and templates can be enrolled either live or offline. Because it stores the enrolled images, a new algorithm can be quickly converted to support new or alternate algorithms and capture devices. The IWS Biometric Engine is built to be hardware "agnostic," and currently supports over 100 hardware capture devices and over 70 biometric algorithms.

The IWS Biometric Engine is available as a Software Development Kit, as well as a platform for custom configurations to meet specific customer requirements. The added suite of products provides government, law enforcement, border management and enterprise businesses, a wide variety of application-specific solutions that address specific government mandates and technology standards. It also provides the ability to integrate into existing legacy systems and expand based upon specific customer requirements. This enables users to integrate a complete solution or components as needed. The application suite of products includes packaged solutions for:

- HSPD-12 Personal Identity Verification
- Border Management
- Applicant Identity Vetting
- Mobile Acquisition
- Physical Access Control
- Single-Sign-On and Logical Access Control

*IWS PIV Management Application.* The Company provides a set of Enterprise Server products within our complete PIV solution, and these software products supply server-based features and functions, while the use case for PIV requires client-based presentation of PIV data and workflow. The IWS PIV Management Application supplies the web-based graphical user interface that presents the user or client interface to the various server functions. Since the server-based applications perform specific functions for specific phases of the PIV life cycle, these server-based applications need to be bound together with additional workflow processes. The IWS PIV Management Application meets this need with software modules that interface and interconnect the server-based applications.

*IWS PIV Middleware.* The IWS PIV Middleware product, which is NIST certified and listed on the GSA approved product list, is a library of functions that connect a card reader & PIV card on the hardware side with a software application. The library implements the specified PIV Middleware API functions that support interoperability of PIV Cards. This software has been developed in conformance with the FIPS-201 specification, and the software has been certified by the NIST Personal Identification Verification Program ("*NPIVP*") Validation Authority as being compliant.

*IWS Background Server.* The IWS Background Server is a software application designed specifically for government and law enforcement organizations to support the first stage of biometric identity management functions such as identity proofing and vetting. IWS Background Check Server automatically processes the submission of an applicant's demographic and biographic data to investigative bureaus for background checks prior to issuing a credential.

*IWS Desktop Security.* IWS Desktop Security is a highly flexible, scalable and modular authentication management platform that is optimized to enhance network security and usability. This architecture provides an additional layer of security to workstations, networks and systems through advanced encryption and authentication technologies. Biometric technologies (face, fingerprint, iris, voice or signature), can be seamlessly coupled with TPM chips to further enhance corporate security. USB tokens, smart cards and RFID technologies can also be readily integrated. Additional features include:

- Support for multiple authentication tools including Public Key Infrastructure ("*PKI*") within a uniformed platform and Privilege Management Infrastructure ("*PMI*") technology to provide more advanced access control services and assure authentication and data integrity;
- Integration with IWS Biometric Engine for searching and match capabilities (1:1, 1:N and X:N);
- Integration with IWS EPI Builder for the production and management of secure credentials;
- Support for both BioAPI and BAPI standards;
- Supports a single sign-on feature that securely manages Internet Explorer and Windows application ID and password information;
- Supports file and folder encryption features; and
- Supports various operating systems, including Microsoft Windows 2000, Windows XP, and Windows Server 2003.

*IWS Biometric Quality Assessment & Enhancement ("IWS Biometric IQA&E").* The IWS Biometric IQA&E is a biometric image enhancement and assessment solution that assists government organizations with the ability to evaluate and enrich millions of biometric images automatically, saving time and costs associated with biometric enrollment while maintaining image and database integrity.

The IWS Biometric IQA&E improves the accuracy and effectiveness of biometric template enrollments. The software may be used stand-alone or in conjunction with the IWS Biometric Engine. IWS Biometric IQA&E provides automated image quality assessment with respect to relevant image quality standards from organizations such as International Civil Aviation Organization, National Institute of Standards and Technology ("*NIST*"), International Organization for Standards ("*ISO*") and American Association of Motor Vehicle Association ("*AAMVA*"). IWS Biometric IQA&E also enables organizations to conduct multi-dimensional facial recognition, which further enhances accuracy for numerous applications including driver licenses, passports and watch lists.

IWS Biometric IQA&E automatically provides real-time biometric image quality analysis and feedback to improve the overall effectiveness of biometric images thus increasing the biometric verification performance, and maintaining database and image data integrity. IWS Biometric IQA&E provides a complete platform that includes an image enhancement library for biometric types including face, finger and iris.

***Secure Credential***

Our secure credential products consist of the following:

*IWS Card Management.* The IWS Card Management System ("*CMS*") is a comprehensive solution to support and manage the issuance of smart cards complete with the following capabilities:

- Biometric enrollment and identity proofing with Smart Card encoding of biometrics;
- Flexible models of central or distributed issuance of credentials;
- Customizable card life-cycle workflow managed by the CMS; and
- Integration of the CMS data with other enterprise solutions, such as physical access control and logical access control (i.e. Single-Sign-On, or SSO).

*IWS EPI Suite.* This is an ID software solution for producing, issuing, and managing secure credentials and personal identification cards. Users can efficiently manage large amounts of data, images and card designs, as well as track and issue multiple cards per person, automatically populate multiple cards and eliminate redundant data entry. IWS EPI Suite was designed to integrate with our customers' existing security and computing infrastructure. We believe that this compatibility may be an appealing feature to corporations, government agencies, transportation departments, school boards, and other public institutions.

*IWS EPI Builder.* This is a software developer's kit and a leading secure credential component of identity management and security solutions, providing all aspects of ID functionality from image and biometric capture to the enrollment, issuance and management of secure documents. It contains components which developers or systems integrators can use to support and produce secure credentials including national IDs, passports, International Civil Aviation Office -compliant travel documents, smart cards and driver licenses. IWS EPI Builder enables organizations to develop custom identification solutions or incorporate sophisticated identification capabilities into existing applications including the ability to capture images, biometric and demographic data; enable biometric identification and verification (1:1 and 1:X) as well as support numerous biometric hardware and software vendors. It also enables users to add electronic identification functionality for other applications, including access control, tracking of time and attendance, point of sale transactions, human resource systems, school photography systems, asset management, inventory control, warehouse management, facilities management and card production systems.

*IWS EPI PrintFarm.* While it is the last stage of PIV Card Issuance, the PIV smart card printing process is by no means the least important stage. Production printing of tens of thousands of PIV cards requires a significant investment and a well-engineered system. The IWS EPI PrintFarm software offers a cost-effective yet high-performance method for high-volume card printing.

*IWS PIV Encoder.* PIV smart cards must be programmed with specific mandatory data, digital signatures and programs in order to maintain the interoperability as well as the security features specified for the cards. The IWS PIV Encoder could be considered to be a complex device driver that properly programs the PIV smart cards. The Encoder interacts with the Card Management System for data payload elements. It interacts with the Certificate Authority to encrypt or sign the PIV smart card data with trusted certificates. Finally, it acts as the application-level device driver to make the specific PIV smart card encoding system properly program the smart card, regardless if the system is a standalone encoding system or one integrated into a card printer.

***Law Enforcement and Public Safety***

We believe our integrated suite of software products significantly reduces the inefficiencies and expands the capabilities of traditional booking and mug shot systems. Using our products, an agency can create a digital database of thousands of criminal history records, each including one or more full-color facial images, finger and palm prints, biographic text information and images of other distinctive physical features such as scars, marks and tattoos ("*SMT's*"). This database can be quickly searched using text queries, or biometric technology that can compare biometric characteristics of an unknown suspect with those in the database.

Our investigative software products can be used to create, edit and distribute both mug photo and SMT photo lineups of any size. In addition, electronic mug books display hundreds of images for a witness to review and from which electronic selections are made. The Witness View software component records the viewing of a lineup (mug photo or SMT) detailing the images provided for viewing along with the image or images selected. In addition to a printed report, the Witness View module provides a non-editable executable file (.exe) that may be played on any computer for court exhibit viewing purposes.

Our IWS Law Enforcement solution consists of software modules, which may also be purchased individually. The IWS Law Enforcement Capture and Investigative module make up our booking system and database. Our add-on modules include LiveScan, Facial Recognition, Law Enforcement Web and Witness View as well as the IWS Biometric Engine.

*IWS Law Enforcement.* IWS Law Enforcement is a digital booking, identification and investigative solution that enables users to digitally capture, store, search and retrieve images and demographic data including mug shots, fingerprints and SMT's. Law enforcement may choose between submitting fingerprint data directly to the State Automated Fingerprint Identification System ("*AFIS*"), FBI criminal repository, or other agencies as required. Additional features and functionality include real-time access to images and data, creating of photo lineups and electronic mug books, and production of identification cards and credentials. IWS Law Enforcement also uses off-the-shelf hardware and is designed to comply with open industry standards so that it can operate on an array of systems ranging from a stand-alone personal computer to a wide area network. To avoid duplication of entries, the system can be integrated easily with several other information storage and retrieval systems, such as a records/jail management system ("*RMS*/*JMS*") or an automated fingerprint identification system.

*Capture.* This software module allows users to capture and store a variety of images (facial, SMT and others such as evidence photos) as well as biographical text information. Each record includes images and text information in an easy-to-view format made up of fields designed and defined by the individual agency. Current customers of this module range from agencies that capture a few thousand mug shots per year to those that capture hundreds of thousands of mug shots each year.

*LiveScan.* This software module is FBI certified which complies with the FBI Integrated Automated Fingerprint Identification System ("*IAFIS*") Image Quality Specifications ("*IQS*") while utilizing FBI certified LiveScan devices from most major vendors. LiveScan allows users to capture single to ten prints and palm data, providing an integrated biometric management solution for both civil and law enforcement use. By adding LiveScan capabilities, law enforcement organizations further enhance the investigative process by providing additional identifiers to identify suspects involved in a crime. In addition, officers no longer need to travel to multiple booking stations to capture fingerprints and mug shots. All booking information including images may be located at a central designation and from there routed to the State AFIS or FBI criminal history record repository.

*Investigative.* This software module allows users to search the database created with IWS Law Enforcement. Officers can conduct text searches in many fields, including file number, name, alias, distinctive features, and other information such as gang membership and criminal history. The Investigative module creates a catalogue of possible matches, allowing officers or witnesses to save time by looking only at mug shots that closely resemble the description of the suspect. This module can also be used to create a line-up of similar facial images from which a witness may identify the suspect.

*Facial Recognition.* This software module uses biometric facial recognition and retrieval technology to help authorities identify possible suspects. Images taken from surveillance videos or photographs can be searched against a digital database of facial images to retrieve any desired number of faces with similar characteristics. This module can also be used at the time of booking to identify persons using multiple aliases. Using biometrics-based technology, the application can search through thousands of facial images in a matter of seconds, reducing the time it would otherwise take a witness to flip through a paper book of facial images that may or may not be similar to the description of the suspect. The Facial Recognition module then creates a selection of possible matches ranked in order of similarity to the suspect, and a percentage confidence level is attributed to each possible match. The application incorporates search engine technology, which we license from various facial recognition algorithm providers.

*LE Web.* This software module enables authorized personnel to access and search agency booking records stored in IWS Law Enforcement through a standard Web browser from within the agency's intranet. This module allows remote access to the IWS Law Enforcement database without requiring the user to be physically connected to the customer's network. This application requires only that the user have access to the Internet and authorization to access the law enforcement agency's intranet.

*EPI Designer for Law Enforcement.* The EPI Designer for LE software is a design solution created for the IWS Law Enforcement databases based on the IWS EPI Suite program. This program is integrated with the various IWS databases an agency is utilizing and allows for unique booking/inmate reports, wristbands, photo ID cards, Wanted or BOLO fliers, etc. to be created from the fields of information stored in booking records. Designs can be created in minutes and quickly added to the IWS Law Enforcement system allowing all users with appropriate permissions immediate access to the newly added form.

***Maintenance and Customer Support***

We offer software and hardware support to our customers. Customers can contract with us for technical support that enables them to use a toll-free number to speak with our technical support center for software support and general assistance 24 hours a day, seven days a week. As many of our government customers operate around the clock and perceive our systems as critical to their day-to-day operations, a very high percentage contract for technical support. For the years ended December 31, 2014, 2013 and 2012, maintenance revenues accounted for approximately 61%, 49% and 71% of our total revenues, respectively.

***Software Customization and Fulfillment***

We directly employ computer programmers and retain independent programmers to develop our software and perform quality control. We provide customers with software that we specifically customize to operate on their existing computer system. We work directly with purchasers of our system to ensure that the system they purchase will meet their unique needs. We configure and test the system either at our facilities or on-site and conduct any customized programming necessary to connect the system with any legacy systems already in place. We can also provide customers with a complete computer hardware system with our software already installed and configured. In either case, the customer is provided with a complete turnkey solution, which can be used immediately. When we provide our customers with a complete solution including hardware, we use off-the-shelf computers, cameras and other components purchased from other companies such as Dell or Hewlett Packard. Systems are assembled and configured either at our facilities or at the customer's location.

**Customers**

We have a wide variety of domestic and international customers. Most of our IWS Law Enforcement customers are government agencies at the federal, state and local levels in the United States. Our secure credential products are also being used in Australia, Canada, the United Arab Emirates, Kuwait, Saudi Arabia, Mexico, Colombia, Costa Rica, Venezuela, Singapore, Indonesia and the Philippines. For the year ended December 31, 2014, one customer accounted for approximately 17% or $725,000 of total revenue and had $0 trade receivables as of the end of the year, as compared to one customer that accounted for approximately 42% or $2,211,000 of total revenue and had $0 trade receivables as of December 31, 2013. For the year ended December 31, 2012, one customer accounted for approximately 15% or 611,000 of total revenue and $0 trade receivables as of the end of the year.

**Our Strategy**

Our strategy is to provide patented open-architected identity management solutions including multi-biometric, secure credential and law enforcement technologies that are stand alone, integrated and/or bundled with key partners including channel relationships and large systems integrators such as, United Technology Security, GCR, Unisys, Lockheed Martin, IBM and Fujitsu, among others. Key elements of our strategy for growth include the following:

***Fully Exploit the Biometrics, Access Control and Identification Markets***

The establishment of the Department of Homeland Security coupled with the movement by governments around the world to authenticate the identity of their citizens, employees and contractors has accelerated the adoption of biometric identification systems that can provide secure credentials and instant access to centrally maintained records for real-time verification of identity and access (physical and logical) privileges. Using our products, an organization can create secure credentials that correspond to records including images and biographic data in a digital database. A border guard or customs agent can stop an individual to quickly and accurately verify his identity against a database of authorized persons, and either allow or deny access as required. Our technology is also standards based and applied to facilitate activities such as federal identification mandates while complying with personal identification verification standards such as HSPD-12, International Civil Aviation Organization standards, American Association of Motor Vehicle Administrators driver licenses, voter registration, immigration control and welfare fraud identification. We believe that these or very similar standards are applicable in markets throughout the world.

With the identity management market growing at a rapid pace, biometric identifiers are becoming recognized and accepted as integral components to the identification process in the public and private sectors. As biometric technologies (facial recognition, fingerprint, iris, etc.) are adopted, identification systems must be updated to enable their use in the field. We have built our solutions to enable the incorporation of one or multiple biometrics, which can be associated with a record and stored both in a database and on a card for later retrieval and verification without regard to the specific hardware employed. We believe the increasing demand for biometric technology will drive demand for our solutions. Our identity management products are built to accommodate the use of biometrics and meet the demanding requirements across the entire identity life cycle.

***Expand Law Enforcement and Public Safety Markets***

We intend to use our successful installations with customers such as the Arizona Department of Public Safety, New South Wales Police, and the San Bernardino County Sheriff's Department as reference accounts and to market IWS Law Enforcement as a superior technological solution. Our recent addition of the LiveScan module and support for local AFIS to our IWS Law Enforcement will enhance its functionality and value to the law enforcement customer as well as increase the potential revenue the Company can generate from a system sale. We primarily sell directly to the law enforcement community. Our sales strategy is to increase sales to new and existing customers including renewing supporting maintenance agreements. We have also established relationships with large systems integrators such as Sagem Morpho to OEM our law enforcement solution utilizing their worldwide sales force. We will focus our sales efforts in the near term to establish IWS Law Enforcement as the integrated mug shot and LiveScan system adopted in as many countries, states, large counties and municipalities as possible. Once we have a system installed in a region, we intend to then sell additional systems or retrieval seats to other agencies within the primary customer's region and in neighboring regions. In addition, we plan to market our integrated investigative modules to the customer, including Facial Recognition, Web and WitnessView. As customer databases of digital mug shots grow, we expect that the perceived value of our investigative modules, and corresponding revenues from sales of those modules, will also grow.

***Software as a Service Business Model***

With the advent of cloud based computing, the proliferation of mobile devices which allow for mobile transactions across wide geographical areas, the emergence of inexpensive and reliable biometric capture devices and the need to secure access to data, product and services, the Company believes that the market for multi-biometric solutions will expand to encompass significant deployments of biometric systems in the commercial and consumer markets. The Company therefore intends to leverage the strength of its existing government clients who have deployed the Company's products for large populations, as well as its foundational patent portfolio in the field of multi-modal biometrics and the fusion of multiple biometric algorithms, to address the commercial and consumer market. As part of its marketing plan, the Company offered new versions of its product suite on a Software as a Service ("*SaaS*") model during 2014. This new business model, which is intended to supplement the Company's existing business model, will allow new commercial and consumer clients to verify identity in order to access data, products or services from mobile and desktop devices. We had no Saas installations in place as of the end of 2014, however, we have received significant interest and have entered into contracts with several customers and partners who currently plan to initiate programs in the first half of 2015.

***Mobile Applications***

The Company strengthened its patent portfolio in June 2012 with the purchase of four U.S. patents relating to wireless technology from Vocel. These patents, combined with the Company's existing foundational patents in the areas of biometric identification, verification, enrollment and fusion, provide a unique and protected foundation on which to build interactive mobile applications that are secured using biometrics.

The combination of our biometric identification technologies and wireless technologies has led to the development of the IWS Interactive Messaging System, which is a push application platform secured by biometrics that transforms mobile devices into a complete mobile ID, enabling companies to create applications that allow a range of unprecedented activities – from secure sharing of sensitive information to biometrically securing a mobile wallet. Identity authentication, using multi-modal biometrics gives users the confidence that their personal information is secure while the push marketing capabilities of the technology allow companies unparalleled interactivity that can be personalized to the needs and interests of their customers.

**Sales and Marketing**

We market and sell our products through our direct sales force and through indirect distribution channels, including systems integrators. As of December 31, 2014, we had sales and account representatives based domestically in the District of Columbia, California and internationally in Mexico. Geographically, our sales and marketing force consisted of 12 persons in the United States, and one person in Mexico as of December 31, 2014.

We sell through a direct sales organization, which is supported by technical experts. Our technical experts are available by telephone and conduct on-site customer presentations in support of our sales professionals.

The typical sales cycle for IWS Biometric Engine and IWS Law Enforcement includes a pre-sale process to define the potential customer's needs and budget, an on-site demonstration and conversations between the potential customer and existing customers. Government agencies are typically required to purchase large systems by including a list of requirements in a Request For Proposal, known as an "RFP," and by allowing several companies to openly bid for the project by responding to the RFP. If our response is selected, we enter into negotiations for the contract and, if successful, ultimately receive a purchase order from the customer. This process can take anywhere from a few months to over a year.

Our Biometric and ID products are also sold to large integrators, direct via our sales force and to end users through distributors. Depending on the customer's requirements, there may be instances that require an RFP. The sales cycle can vary from a few weeks to a year.

In addition to our direct sales force, we have developed relationships with a number of systems integrators who contract with government agencies for the installation and integration of large computer and communication systems. By acting as a subcontractor to these systems integrators, we are able to avoid the time consuming and often-expensive task of submitting proposals to government agencies, and we also gain access to large clients.

We also work with companies that offer complementary products, where value is created through product integration. Through teaming arrangements we are able to enhance our products and to expand our customer base through the relationships and contracts of our strategic partners.

We plan to continue to market and sell our products internationally. Some of the challenges and risks associated with international sales include the difficulty in protecting our intellectual property rights, difficulty in enforcing agreements through foreign legal systems and volatility and unpredictability in the political and economic conditions of foreign countries. We believe we can work to successfully overcome these challenges.

**Competition**

***The Law Enforcement and Public Safety Markets***

Due to the fragmented nature of the law enforcement and public safety market and the modular nature of our product suite, we face different degrees of competition with respect to each IWS Law Enforcement module. We believe the principal bases on which we compete with respect to all of our products are:

- the unique ability to integrate our modular products into a complete biometric, LiveScan, imaging and investigative system;
- our reputation as a reliable systems supplier;
- the usability and functionality of our products; and
- the responsiveness, availability and reliability of our customer support.

Our law enforcement product line faces competition from other companies such as DataWorks Plus and 3M. Internationally, there are often a number of local companies offering solutions in most countries.

***Secure Credential Market***

Due to the breadth of our software offering in the secure credential market space, we face differing degrees of competition in certain market segments. The strength of our competitive position is based upon:

- our strong brand reputation with a customer base which includes small and medium-sized businesses, Fortune 500 corporations and large government agencies;
- the ease of integrating our technology into other complex applications; and
- the leveraged strength that comes from offering customers software tools, packaged solutions and Web-based service applications that support a wide range of hardware peripherals.

Our software faces competition from Datacard Corporation, a privately held manufacturer of hardware, software and consumables for the ID market as well as small, regionally based companies.

***Biometric Market***

The market to provide biometric systems to the identity management market is evolving and we face competition from a number of sources. We believe that the strength of our competitive position is based on:

- our ability to provide a system which enables the enrollment, management and authentication of multiple biometrics managing population databases of unlimited sizes;
- searches can be 1:1 (verification), 1:N (identification), X:N (investigative), and N:N (database integrity);
- the system is technology and biometric agnostic, enabling the use of biometric devices and algorithms from any vendor, and the support of the following biometric types: finger, face, iris, hand geometry, palm, DNA, signature, voice, and 3D face and retina; and
- we hold five patents covering our core multi-modal biometric and fusion technology, which we believe will give us a competitive advantage over our direct competitors who have little or no patent protection.

Our multi-biometric product faces competition from French-based Safran, Irish-based Daon, 3M and Aware Inc., none of which have offerings with the scope and flexibility of our IWS Biometric Engine and its companion suite of products or relevant patent protection.

**Intellectual Property**

We rely on trademark, patent, trade secret and copyright laws and confidentiality and license agreements to protect our intellectual property. We have several federally registered trademarks including the trademark ImageWare and IWS Biometric Engine as well as trademarks for which there are pending trademark registrations with the United States, Canadian and other International Patent & Trademark Offices.

We hold several issued patents and have several other patent applications pending for elements of our products. We believe we have the foundational patents regarding the use of multiple biometrics and continue to be an IP leader in the biometric arena. It is our belief that this intellectual property leadership will create a sustainable competitive advantage. In addition to our eight issued U.S. and foreign patents, we recently filed three new patent applications surrounding new “Anonymous Matching” technologies. These technologies will allow biometric matching for identity verification while protecting the privacy of an individual. It is our belief that such technology will be critical to providing biometric management solutions for the consumer market where privacy protection has been a historical issue and barrier to biometric adoption.

The Company strengthened its patent portfolio in June 2012 with the purchase of four U.S. patents relating to wireless technology from Vocel. These patents, combined with the Company’s existing foundational patents in the areas of biometric identification, verification, enrollment and fusion, provide a unique and protected foundation on which to build interactive mobile applications that are secured using biometrics.

The combination of our biometric identification technologies and wireless technologies has led to the development of the IWS Interactive Messaging System, which is a push application platform secured by biometrics that transforms mobile devices into a complete mobile ID, enabling companies to create applications that allow a range of unprecedented activities – from secure sharing of sensitive information to biometrically securing a mobile wallet. Identity authentication, using multi-modal biometrics gives users the confidence that their personal information is secure while the push marketing capabilities of the technology allow companies unparalleled interactivity that can be personalized to the needs and interests of their customers.

We regard our software as proprietary and retain title to and ownership of the software we develop. We attempt to protect our rights in the software primarily through patents and trade secrets. We have not published the source code of most of our software products and require employees and other third parties who have access to the source code and other trade secret information to sign confidentiality agreements acknowledging our ownership and the nature of these materials as our trade secrets.

Despite these precautions, it may be possible for unauthorized parties to copy or reverse-engineer portions of our products. While our competitive position could be threatened by disclosure or reverse engineering of this proprietary information, we believe that copyright and trademark protection are less important than other factors such as the knowledge, ability, and experience of our personnel, name recognition and ongoing product development and support.

Our software products are licensed to end users under a perpetual, nontransferable, nonexclusive license that stipulates which modules can be used and how many concurrent users may use them. These forms of licenses are typically not signed by the licensee and may be more difficult to enforce than signed agreements in some jurisdictions.

**Research and Development**

Our research and development team consisted of 32, 32 and 24 programmers, engineers and other employees as of December 31, 2014, 2013 and 2012, respectively. We also contract with outside programmers for specific projects as needed. We spent approximately $4.5 million, $3.9 million and $3.2 million on research and development in 2014, 2013 and 2012, respectively. We continually work to increase the speed, accuracy, and functionality of our existing products. We anticipate that our research and development efforts will continue to focus on new technology and products for the identity management markets.

**Employees**

We had a total of 62 and 61 full-time employees as of December 31, 2014 and 2013, respectively. Our employees are not covered by any collective bargaining agreement, and we have never experienced a work stoppage. We believe that our relations with our employees are good.

**Environmental Regulation**

Our business does not require us to comply with any particular environmental regulations.

**ITEM 1A. RISK FACTORS**

*An investment in our Common Stock involves a high degree of risk. Before investing in our Common Stock, you should consider carefully the specific risks detailed in this "Risk Factors" section and any prospectus or prospectus supplement. If any of these risks occur, our business, results of operations and financial condition could be harmed, the price of our Common Stock could decline, and you may lose all or part of your investment.*

***We have a history of significant recurring losses totaling approximately $136.3 million at December 31, 2014, and these losses may continue in the future.***

As of December 31, 2014, we had an accumulated deficit of approximately $136.3 million, and these losses may continue in the future. We expect to continue to incur significant sales and marketing, research and development, and general and administrative expenses. As a result, we will need to generate significant revenues to achieve profitability, and we may never achieve profitability.

***Our operating results have fluctuated in the past and are likely to fluctuate significantly in the future.***

Our operating results have fluctuated in the past. These fluctuations in operating results are the consequence of:

- varying demand for and market acceptance of our technology and products;
- changes in our product or customer mix;
- the gain or loss of one or more key customers or their key customers, or significant changes in the financial condition of one or more of our key customers or their key customers;
- our ability to introduce, certify and deliver new products and technologies on a timely basis;
- the announcement or introduction of products and technologies by our competitors;
- competitive pressures on selling prices;
- costs associated with acquisitions and the integration of acquired companies, products and technologies;
- our ability to successfully integrate acquired companies, products and technologies;
- our accounting and legal expenses; and
- general economic conditions.

These factors, some of which are not within our control, will likely continue in the future. To respond to these and other factors, we may need to make business decisions that could result in failure to meet financial expectations. If our quarterly operating results fail to meet or exceed the expectations of securities analysts or investors, our stock price could drop suddenly and significantly. Most of our expenses, such as employee compensation, inventory and debt repayment obligations, are relatively fixed in the short term. Moreover, our expense levels are based, in part, on our expectations regarding future revenue levels. As a result, if our revenue for a particular period were below our expectations, we would not be able to proportionately reduce our operating expenses for that period. Any revenue shortfall would have a disproportionately negative effect on our operating results for the period.

***We depend upon a small number of large system sales ranging from $100,000 to in excess of $2,000,000 and we may fail to achieve one or more large system sales in the future.***

Historically, we have derived a substantial portion of our revenues from a small number of sales of large, relatively expensive systems, typically ranging in price from $100,000 to $2,000,000. If we fail to receive orders for these large systems in a given sales cycle on a consistent basis, our business could be significantly harmed. Further, our quarterly results are difficult to predict because we cannot predict in which quarter, if any, large system sales will occur in a given year. As a result, we believe that quarter-to-quarter comparisons of our results of operations are not a good indication of our future performance. In some future quarters, our operating results may be below the expectations of securities analysts and investors, in which case the market price of our Common Stock may decrease significantly.

***Our lengthy sales cycle may cause us to expend significant resources for as long as one year in anticipation of a sale to certain customers, yet we still may fail to complete the sale.***

When considering the purchase of a large computerized identity management system, potential customers of ours may take as long as eighteen months to evaluate different systems and obtain approval for the purchase. Under these circumstances, if we fail to complete a sale, we will have expended significant resources and received no revenue in return. Generally, customers consider a wide range of issues before committing to purchase our products, including product benefits, ability to operate with their current systems, product reliability and their own budgetary constraints. While potential customers are evaluating our products, we may incur substantial selling costs and expend significant management resources in an effort to accomplish potential sales that may never occur. In times of economic recession, our potential customers may be unwilling or unable to commit resources to the purchase of new and costly systems.

***A significant number of our customers and potential customers are government agencies that are subject to unique political and budgetary constraints and have special contracting requirements, which may affect our ability to obtain new and retain current government customers.***

A significant number of our customers are government agencies. These agencies often do not set their own budgets and therefore have little control over the amount of money they can spend from quarter-to-quarter or year-to-year. In addition, these agencies experience political pressure that may dictate the manner in which they spend money. Due to political and budgetary processes and other scheduling delays that may frequently occur relating to the contract or bidding process, some government agency orders may be canceled or substantially delayed, and the receipt of revenues or payments from these agencies may be substantially delayed. In addition, future sales to government agencies will depend on our ability to meet government contracting requirements, certain of which may be onerous or impossible to meet, resulting in our inability to obtain a particular contract. Common requirements in government contracts include bonding requirements, provisions permitting the purchasing agency to modify or terminate at will the contract without penalty, and provisions permitting the agency to perform investigations or audits of our business practices, any of which may limit our ability to enter into new contracts or maintain our current contracts.

***During the year ended December 31, 2014, one customer accounted for approximately 17% of our total revenues. Any material decrease in revenue from these customers, or in the event the Company is unable to replace the revenue with additional customers, our financial condition and results from operations could be materially and adversely affected.***

During the year ended December 31, 2014, one customer accounted for approximately 17% or $725,000 of our total revenues. If these customers were to significantly reduce its relationship with the Company, or in the event the Company is unable to replace the revenue through the sale of its products to additional customers, the Company's financial condition and results from operations could be negatively impacted, and such impact would be material.

***We occasionally rely on systems integrators to manage our large projects, and if these companies do not perform adequately, we may lose business.***

We occasionally act as a subcontractor to systems integrators who manage large projects that incorporate our systems, particularly in foreign countries. We cannot control these companies, and they may decide not to promote our products or may price their services in such a way as to make it unprofitable for us to continue our relationship with them. Further, they may fail to perform under agreements with their customers, in which case we might lose sales to these customers. If we lose our relationships with these companies, our business, financial condition and results of operations may suffer.

***If the patents we own or license, or our other intellectual property rights, do not adequately protect our products and technologies, we may lose market share to our competitors and our business, financial condition and results of operations would be adversely affected.***

Our success depends significantly on our ability to protect our rights to the technologies used in our products. We rely on patent protection, trade secrets, as well as a combination of copyright and trademark laws and nondisclosure, confidentiality and other contractual arrangements to protect our technology. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. In addition, we cannot be assured that any of our current and future pending patent applications will result in the issuance of a patent to us. The U.S. Patent and Trademark Office ("*PTO*") may deny or require significant narrowing of claims in our pending patent applications, and patents issued as a result of the pending patent applications, if any, may not provide us with significant commercial protection or may not be issued in a form that is advantageous to us. We could also incur substantial costs in proceedings before the PTO. These proceedings could result in adverse decisions as to the claims included in our patents.

Our issued and licensed patents and those that may be issued or licensed in the future may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products. Additionally, upon expiration of our issued or licensed patents, we may lose some of our rights to exclude others from making, using, selling or importing products using the technology based on the expired patents. We also must rely on contractual rights with the third parties that license technology to us to protect our rights in the technology licensed to us. Although we have taken steps to protect our intellectual property and technology, there is no assurance that competitors will not be able to design around our patents. We also rely on unpatented proprietary technology. We cannot assure you that we can meaningfully protect all our rights in our unpatented proprietary technology or that others will not independently develop substantially equivalent proprietary products or processes or otherwise gain access to our unpatented proprietary technology. We seek to protect our know-how and other unpatented proprietary technology with confidentiality agreements and intellectual property assignment agreements with our employees. However, such agreements may not provide meaningful protection for our proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements or in the event that our competitors discover or independently develop similar or identical designs or other proprietary information. In addition, we rely on the use of registered and common law trademarks with respect to the brand names of some of our products. Our common law trademarks provide less protection than our registered trademarks. Loss of rights in our trademarks could adversely affect our business, financial condition and results of operations.

Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States. If we fail to apply for intellectual property protection or if we cannot adequately protect our intellectual property rights in these foreign countries, our competitors may be able to compete more effectively against us, which could adversely affect our competitive position, as well as our business, financial condition and results of operations.

***If third parties claim that we infringe their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling certain products.***

Whether a product infringes a patent involves complex legal and factual issues, the determination of which is often uncertain. We face the risk of claims that we have infringed on third parties' intellectual property rights. Searching for existing intellectual property rights may not reveal important intellectual property and our competitors may also have filed for patent protection, which is not yet a matter of public knowledge, or claimed trademark rights that have not been revealed through our availability searches. Our efforts to identify and avoid infringing on third parties' intellectual property rights may not always be successful. Any claims of patent or other intellectual property infringement, even those without merit, could:

- increase the cost of our products;
- be expensive and time consuming to defend;
- result in us being required to pay significant damages to third parties;
- force us to cease making or selling products that incorporate the challenged intellectual property;
- require us to redesign, reengineer or rebrand our products;
- require us to enter into royalty or licensing agreements in order to obtain the right to use a third party's intellectual property, the terms of which may not be acceptable to us;
- require us to indemnify third parties pursuant to contracts in which we have agreed to provide indemnification to such parties for intellectual property infringement claims;
- divert the attention of our management; and
- result in our customers or potential customers deferring or limiting their purchase or use of the affected products until the litigation is resolved.

In addition, new patents obtained by our competitors could threaten a product's continued life in the market even after it has already been introduced.

***We operate in foreign countries and are exposed to risks associated with foreign political, economic and legal environments and with foreign currency exchange rates.***

We have significant foreign operations. As a result, we are exposed to risks, including among others, risks associated with foreign political, economic and legal environments and with foreign currency exchange rates. Our results may be adversely affected by, among other things, changes in government policies with respect to laws and regulations, anti-inflation measures, currency conversions, collection of receivables abroad and rates and methods of taxation.

***We depend on key personnel, the loss of any of whom could materially adversely affect future operations***.

Our success will depend to a significant extent upon the efforts and abilities of our executive officers and other key personnel. The loss of the services of one or more of these key employees and any negative market or industry perception arising from the loss of such services could have a material adverse effect on us and the trading price of our Common Stock. Our business will also be dependent upon our ability to attract and retain qualified personnel. Acquiring and keeping these personnel could prove more difficult or cost substantially more than estimated and we cannot be certain that we will be able to retain such personnel or attract a high caliber of personnel in the future.

***We face competition from companies with greater financial, technical, sales, marketing and other resources, and, if we are unable to compete effectively with these competitors, our market share may decline and our business could be harmed***.

We face competition from other established companies. A number of our competitors have longer operating histories, larger customer bases, significantly greater financial, technological, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly than we can to new or changing opportunities, technologies, standards or client requirements, more quickly develop new products or devote greater resources to the promotion and sale of their products and services than we can. Likewise, their greater capabilities in these areas may enable them to better withstand periodic downturns in the identity management solutions industry and compete more effectively on the basis of price and production. In addition, new companies may enter the markets in which we compete, further increasing competition in the identity management solutions industry.

We believe that our ability to compete successfully depends on a number of factors, including the type and quality of our products and the strength of our brand names, as well as many factors beyond our control. We may not be able to compete successfully against current or future competitors, and increased competition may result in price reductions, reduced profit margins, loss of market share and an inability to generate cash flows that are sufficient to maintain or expand the development and marketing of new products, any of which would adversely impact our results of operations and financial condition.

**Risks Related to Our Securities**

***Our Common Stock is subject to "penny stock" rules.***

Our stock is currently defined as a "penny stock" under Rule 3a51-1 promulgated under the Exchange Act. "Penny stocks" are subject to Rules 15g-2 through 15g-7 and Rule 15g-9, which impose additional sales practice requirements on broker-dealers that sell penny stocks to persons other than established customers and institutional accredited investors. Among other things, for transactions covered by these rules, a broker-dealer must make a special suitability determination for the purchaser and have received the purchaser's written consent to the transaction prior to sale. Consequently, these rules may affect the ability of broker-dealers to sell our Common Stock and affect the ability of holders to sell their shares of our Common Stock in the secondary market. To the extent our Common Stock is subject to the penny stock regulations, the market liquidity for our shares will be adversely affected.

***Our stock price has been volatile, and your investment in our Common Stock could suffer a decline in value.***

There has been significant volatility in the market price and trading volume of equity securities, which is unrelated to the financial performance of the companies issuing the securities. These broad market fluctuations may negatively affect the market price of our Common Stock. You may not be able to resell your shares at or above the price you pay for those shares due to fluctuations in the market price of our Common Stock caused by changes in our operating performance or prospects and other factors.

Some specific factors that may have a significant effect on our Common Stock market price include:

- actual or anticipated fluctuations in our operating results or future prospects;
- our announcements or our competitors' announcements of new products;
- the public's reaction to our press releases, our other public announcements and our filings with the Securities and Exchange Commission (the "*SEC*");
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles;
- changes in our growth rates or our competitors' growth rates;
- developments regarding our patents or proprietary rights or those of our competitors;
- our inability to raise additional capital as needed;
- substantial sales of Common Stock underlying warrants and preferred stock;
- concern as to the efficacy of our products;
- changes in financial markets or general economic conditions;
- sales of Common Stock by us or members of our management team; and
- changes in stock market analyst recommendations or earnings estimates regarding our Common Stock, other comparable companies or our industry generally.

***Our future sales of our Common Stock could adversely affect its price and our future capital-raising activities could involve the issuance of equity securities, which would dilute shareholders' investments and could result in a decline in the trading price of our Common Stock.***

We may sell securities in the public or private equity markets if and when conditions are favorable, even if we do not have an immediate need for additional capital at that time. Sales of substantial amounts of our Common Stock, or the perception that such sales could occur, could adversely affect the prevailing market price of our Common Stock and our ability to raise capital. We may issue additional Common Stock in future financing transactions or as incentive compensation for our executive management and other key personnel, consultants and advisors. Issuing any equity securities would be dilutive to the equity interests represented by our then-outstanding shares of Common Stock. The market price for our Common Stock could decrease as the market takes into account the dilutive effect of any of these issuances. Furthermore, we may enter into financing transactions at prices that represent a substantial discount to the market price of our Common Stock. A negative reaction by investors and securities analysts to any discounted sale of our equity securities could result in a decline in the trading price of our Common Stock.

***The holders of our preferred stock have certain rights and privileges that are senior to our Common Stock, and we may issue additional shares of preferred stock without stockholder approval that could have a material adverse effect on the market value of the Common Stock.***

Our Board of Directors ("*Board*") has the authority to issue a total of up to four million shares of preferred stock and to fix the rights, preferences, privileges, and restrictions, including voting rights, of the preferred stock, which typically are senior to the rights of the Common Stockholders, without any further vote or action by the Common Stockholders. The rights of our Common Stockholders will be subject to, and may be adversely affected by, the rights of the holders of the preferred stock that have been issued, or might be issued in the future. Preferred stock also could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. This could delay, defer, or prevent a change in control. Furthermore, holders of preferred stock may have other rights, including economic rights, senior to the Common Stock. As a result, their existence and issuance could have a material adverse effect on the market value of the Common Stock. We have in the past issued and may from time to time in the future issue, preferred stock for financing or other purposes with rights, preferences, or privileges senior to the Common Stock. As of December 31, 2014, we had one series of preferred stock outstanding, Series B Preferred Stock ("*Series B Preferred*").

The provisions of our Series B Preferred prohibit the payment of dividends on the Common Stock unless the dividends on those preferred shares are first paid. In addition, upon a liquidation, dissolution or sale of our business, the holders of the Series B Preferred will be entitled to receive, in preference to any distribution to the holders of Common Stock, initial distributions of $2.50 per share, plus all accrued but unpaid dividends. As of December 31, 2014, we had cumulative undeclared dividends on the Series B Preferred of approximately $9,750.

***Certain large shareholders may have certain personal interests that may affect the Company.***

As a result of the shares issued to Goldman Capital Management and related entities controlled by Neal Goldman, a member of our Board of Directors (together, "*Goldman*"), Goldman beneficially owns, in the aggregate, approximately 37.0% of the Company's outstanding voting securities. As a result, Goldman has the potential ability to exert influence over both the actions of the Board of Directors and the outcome of issues requiring approval by the Company's shareholders. This concentration of ownership may have effects such as delaying or preventing a change in control of the Company that may be favored by other shareholders or preventing transactions in which shareholders might otherwise recover a premium for their shares over current market prices.

***Our corporate documents and Delaware law contain provisions that could discourage, delay or prevent a change in control of the Company.***

Provisions in our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our certificate of incorporation authorizes preferred stock, which carries special rights, including voting and dividend rights. With these rights, preferred stockholders could make it more difficult for a third party to acquire us.

We are also subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. Under these provisions, if anyone becomes an "interested stockholder," we may not enter into a "business combination" with that person for three years without special approval, which could discourage a third party from making a takeover offer and could delay or prevent a change of control. For purposes of Section 203, "interested stockholder" means, generally, someone owning 15% or more of our outstanding voting stock or an affiliate of ours that owned 15% or more of our outstanding voting stock during the past three years, subject to certain exceptions as described in Section 203.

***We do not expect to pay cash dividends on our Common Stock for the foreseeable future.***

We have never paid cash dividends on our Common Stock and do not anticipate that any cash dividends will be paid on the Common Stock for the foreseeable future. The payment of any cash dividend by us will be at the discretion of our Board of Directors and will depend on, among other things, our earnings, capital, regulatory requirements and financial condition. Furthermore, the terms of our Series B Preferred directly limit our ability to pay cash dividends on our Common Stock.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

Our corporate headquarters are located in San Diego, California where we occupy 9,927 square feet of office space. This facility is leased through October 2017 at a cost of approximately $18,000 per month. In addition to our corporate headquarters, we also occupied the following spaces at December 31, 2014:

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

**ITEM 3. LEGAL PROCEEDINGS**

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") against the Company in the United States District Court for the Eastern District of Texas, entitled Blue Spike, LLC v. ImageWare Systems, Inc., Case No. 12-cv-688-LED. The four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

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

**ITEM 4. MINE SAFETY DISCLOSURES**

None.

**PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

**Market Information**

Our Common Stock does not trade on an established securities exchange. Our Common Stock is quoted under the symbol "IWSY" on the OTCQB marketplace. The following table sets forth the high and low sale prices for our Common Stock for each quarter in 2014 and 2013:

| 2014 Fiscal Quarters | High | Low |
|---|---|---|
| First Quarter | $ 2.44 | $ 1.76 |
| Second Quarter | $ 2.42 | $ 1.60 |
| Third Quarter | $ 3.07 | $ 1.86 |
| Fourth Quarter | $ 2.61 | $ 1.60 |
| | | |
| **2013 Fiscal Quarters** | **High** | **Low** |
| First Quarter | $ 1.19 | $ 0.79 |
| Second Quarter | $ 2.65 | $ 0.85 |
| Third Quarter | $ 2.85 | $ 1.55 |
| Fourth Quarter | $ 2.14 | $ 1.26 |

**Holders**

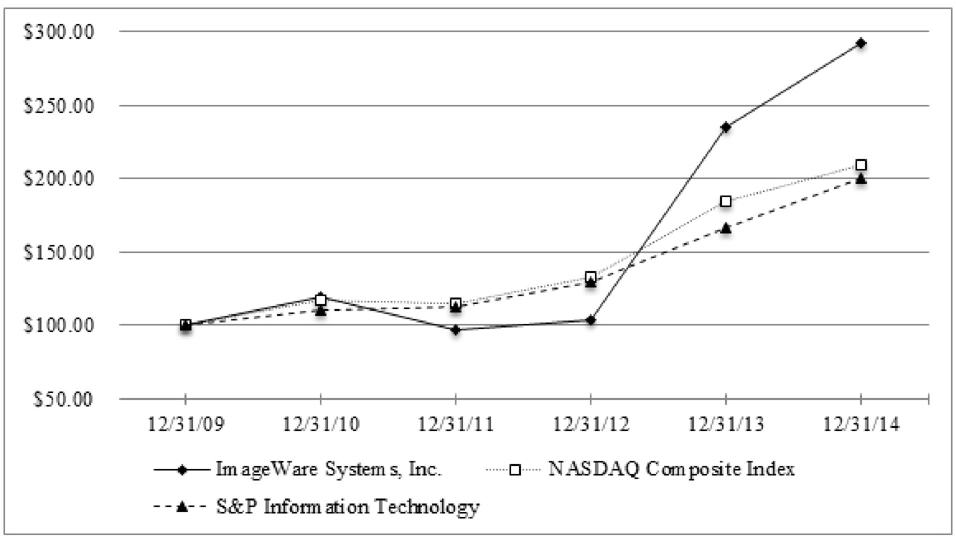
As of March 1, 2015, we had approximately 157 holders of record of our Common Stock. A significant number of our shares were held in street name and, as such, we believe that the actual number of beneficial owners is significantly higher.

**Stock Performance Graph**

The graph below compares the cumulative total shareholder return on our Common Stock with the cumulative total returns of the NASDAQ Composite Index and the S&P Information Technology Index. The graph tracks the performance of a $100 investment in our Common Stock and in each index (with the reinvestment of all dividends) from December 31, 2009 to December 31, 2014. The stock price performance included in this graph is not necessarily indicative of future stock price performance.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN***

ImageWare Systems, Inc., the NASDAQ Composite Index, and the S&P Information Technology Index




*$100 invested on 12/31/09 in stock or index, including reinvestment of dividends.

| | Value of Investment ($) | | | | | |
|---|---|---|---|---|---|---|
| | **12/31/09** | **12/31/10** | **12/31/11** | **12/31/12** | **12/31/13** | **12/31/14** |
| ImageWare Systems, Inc. | $ 100.00 | $ 119.51 | $ 97.56 | $ 103.66 | $ 235.37 | $ 292.68 |
| NASDAQ Composite Index | $ 100.00 | $ 116.91 | $ 114.81 | $ 133.07 | $ 184.06 | $ 208.71 |
| S&P Information Technology Index | $ 100.00 | $ 110.19 | $ 112.85 | $ 129.57 | $ 166.41 | $ 199.89 |

*The stock performance graph above shall not be deemed incorporated by reference into any filing by us under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that we specifically incorporate such information by reference, and shall not otherwise be deemed filed under such Acts.*

**Dividends**

We have never declared or paid cash dividends on our Common Stock. We currently intend to retain all available funds and any future earnings for use in the operation of our business and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to declare cash dividends will be made at the discretion of our Board of Directors and will depend on our financial condition, results of operations, capital requirements, general business conditions and other factors that our Board of Directors may deem relevant.

As of December 31, 2014, 2013 and 2012, the Company had cumulative undeclared dividends of approximately $8,000, relating to our Series B Preferred.

**Repurchases**

We did not repurchase any shares of our Common Stock during fiscal 2014, 2013 or 2012.

**Securities Authorized for Issuance under Equity Compensation Plans**

For a discussion of our equity compensation plans, please see Item 12 of this Annual Report.

**ITEM 6. SELECTED FINANCIAL DATA**

The following data has been derived from our audited financial statements, including the consolidated balance sheets at December 31, 2014 and 2013 and the related consolidated statements of operations for the three years ended December 31, 2014 and related notes appearing elsewhere in this report. The statement of operations data for the years ended December 31, 2011 and 2010 and the balance sheet data as of December 31, 2012, 2011 and 2010 are derived from our audited consolidated financial statements that are not included in this report. You should read the selected financial data set forth below in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our financial statements and related notes included elsewhere in this report.

| Statement of Operations Data: (In thousands, except share and per share data) | Year Ended December 31, 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| **Revenues:** | | | | | |
| Product | $ 1,634 | $ 2,686 | $ 1,145 | $ 2,596 | $ 3,192 |
| Maintenance | 2,525 | 2,618 | 2,806 | 2,878 | 2,619 |
| | 4,159 | 5,304 | 3,951 | 5,474 | 5,811 |
| **Cost of revenues:** | | | | | |
| Product | 257 | 319 | 227 | 459 | 1,059 |
| Maintenance | 735 | 771 | 975 | 935 | 938 |
| Gross profit | 3,167 | 4,214 | 2,749 | 4,080 | 3,814 |
| **Operating expenses:** | | | | | |
| General and administrative | 3,818 | 3,378 | 3,430 | 2,327 | 2,546 |
| Sales and marketing | 2,471 | 2,129 | 1,830 | 1,404 | 1,528 |
| Research and development | 4,495 | 3,869 | 3,180 | 2,664 | 2,531 |
| Depreciation and amortization | 179 | 125 | 69 | 28 | 50 |
| | 10,963 | 9,501 | 8,509 | 6,423 | 6,655 |
| Loss from operations | (7,796) | (5,287) | (5,760) | (2,343) | (2,841) |
| Interest expense | 416 | 221 | 18 | 4,851 | 1,123 |
| Change in fair value of financing obligation | — | — | — | — | (551) |
| Change in fair value of derivative liabilities | — | 4,776 | 4,712 | (3,970) | 738 |
| Loss on debt modification | — | — | — | — | 1,100 |
| Other income, net | (297) | (443) | (322) | (25) | (328) |
| Loss before income taxes | (7,915) | (9,841) | (10,168) | (3,199) | (4,923) |
| Income tax (benefit) expense | 25 | 8 | 22 | (19) | 126 |
| Net loss | $ (7,940) | $ (9,849) | $ (10,190) | $ (3,180) | $ (5,049) |
| Preferred dividends | (51) | (51) | (51) | (383) | (396) |
| Net loss available to common shareholders | $ (7,991) | $ (9,900) | $ (10,241) | $ (3,563) | $ (5,445) |
| **Basic and diluted loss per common share** | | | | | |
| Net loss | $ (0.09) | $ (0.12) | $ (0.14) | $ (0.12) | $ (0.22) |
| Preferred dividends | (—) | (—) | (—) | (0.01) | (0.02) |
| Basic and diluted loss per share available to common shareholders | $ (0.09) | $ (0.12) | $ (0.14) | $ (0.13) | $ (0.24) |
| Basic and diluted weighted-average shares outstanding | 91,795,971 | 81,231,962 | 70,894,916 | 27,316,475 | 23,175,405 |

| **Balance Sheet Data:**<br>(In thousands, except share and per share amounts) | **December 31,**<br>**2014** | **2013** | **2012** | **2011** | **2010** |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current Assets: | | | | | |
| Cash and cash equivalents | $ 218 | $ 2,363 | $ 4,225 | $ 6,773 | $ 103 |
| Accounts receivable, net of allowance for doubtful accounts | 266 | 302 | 328 | 348 | 239 |
| Inventory, net | 916 | 505 | 262 | 45 | 12 |
| Other current assets | 86 | 148 | 86 | 66 | 57 |
| Total Current Assets | 1,486 | 3,318 | 4,901 | 7,232 | 411 |
| Property and equipment, net | 211 | 245 | 150 | 18 | 19 |
| Other assets | 153 | 395 | 44 | 58 | 58 |
| Intangible assets, net of accumulated amortization | 144 | 172 | 200 | 63 | 78 |
| Goodwill | 3,416 | 3,416 | 3,416 | 3,416 | 3,416 |
| **Total Assets** | **$ 5,410** | **$ 7,546** | **$ 8,711** | **$ 10,787** | **$ 3,982** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)** | | | | | |
| Current Liabilities: | | | | | |
| Accounts payable | $ 459 | $ 486 | $ 759 | $ 1,103 | $ 1,161 |
| Deferred revenue | 1,827 | 1,662 | 1,561 | 1,066 | 1,073 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | — | — | — | — | 241 |
| Accrued expenses | 1,013 | 924 | 1,266 | 2,005 | 1,822 |
| Derivative liabilities | — | 57 | — | — | — |
| Notes payable to related parties | — | 55 | 65 | 110 | 110 |
| Total Current Liabilities | 3,299 | 3,184 | 3,651 | 4,284 | 4,407 |
| Convertible secured notes payable, net of discount | — | — | — | — | 1,427 |
| Derivative liabilities | — | — | 2,244 | 11,824 | 15,653 |
| Pension obligation | 1,834 | 1,031 | 401 | — | — |
| Other long-term liabilities | — | — | 72 | 391 | 401 |
| Total Liabilities | 6,444 | 4,215 | 6,368 | 16,499 | 21,888 |
| Shareholders' Equity (Deficit): | | | | | |
| Preferred stock, authorized 4,000,000 shares: | | | | | |
| Series B Convertible Redeemable Preferred Stock, $0.01 par value | 2 | 2 | 2 | 2 | 2 |
| Series C convertible preferred stock, $0.01 par value | — | — | — | — | — |
| Series D convertible preferred stock, $0.01 par value | — | — | — | — | — |
| Common Stock, $0.01 par value | 934 | 874 | 765 | 679 | 237 |
| Additional paid-in capital | 135,982 | 131,652 | 120,182 | 101,720 | 85,186 |
| Treasury stock, at cost | (64) | (64) | (64) | (64) | (64) |
| Accumulated other comprehensive loss | (1,594) | (830) | (139) | (65) | (62) |
| Accumulated deficit | (136,294) | (128,303) | (118,403) | (107,984) | (103,205) |
| Total Shareholders' Equity (Deficit) | 1,034 | 3,331 | 2,343 | (5,712) | (17,906) |
| **Total Liabilities and Shareholders' Equity (Deficit)** | **$ 5,410** | **$ 7,546** | **$ 8,711** | **$ 10,787** | **$ 3,982** |

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-K. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including (without limitation) the disclosures made under the captions "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors," and in the audited consolidated financial statements and related notes included in this Annual Report on Form 10-K.*

**Overview**

We are a pioneer and leader in the emerging market for biometrically enabled software-based identity management solutions. Using those human characteristics that are unique to us all, we create software that provides a highly reliable indication of a person's identity. Our "flagship" product is our patented IWS Biometric Engine®. Scalable for small city business or worldwide deployment, our IWS Biometric Engine is a multi-biometric software platform that is hardware and algorithm independent, enabling the enrollment and management of unlimited population sizes. It allows a user to utilize one or more biometrics on a seamlessly integrated platform. Our products are used to manage and issue secure credentials, including national IDs, passports, driver licenses and access control credentials. Our products also provide law enforcement with integrated mug shot, fingerprint LiveScan and investigative capabilities. We also provide comprehensive authentication security software using biometrics to secure physical and logical access to facilities or computer networks or Internet sites. Biometric technology is now an integral part of all markets we address and all of our products are integrated into the IWS Biometric Engine.

While we have historically marketed our products to the government market at the federal, state and local levels, the emergence of cloud based computing - a mobile market that demands increased security and interoperable systems, and the proven success of our products in the government market, will enable us to enlarge our target market focus to include the emerging consumer and non-government enterprise marketplace.

Our biometric technology is a core software component of an organization's security infrastructure and includes a multi-biometric identity management solution for enrolling, managing, identifying and verifying the identities of people by the physical characteristics of the human body. We develop, sell and support various identity management capabilities within government (federal, state and local), law enforcement, commercial enterprises, and transportation and aviation markets for identification and verification purposes. Our IWS Biometric Engine is a patented biometric identity management software platform for multi-biometric enrollment, management and authentication, managing population databases of virtually unlimited sizes. It is hardware agnostic and can utilize different types of biometric algorithms. It allows different types of biometrics to be operated at the same time on a seamlessly integrated platform. It is also offered as a Software Development Kit ("*SDK*") based search engine, enabling developers and system integrators to implement a biometric solution or integrate biometric capabilities into existing applications without having to derive biometric functionality from pre-existing applications. The IWS Biometric Engine combined with our secure credential platform, IWS EPI Builder, provides a comprehensive, integrated biometric and secure credential solution that can be leveraged for high-end applications such as passports, driver licenses, national IDs, and other secure documents.

Our law enforcement solutions enable agencies to quickly capture, archive, search, retrieve, and share digital images, fingerprints and other biometrics as well as criminal history records on a stand-alone, networked, wireless or Web-based platform. We develop, sell and support a suite of modular software products used by law enforcement and public safety agencies to create and manage criminal history records and to investigate crime. Our IWS Law Enforcement solution consists of five software modules: Capture and Investigative modules, which provide a criminal booking system with related databases as well as the ability to create and print mug photo/SMT image lineups and electronic mugbooks; a Facial Recognition module, which uses biometric facial recognition to identify suspects; a Web module, which provides access to centrally stored records over the Internet in a connected or wireless fashion; and a LiveScan module, which incorporates LiveScan capabilities into IWS Law Enforcement providing integrated fingerprint and palm print biometric management for civil and law enforcement use. The IWS Biometric Engine is also available to our law enforcement clients and allows them to capture and search using other biometrics such as iris or DNA.

Our secure credential solutions empower customers to create secure and smart digital identification documents with complete ID systems. We develop, sell and support software and design systems which utilize digital imaging and biometrics in the production of photo identification cards, credentials and identification systems. Our products in this market consist of IWS EPI Suite and IWS EPI Builder (an SDK). These products allow for the production of digital identification cards and related databases and records and can be used by, among others, schools, airports, hospitals, corporations or governments. We have added the ability to incorporate multiple biometrics into the ID systems with the integration of IWS Biometric Engine to our secure credential product line.

Our enterprise authentication software includes the IWS Desktop Security product which is a comprehensive authentication management infrastructure solution providing added layers of security to workstations, networks and systems through advanced encryption and authentication technologies. IWS Desktop Security is optimized to enhance network security and usability, and uses multi-factor authentication methods to protect access, verify identity and help secure the computing environment without sacrificing ease-of-use features such as quick login. Additionally, IWS Desktop Security provides an easy integration with various smart card-based credentials including the CAC credentials, HSPD-12, PIV credentials, and TWIC with an organization's access control process. IWS Desktop Security provides the crucial end-point component of a LACS, and when combined with a Physical Access Control System ("*PACS*"), organizations benefit from a complete door to desktop access control and security model.

**Recent Developments**

*Series E Preferred Stock Financing*

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

In February 2015 the Company completed a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*"). Approximately 2,000 shares were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit, as defined below, was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10.0 million, with net proceeds of approximately $9.925 million after deducting offering expenses of approximately $75,000.

*Amendment to 1999 Stock Option Plan*

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

*Settlement of Blue Spike Matter*

On August 21, 2012, a complaint for patent infringement was filed by BlueSpike against the Company in the United States District Court for the Eastern District of Texas, entitled Blue Spike, LLC v. ImageWare Systems, Inc., Case No. 12-cv-688-LED. The four Patents were related to digital signal abstracting technology. On October 20, 2014, the Company and Blue Spike entered into the Settlement Agreement, wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

*Lines of Credit*

At December 31, 2014, the Company had two unsecured lines of credit, one with maximum available borrowings of up to $5.0 million that matures in March 2017 (the "*Line of Credit*") and another with maximum available borrowings of up to $500,000 that matures in March 2015 (the "*$500K Line of Credit*") (together, the "*Lines of Credit*"). The Lines of Credit were extended by two existing members of our Board of Directors (the "*Holders*") and, at the election of the Holders, are convertible into shares of the Company's Common Stock at prices ranging from $0.95 per share to $2.30 per share, in accordance with the terms and conditions of the Lines of Credit.

Advances under the Lines of Credit are made at the Company's request. Up to the date of the Series E Financing, the Company received $1.95 million in advances under the Line of Credit and no advances under the $500K Line of Credit. As a result of the Series E Financing, approximately 2,000 shares of Series E Preferred were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1.95 million in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

**Critical Accounting Estimates**

The discussion and analysis of our consolidated financial condition and results of operations are based on our 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 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 consolidated financial statements and the reported amounts of revenues and expenses during a fiscal period. The Securities and Exchange Commission ("*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.

The following are our critical accounting policies because we believe they are both important to the portrayal of our financial condition and results of operations and require critical management judgments and estimates about matters that are uncertain. If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected.

***Revenue Recognition.*** Our revenue recognition policy is significant because our revenue is a key component of our consolidated results of operations. We recognize 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; and
- Lost contract customer support ("*PCS*")

The Company's revenue recognition policies are consistent with U.S. GAAP including 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: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable, and collectability is reasonably assured.

We recognize revenue and profit as work progresses on long-term, fixed-price contracts involving significant amount of hardware and software customization using the percentage of completion method based on costs incurred to date compared to total estimated costs at completion. Revenue from contracts for which we cannot reliably estimate total costs or there are not significant amounts of customization are recognized upon completion. Determining when a contract should be accounted for using the percentage of completion method involves judgment. Critical items that are considered in this process are the degree of customization and related labor hours necessary to complete the required work as well as ongoing estimates of the future labor hours needed to complete the contract. We also generate non-recurring revenue from the licensing of our software. Software license revenue is recognized upon the execution of a license agreement, upon deliverance, when fees are fixed and determinable, collectability is probable, when all other significant obligations have been fulfilled and the Company has obtained vendor specific objective evidence ("*VSOE*") of the fair value of the undelivered element. VSOE of fair value for customer support services is determined by reference to the price the customer pays for such element when sold separately; that is, the renewal rate offered to customers. In those instances when objective and reliable evidence of fair value exists for the undelivered items but not for the delivered items, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of arrangement consideration allocated to the delivered items equals the total arrangement consideration less the aggregate fair value of the undelivered items. We also generate 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. Pricing of maintenance contracts is consistent period to period and calculated as a percentage of the software or hardware revenue. Amounts collected in advance for maintenance services are included in current liabilities under "Deferred revenues." Sales tax collected from customers is excluded from revenue.

***Allowance for Doubtful Accounts.*** We provide an allowance for our accounts receivable for estimated losses that may result from our customers' inability to pay. We determine the amount of allowance by analyzing historical losses, customer concentrations, customer creditworthiness, current economic trends, the age of the accounts receivable balances and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was $266,000, net of allowance for doubtful accounts of $3,000 at December 31, 2014. Our accounts receivable balance was $302,000, net of allowance for doubtful accounts of $3,000 at December 31, 2013. Our accounts receivable balance was $328,000, net of allowance for doubtful accounts of $3,000 at December 31, 2012.

***Valuation of Goodwill, Other Intangible and Long-Lived Assets.*** The Company accounts for its intangible assets under the provisions of ASC 350, "*Intangibles - Goodwill and Other*". In accordance with ASC 350, intangible assets with a definite life are analyzed for impairment under ASC 360-10-05 and intangible assets with an indefinite life are analyzed for impairment under ASC 360. In accordance with ASC 350, goodwill, or the excess of cost over fair value of net assets acquired is tested for impairment using a fair value approach at the "reporting unit" level. A reporting unit is the operating segment, or a business one level below that operating segment (referred to as a component) if discrete financial information is prepared and regularly reviewed by management at the component level. The Company's reporting unit is at the entity level. The Company recognizes an impairment charge for any amount by which the carrying amount of a reporting unit's goodwill exceeds its fair value. The Company uses fair value methodologies to establish fair values.

We assess impairment of goodwill and identifiable intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to historical or expected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy of our overall business; and
- Significant negative industry or economic trends.

The Company annually, or more frequently if events or circumstances indicate a need, tests the carrying amount of goodwill for impairment. The Company performs its annual impairment test in the fourth quarter of each year. 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 units to the carrying value of the reporting unit. The Company determined that its only reporting unit is Identity Management. Based on the results of this impairment test, the Company determined that its goodwill assets were not impaired as of December 31, 2014.

The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate their net book value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. Impairment, if any, is based on the excess of the carrying amount over the fair value, based on market value when available, or discounted expected cash flows, of those assets and is recorded in the period in which the determination is made. The Company's management currently believes there is no impairment of its long-lived assets. There can be no assurance, however, that market conditions will not change or demand for the Company's products under development will continue. Either of these could result in future impairment of long-lived assets.

There are many management assumptions and estimates underlying the determination of an impairment loss, and estimates using different, but reasonable, assumptions could produce significantly different results. Significant assumptions include estimates of future levels of revenues and operating expenses. Therefore, the timing and recognition of impairment losses by us in the future, if any, may be highly dependent upon our estimates and assumptions. There can be no assurance that goodwill impairment will not occur in the future.

Goodwill and other net intangible assets amounted to approximately $3,560,000 at December 31, 2014, $3,588,000 at December 31, 2013, and $3,616,000 at December 31, 2012.

***Stock-Based Compensation.*** At December 31, 2014, 2013 and 2012, the Company had two 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 for all share-based payment awards is recognized using the straight-line single-option method. 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 stock option grants was approximately $618,000, $575,000 and $571,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

In January 2010, the Company issued 847,258 shares of restricted stock to members of management and the Board as compensation for the cancellation of options to purchase 1,412,096 shares of the Company's Common Stock. The restricted shares vested in quarterly increments over a three-year period, and became fully vested in January 2013. 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. Although the Company recorded $37,000 in compensation expense related to the restricted shares in the year ended December 31, 2012, no compensation expense was recorded for the 2013 and 2014 periods.

ASC 718 requires the use of a valuation model to calculate the fair value of stock-based awards. For the years ended December 31, 2014, 2013 and 2012, 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 ranged from 71% to 73% for the grants issued during the year ended December 31, 2014, as compared to 78% to 86% for the grants issued during the years ended December 31, 2013 and 2012. 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 to value the grants issued in 2014, 2013 and 2012 as computed by this method was 5.9 years. The effect of 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 were 2.6% for the years ended December 31, 2014, 2013 and 2012. Dividend yield is zero as the Company does not expect to declare any dividends on the Company's common shares 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.

***Income Taxes.*** The Company accounts for income taxes in accordance with ASC 740, "*Accounting for Income Taxes*." Deferred income taxes are recognized for the tax consequences related to temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for tax purposes at each year-end, based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. A valuation allowance is established when necessary based on the weight of available evidence, if it is considered more likely than not that all or some portion of the deferred tax assets will not be realized. Income tax expense is the sum of current income tax plus the change in deferred tax assets and liabilities.

ASC 740-10 requires a company to first determine whether it is more-likely-than-not (defined as a likelihood of more than fifty percent) that a tax position will be sustained based on its technical merits as of the reporting date, assuming that taxing authorities will examine the position and have full knowledge of all relevant information. A tax position that meets this more-likely-than-not threshold is then measured and recognized at the largest amount of benefit that is greater than fifty percent likely to be realized upon effective settlement with a taxing authority.

We recognize and measure uncertain tax positions in accordance with U.S. GAAP, pursuant to which we only recognize the tax benefit from an uncertain tax position if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. Any tax benefits recognized in the consolidated financial statements from such positions are then measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. We report a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. U.S. GAAP further requires that a change in judgment related to the expected ultimate resolution of uncertain tax positions be recognized in earnings in the quarter of such change. We recognize interest and penalties, if any, related to unrecognized tax benefits in income tax expense.

We file annual income tax returns in multiple taxing jurisdictions around the world. A number of years may elapse before an uncertain tax position is audited and finally resolved. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, we believe that our analysis of income tax reserves reflects the most likely outcome. We adjust these reserves, if any, as well as the related interest, in light of changing facts and circumstances. Settlement of any particular position could require the use of cash.

Significant judgment is required in evaluating the Company's uncertain tax positions and determining the Company's provision for income taxes. No assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in the Company's historical income tax provisions and accruals. The Company adjusts these items in light of changing facts and circumstances. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made.

The Internal Revenue Code (the "*Code*") limits the availability of certain tax credits and net operating losses that arose prior to certain cumulative changes in a corporation's ownership resulting in a change of control of the Company. The Company's use of its net operating loss carryforwards and tax credit carryforwards will be significantly limited because the Company believes it underwent "ownership changes," as defined under Section 382 of the Internal Revenue Code, in 1991, 1995, 2000, 2003, 2004, 2011 and 2012, though the Company has not performed a study to determine the limitation. The Company has reduced its deferred tax assets to zero relating to its federal and state research credits because of such limitations. The Company continues to disclose the tax effect of the net operating loss carryforwards at their original amount as the actual limitation has not yet been quantified. The Company has also established a full valuation allowance for substantially all deferred tax assets due to uncertainties surrounding its ability to generate future taxable income to realize these assets. Since substantially all deferred tax assets are fully reserved, future changes in tax benefits will not impact the effective tax rate. Management periodically evaluates the recoverability of the deferred tax assets. If it is determined at some time in the future that it is more likely than not that deferred tax assets will be realized, the valuation allowance would be reduced accordingly at that time.

***Fair-Value Measurements.*** 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). |

Assessing the significance of a particular input to the fair value measurement requires judgment, considering factors specific to the asset or liability. Determining whether a fair value measurement is based on Level 1, Level 2, or Level 3 inputs is important because certain disclosures are applicable only to those fair value measurements that use Level 3 inputs. The use of Level 3 inputs may include information derived through extrapolation or interpolation which involves management assumptions.

***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 the common and preferred stock, warrants and convertible debt it issues to determine whether there are embedded derivative instruments, including embedded conversion options, which are required to 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, that is required to be bifurcated, 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.

For a detailed discussion on the application of these and other accounting policies, see Note 2 in the Notes to the Consolidated Financial Statements beginning on page F-12.

**Results of Operations**

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

**Comparison of Results for Fiscal Years Ended December 31, 2014, 2013 and 2012**

***Product Revenue***

| Net Product Revenue (dollars in thousands) | Year Ended December 31, 2014 | $ Change | % Change | Year Ended December 31, 2013 | $ Change | % Change | Year Ended December 31, 2012 |
|---|---|---|---|---|---|---|---|
| Software and royalties | $ 1,313 | $ (1,124) | (46)% | $ 2,437 | $ 1,491 | 158% | $ 946 |
| *Percentage of total net product revenue* | 80% | | | 91% | | | 83% |
| Hardware and consumables | $ 110 | $ 32 | 41 % | $ 78 | $ (60) | (43)% | $ 138 |
| *Percentage of total net product revenue* | 7% | | | 3% | | | 12% |
| Services | $ 211 | $ 40 | 23 % | $ 171 | $ 110 | 180% | $ 61 |
| *Percentage of total net product revenue* | 13% | | | 6% | | | 5% |
| Total net product revenue | $ 1,634 | $ (1,052) | (39)% | $ 2,686 | $ 1,541 | 135% | $ 1,145 |

Software and royalty revenue decreased 46% or approximately $1,124,000 during the year ended December 31, 2014 as compared to the corresponding period in 2013. This decrease is due to lower sales of identification software licenses of approximately $1,383,000, lower sales of boxed identity management software sold through our distribution channel of approximately $31,000 and lower law enforcement project related revenues of approximately $116,000, offset by higher identification software royalties of approximately $406,000. The decrease in identification software license revenue received during the year ended December 31, 2014 compared to the 2013 period is principally due to the positive impact of non-recurring revenue received from one customer during the 2013 period.

Software and royalty revenue increased 158% or approximately $1,491,000 during the year ended December 31, 2013 as compared to the corresponding period in 2012. This increase is due to higher sales of identification software license revenue of approximately $1,528,000 and higher law enforcement project related revenue of approximately $27,000, offset by lower sales of our boxed identity management software sold through our distribution channel of approximately $24,000 and lower royalty revenue of approximately $40,000 for the year ended December 31, 2013 as compared to the corresponding period of 2012.

Revenue from the sale of hardware and consumables increased 41% or approximately $32,000 during the year ended December 31, 2014 as compared to the corresponding period in 2013. This increase is due to higher sales of hardware and consumables into project solutions for the year ended December 31, 2014. During the 2013 period, revenue from the sale of hardware and consumables decreased 43% or approximately $60,000 as compared to the corresponding period in 2012. The decrease for the 2013 compared to the 2012 periods reflect lower revenue 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 23% or approximately $40,000 during the year ended December 31, 2014 as compared to the corresponding period in 2013, due primarily to the completion of the service elements in certain law enforcement and identification project solutions. Such revenue increased 180% or approximately $110,000 during the year ended December 31, 2013 as compared to the corresponding period in 2012, due primarily to the completion of the service elements 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 year ended December 31, 2014, we continued to accelerate our efforts to move the Biometric Engine into cloud and mobile markets, and expanded our end-user market into non-government sectors including commercial, consumer and healthcare applications. We anticipate that we will see positive developments from these efforts in the first half of 2015, which should help us to begin to smooth out our period-to-period fluctuations in revenue and enable us to provide better visibility into the timing of future revenues.

***Maintenance Revenue***

| **Net Maintenance Revenue (dollars in thousands)** | **Year Ended December 31, 2014** | **$ Change** | **% Change** | **Year Ended December 31, 2013** | **$ Change** | **% Change** | **Year Ended December 31, 2012** |
|---|---|---|---|---|---|---|---|
| Maintenance Revenue | $ 2,525 | $ (93) | (4)% | $ 2,618 | $ (188) | (7)% | $ 2,806 |

Maintenance revenue was approximately $2,525,000 for the year ended December 31, 2014, as compared to approximately $2,618,000 and $2,806,000 for the corresponding periods in 2013 and 2012, respectively. For the year ended December 31, 2014, identity management maintenance revenue was approximately $971,000 as compared to $921,000 for the comparable period in 2013. The increase is due to the expansion on the Company's identity management installed base. Law enforcement maintenance revenue was approximately $1,554,000 for the twelve months ended December 2014 as compared to $1,697,000 for the comparable period in 2013. The decrease is primarily due to the expiration of certain law enforcement maintenance contracts.

For the year ended December 31, 2013, maintenance revenues decreased approximately $188,000 as compared to the comparable period in 2012 due primarily to the expiration of certain law enforcement maintenance contracts.

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

***Cost of Product Revenue***

| **Cost of Product Revenue (dollars in thousands)** | **Year Ended December 31, 2014** | **$ Change** | **% Change** | **Year Ended December 31, 2013** | **$ Change** | **% Change** | **Year Ended December 31, 2012** |
|---|---|---|---|---|---|---|---|
| Software and royalties | $ 66 | $ (78) | (54)% | $ 144 | $ 28 | 24% | $ 116 |
| *Percentage of software and royalty product revenue* | 5% | | | 6% | | | 12% |
| Hardware and consumables | $ 91 | $ 23 | 34% | $ 68 | $ (2) | (3)% | $ 70 |
| *Percentage of hardware and consumables product revenue* | 83% | | | 87% | | | 51% |
| Services | $ 100 | $ (7) | (7)% | $ 107 | $ 66 | 161% | $ 41 |
| *Percentage of services product revenue* | 47% | | | 63% | | | 67% |
| Total cost of product revenue | $ 257 | $ (62) | (19)% | $ 319 | $ 92 | 41% | $ 227 |
| *Percentage of total product revenue* | 16% | | | 12% | | | 20% |

The cost of software and royalty product revenue decreased 54% or approximately $78,000 during the year ended December 31, 2014 as compared to the corresponding period in 2013. This decrease primarily reflects lower software and royalty revenue of approximately $1,124,000. The cost of software and royalty product revenue increased during the year ended December 31, 2013 as compared to the corresponding period in 2012 due primarily to the positive impact of non-recurring revenue received from one customer in the 2013 period. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

The cost of product revenue for our hardware and consumable sales during the year ended December 31, 2014 increased approximately $23,000 as compared to the corresponding period in 2013, primarily due to increased sales of hardware and consumable during the year ended December 31, 2014 as compared to the corresponding period of 2013. During the year ended December 31, 2013, our cost of product revenue for our hardware and consumable sales decreased by approximately $2,000, as compared to the corresponding period in 2012, as a result of the overall decrease in hardware and consumable revenue for the year ended December 31, 2013.

Cost of services revenue decreased 7% or approximately $7,000 during the year ended December 31, 2014 as compared to the corresponding period in 2013 despite higher services product revenue of approximately of $40,000 for the year ended December 31, 2014 as compared to the corresponding period of 2013. This inverse relationship was caused by the 2013 year containing the completion of several smaller law enforcement projects with uncharacteristically high cost of service revenue as compared to the 2014 containing the completion of a large identity management project at relatively low cost of service revenue. Cost of service revenue can vary depending upon the complexity of the project solution and the mix of labor resources utilized to complete the service element.

***Cost of Maintenance Revenue***

| **Maintenance cost of revenue (dollars in thousands)** | **Year Ended December 31, 2014** | **$ Change** | **% Change** | **Year Ended December 31, 2013** | **$ Change** | **% Change** | **Year Ended December 31, 2012** |
|---|---|---|---|---|---|---|---|
| Total maintenance cost of revenue | $ 735 | $ (36) | (5)% | $ 771 | $ (204) | (21)% | $ 975 |
| *Percentage of total maintenance revenue* | 29 % | | | 29% | | | 35% |

Cost of maintenance revenue decreased 5% or approximately $36,000 during the year ended December 31, 2014, as compared to the corresponding period in 2013 due to lower maintenance revenues of approximately $93,000 and lower non-labor related maintenance costs. Cost of maintenance revenue decreased 21% or approximately $204,000 during the year ended December 31, 2013 as compared to the corresponding period in 2012 due to lower maintenance revenue of approximately $188,000 combined with the movement of our technical support functions from our Canadian office to our San Diego office during the fiscal 2012. The decrease in the cost of maintenance revenue as a percentage of maintenance revenue from 35% for the year ended December 31, 2012 to 29% for the corresponding period of 2013 reflect the cost savings realized by the movement of the technical support functions to our San Diego office.

***Product Gross Profit***

| Product gross profit (dollars in thousands) | Years Ended December 31, 2014 | $ Change | % Change | Years Ended December 31, 2013 | $ Change | % Change | Years Ended December 31, 2012 |
|---|---|---|---|---|---|---|---|
| Software and royalties | $ 1,247 | $ (1,046) | (46)% | $ 2,293 | $ 1,463 | 176% | $ 830 |
| *Percentage of software and royalty product revenue* | 95% | | | 94% | | | 88% |
| Hardware and consumables | $ 19 | $ 9 | 90% | $ 10 | $ (58) | (85)% | $ 68 |
| *Percentage of hardware and consumables product revenue* | 17% | | | 13% | | | 49% |
| Services | $ 111 | $ 47 | 73% | $ 64 | $ 44 | 220% | $ 20 |
| *Percentage of services product revenue* | 53% | | | 37% | | | 33% |
| Total product gross profit | $ 1,377 | $ (990) | (42)% | $ 2,367 | $ 1,449 | 158% | $ 918 |
| *Percentage of total product revenue* | 84% | | | 88% | | | 80% |

Software and royalty gross profit decreased 46% or approximately $1,046,000 for the year ended December 31, 2014, as compared to the corresponding period in 2013, due primarily to lower software and royalty product revenues of approximately $1,124,000 offset by lower cost of software and royalty product revenues of approximately $78,000. This decrease is principally due to the positive impact of non-recurring revenue received from one customer who accounted for approximately 42% or 2,211,000 of our total revenue during the 2013 period. Software and royalty gross profit increased 176% or approximately $1,463,000 for the year ended December 31, 2013 from the corresponding period in 2012 due primarily to higher software product sales of approximately $1,491,000. In addition to changes in costs of software and royalty product revenue caused by revenue level fluctuations, costs of products can vary as a percentage of product revenue from period to period depending upon level of software customization and third party software license content included in product sales during a given period.

Hardware and consumables gross profit increased 90% or approximately $9,000 for the year ended December 31, 2014, as compared to the 2013 period. This increase was primarily due to the higher sales of hardware and consumables during the 2014 period. Conversely, hardware and consumables gross profit decreased 85% or approximately $58,000 for the year ended December 31, 2013 from the corresponding period in 2012, due to lower hardware and consumables product revenues of approximately $60,000.

Services gross profit increased 73% or approximately $47,000 during the year ended December 31, 2014, as compared to the corresponding period in 2013. This increase reflects higher services revenues of approximately $40,000 related to project-oriented work during the year ended December 31, 2014. The Company experienced a similar increase during the year ended December 31, 2013 when compared to the 2012 period, also resulting from higher service revenues.

***Maintenance Gross Profit***

| Maintenance gross profit (dollars in thousands) | Year Ended December 31, 2014 | $ Change | % Change | Year Ended December 31, 2013 | $ Change | % Change | Year Ended December 31, 2012 |
|---|---|---|---|---|---|---|---|
| Total maintenance gross profit | $ 1,791 | $ (56) | (3)% | $ 1,847 | $ 16 | 1% | $ 1,831 |
| *Percentage of total maintenance revenue* | 71% | | | 71% | | | 65% |

Gross margins related to maintenance revenue were 71% for the years ended December 31, 2014 and 2013. The dollar decrease of approximately $56,000 for the 2014 year as compared to the corresponding 2013 period primarily resulted from lower maintenance revenue of approximately $93,000 for the year ended December 31, 2014 as compared to the corresponding period in 2013 offset by lower cost of maintenance revenue of approximately $36,000 for the 2014 year as compared to the 2013 year. Gross margins related to maintenance revenue for the year ended December 31, 2013 increased to 71% from 65% for the same period ended 2012, due to lower maintenance cost of revenue resulting from reduced costs incurred from the movement of certain technical support functions from our Canadian office to our San Diego office during fiscal 2013.

***Operating Expense***

| **Operating Expense (dollars in thousands)** | **Year Ended December 31, 2014** | **$ Change** | **% Change** | **Year Ended December 31, 2013** | **$ Change** | **% Change** | **Year Ended December 31, 2012** |
|---|---|---|---|---|---|---|---|
| General and administrative | $ 3,818 | $ 440 | 13% | $ 3,378 | $ (52) | (2)% | $ 3,430 |
| *Percentage of total net revenue* | 92% | | | 64% | | | 87% |
| Sales and marketing | $ 2,471 | $ 342 | 16% | $ 2,129 | $ 299 | 16% | $ 1,830 |
| *Percentage of total net revenue* | 59% | | | 40% | | | 46% |
| Research and development | $ 4,495 | $ 626 | 16% | $ 3,869 | $ 689 | 22% | $ 3,180 |
| *Percentage of total net revenue* | 108% | | | 73% | | | 80% |
| Depreciation and amortization | $ 179 | $ 54 | 43% | $ 125 | $ 56 | 81% | $ 69 |
| *Percentage of total net revenue* | 4% | | | 2% | | | 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 $440,000 in general and administrative expense for the year ended December 31, 2014, as compared to the corresponding period in 2013, is comprised of the following major components:

- Increase in professional fees including consulting services and contract services of approximately $349,000 due primarily to increases in audit related fees of approximately $41,000, increases in various consulting and contract services of approximately $105,000, increase in legal fees of approximately $217,000, increases in patent expenses of approximately $35,000, offset by decreases in Board of Director fees of approximately $49,000.

- Increase in personnel related expense of approximately $22,000 due to fringe benefit increases.

- Increase in stock-based compensation expense of approximately $23,000.

- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately $46,000.

The dollar decrease of approximately $52,000 in general and administrative expense for the year ended December 31, 2013, as compared to the corresponding period in 2012, is comprised of the following major components:

- Decrease in professional fees including consulting services and contract services of approximately $304,000 due primarily to decreases in audit related fees of approximately $134,000, decreases in various consulting and contract services of approximately $99,000, decreases in patent expenses of approximately $164,000 offset by increases in Board of Director fees of approximately $93,000.

- Increase in personnel related expense of approximately $190,000 due to headcount increases.

- Decrease in stock-based compensation expense of approximately $23,000.

- Increase in travel, insurances, licenses, dues, rent, and office related costs of approximately $85,000.

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 Expense***

Sales and marketing expense consists primarily of the salaries, commissions, other incentive compensation, employee benefits and travel expense of our sales, marketing, and business development.

The dollar increase in sales and marketing expense of approximately $342,000 during the year ended December 31, 2014, as compared to the corresponding period in 2013, is primarily comprised of the following major components:

- Increase in personnel related expense of approximately $195,000 due primarily to headcount increases.

- Increase in travel and trade show expenses of approximately $100,000.

  Increase in our Mexico sales office expense of approximately $60,000.

- Increase in contract services and marketing partnership fees of approximately $8,000 offset by decreases in office related expenses of approximately $31,000.

- Increase in stock-based compensation of approximately $10,000.

The dollar increase in sales and marketing expense of approximately $299,000 during the year ended December 31, 2013, as compared to the corresponding period in 2012, is primarily comprised of the following major components:

- Increase in personnel related expense of approximately $190,000 due primarily to headcount increases.

- Increase in professional services of approximately $64,000.

- Increase in contract services and marketing partnership fees of approximately $89,000 offset by decreases in travel and trade show expenses and office related expenses of approximately $39,000.

- Decrease in stock-based compensation of approximately $5,000.

We anticipate that the level of expense incurred for sales and marketing during the year ended December 31, 2015 will increase as we pursue large project solution opportunities.

***Research and Development Expense***

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.

Research and development expense increased approximately $626,000 for the year ended December 31, 2014, as compared to the corresponding period in 2013, due primarily to the following major components:

- Increase in personnel expenditures of approximately $194,000 due to headcount increases combined with increases in contractor and contract services of approximately $369,000.

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

- Increase in stock-based compensation of approximately $9,000.

Research and development expense increased approximately $689,000 for the year ended December 31, 2013, as compared to the corresponding period in 2012, due primarily to the following major components:

- Increase in personnel expenditures of approximately $493,000 due to headcount increases combined with increases in contractor and contract services of approximately $152,000.

- Increase in travel, rent and office related costs of approximately $50,000.

- Decrease in stock-based compensation of approximately $6,000.

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 as well as continue to enhance existing products.

***Depreciation and Amortization***

During the year ended December 31, 2014, depreciation and amortization expense increased approximately $54,000 as compared to the corresponding period in 2013. During the year ended December 31, 2013, depreciation and amortization expense increased approximately $56,000 as compared to the corresponding period in 2012. The increases during the 2014 and 2013 periods reflect higher depreciation expense on recent equipment purchases needed to replace older, obsolete equipment. The relatively small amount of depreciation and amortization in both periods is a reflection of the relatively small property and equipment carrying value.

***Interest Expense (Income), Net***

For the year ended December 31, 2014, we recognized interest income of $29,000 and interest expense of $445,000. For the year ended December 31, 2013, we recognized interest income of $1,000 and interest expense of $222,000. For the year ended December 31, 2012, we recognized interest income of $3,000 and interest expense of $21,000.

Interest expense for the year ended December 31, 2014 contains the following components:

- Approximately $369,000 of amortization expense of deferred financing fees related to the Lines of Credit;
- Approximately $56,000 of amortization expense of recognized beneficial conversion feature related to the Lines of Credit borrowings;
- Approximately $19,000 related to coupon interest on our 7% related party convertible notes and 8% Line of Credit borrowings, and
- Approximately $1,000 related to miscellaneous interest charges.

Interest income of approximately $29,000 relates to interest charges to certain customers.

Interest expense for the year ended December 31, 2013 contains the following components:

- Coupon interest of approximately $4,000 related to our Related Party Convertible Notes; and
- Deferred financing fee amortization expense of approximately $218,000.

Interest expense for the year ended December 31, 2012 contains the following components:

- Coupon interest on secured notes payable and convertible notes payable of approximately $5,000; and
- Other interest expense of approximately $16,000.

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

For the years ended December 31, 2014, 2013 and 2012, we recognized non-cash expenses of approximately $0, $4,776,000 and $4,712,000, respectively. This expense is related to the change in fair value of the Company’s derivative liabilities associated with the anti-dilution provisions in certain warrants to purchase shares of our Common Stock. The derivative liabilities were revalued using available market information and commonly accepted valuation methodologies. During the three months ended March 31, 2014, all remaining warrants qualifying for derivative liability treatment were exercised for cash proceeds of $20,000 resulting in the issuance of 40,000 shares of the Company’s Common Stock with an aggregate fair value of approximately $57,000.

***Other Income, Net***

For the year ended December 31, 2014, we recognized other income of approximately $297,000 and other expense of $0. Other income for the year ended December 31, 2014 is comprised of approximately $223,000 from the write off of certain accounts payable and accrued expenses due the expiration of the legal statute of limitations on such liabilities, approximately $35,000 relating to the litigation settlement of certain patent infringement matters in favor of the Company, approximately $37,000 from the return of an advertising deposit previously written off due to uncertainties regarding its return and $2,000 in miscellaneous receipts. For the year ended December 31, 2013, we recognized other income of $446,000 and other expense of $3,000. Other income for the year ended December 31, 2013 is comprised of approximately $440,000 from the write off of certain accounts payable and accrued expenses due the expiration of the legal statute of limitations on such liabilities and $6,000 in miscellaneous receipts. For the year ended December 31, 2012, we recognized other income of $336,000 and other expense of $14,000. Other income for the year ended December 31, 2012 contains approximately $336,000 from the write off of certain accounts payable due to the expiration of the legal statute of limitations on such account payable.

***Income Tax Expense***

During the year ended December 2014, we recorded an expense of $25,000 from income taxes, as compared to an expense of $8,000 for the year ended December 31, 2013, and expense of $22,000 for the year ended December 31, 2012.

During the year ended December 31, 2014, our expense for income taxes of $25,000 related to taxes on income generated in certain foreign jurisdictions offset by research and development tax credits generated in certain foreign jurisdictions.

During the year ended December 31, 2013, our expense for income taxes of $8,000 related to taxes on income generated in certain foreign jurisdictions offset by research and development tax credits generated in certain foreign jurisdictions.

We have incurred consolidated pre-tax losses during the years ended December 31, 2014, 2013 and 2012, and have incurred operating losses in all periods prior to 2009. Management has determined that it is more likely than not that a tax benefit from such losses will not be realized. Accordingly, we did not record a benefit for income taxes for these periods.

**Liquidity and Capital Resources**

At December 31, 2014, our principal sources of liquidity consisted of cash and cash equivalents of $218,000 and accounts receivable, net of $266,000. As of December 31, 2014, we had negative working capital of $1,813,000, which included $1,827,000 of deferred revenue. We have a history of recurring losses, and as of December 31, 2014, we have incurred a cumulative net loss of approximately $136,294,000.

During the year ended December 31, 2014, we borrowed an aggregate of $1,550,000 under the Line of Credit for working capital purposes, and have not made any advances under the $500K Line of Credit. Subsequent to December 31, 2014, we borrowed $750,000 and repaid $350,000 under the Line of Credit borrowing facility. In February 2015 the Company consummated the Series E Financing resulting in the issuance of 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share. Approximately 2,000 shares of Series E Preferred were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing the Company's borrowing capacity under the Line of Credit was reduced to $3,050,000 and the $500K Line of Credit was terminated in accordance with its terms.

The Series E Financing resulted in gross proceeds to the Company of approximately $10.0 million, with net proceeds of approximately $9.925 million after deducting offering expenses of approximately $75,000.

As a result of the Series E Financing, we currently have remaining available borrowing capacity aggregating $3,050,000. Any outstanding balance under the Line of Credit is currently set to mature in March 2017, and all amounts due thereunder are required to be repaid at such time, unless the maturity date is extended or the outstanding balance is converted into shares of Common Stock at the option of the holder.

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

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

***Operating Activities***

Net cash used in operating activities was $6,422,000 during the year ended December 31, 2014 as compared to $4,851,000 during the year ended December 31, 2013 and $5,553,000 during the year ended December 31, 2012. During the year ended December 31, 2014, net cash used in operating activities consisted of net loss of $7,940,000 and an increase in operating cash from changes in assets and liabilities of $228,000. We also incurred $1,290,000 in net non-cash costs including $909,000 in stock based compensation (which includes $53,000 in warrants issued in lieu of cash as compensation), $426,000 in debt issuance cost amortization and debt discount amortization, and $179,000 in depreciation and amortization offset by $224,000 of non-cash income primarily from the write-off of certain accounts payable and accrued expenses due to the expiration of the statute of limitations. During the year ended December 31, 2014, we used cash of $314,000 to fund increases in current assets and generated cash of $542,000 through increases in current liabilities and deferred revenues, excluding debt.

The cash used in operations of $4,851,000 during the year ended December 31, 2013 consisted of net loss of $9,849,000 and a decrease in operating cash from changes in assets and liabilities of $404,000. Those amounts were offset by net non-cash costs of $5,402,000, including a $4,776,000 unrealized loss related to the change in value of our derivative liabilities, $724,000 in stock-based compensation (which includes $108,000 in warrants issued in lieu of cash as compensation), $217,000 in debt insurance cost amortization, and $125,000 in depreciation and intangible asset amortization offset by $440,000 of non-cash income primarily from the write-off of certain accounts payable and accrued expenses due to the expiration of the statute of limitations. During the year ended December 31, 2013, we used cash of $267,000 to fund increases in current assets and used cash of $137,000 through reductions in current liabilities and deferred revenues, excluding debt.

The cash used in operations of $5,553,000 during the year ended December 31, 2012 consisted of net loss of $10,190,000 and a decrease in operating cash from changes in assets and liabilities of $458,000. Those amounts were offset by net non-cash costs of $5,095,000, including a $4,712,000 unrealized loss related to the change in value of our derivative liabilities, $608,000 in stock based compensation and $69,000 in depreciation and amortization, $27,000 related to warrants issued in lieu of cash, $15,000 in deferred financing fee expense offset by $336,000 of non-cash income from the write-off of certain accounts payable due to the expiration of the statute of limitations. During the year ended December 31, 2012, we used cash of $217,000 from increases in current assets and used cash of $241,000 through decreases in current liabilities and deferred revenues, excluding debt.

***Investing Activities***

Net cash used in investing activities was $117,000 for the year ended December 31, 2014, $193,000 for the year ended December 31, 2013 and $181,000 for the year ended December 31, 2012. For the year ended December 31, 2014, 2013 and 2012, we used cash to fund capital expenditures of computer equipment, software and furniture and fixtures. This level of equipment purchases resulted primarily from the replacement of older equipment.

***Financing Activities***

We generated cash of $4,414,000 from financing activities for the year ended December 31, 2014, as compared to $3,251,000 for the year ended December 31, 2013 and $3,260,000 for the year ended December 31, 2012. During the year ended December 31, 2014, we generated cash of $2,848,000 from the exercise of 4,742,632 Common Stock warrants and $67,000 from the exercise of 98,617 Common Stock options. We also generated cash of $1,550,000 from the issuance of notes payable with warrants resulting from borrowing under our Line of Credit. We used cash of $51,000 for the payment of dividends on our Series B Convertible Redeemable Preferred Stock ("*Series B Preferred*"). During the year ended December 31, 2013, we generated cash of $3,291,000 from the exercise of 6,132,779 Common Stock warrants and $11,000 from the exercise of 35,310 Common Stock options. We used cash of $51,000 for the payment of dividends on our Series B Preferred. During the year ended December 31, 2012, we generated cash of $3,527,000 from the exercise of 7,052,647 Common Stock warrants and $7,000 from the exercise of 24,924 Common Stock options. We used cash of $229,000 for the payment of dividends on our Series B Preferred and $45,000 for the repayment of notes payable.

***Debt***

At December 31, 2014, we had approximately $1,550,000 in outstanding debt, exclusive of any debt discounts, and $17,000 in related accrued interest, each related to the amounts borrowed under the Line of Credit.

*7% Convertible Promissory Notes to Related Parties*

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

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

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

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

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

In June 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of $55,000 into 100,000 shares of Common Stock of the Company. The holders also elected to convert approximately $30,000 in accrued interest into 54,607 shares of the Company's Common Stock and in August 2014 the holders exercised 136,364 warrants, on a cashless basis, resulting in the issuance of 105,451 shares of Common Stock.

*Lines of Credit*

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowings of up to $2,500,000 (the "*Line of Credit*"). The Line of Credit was extended by an existing shareholder and member of our Board of Directors (the "*Holder*"). In March 2014, the Line of Credit's borrowing was increased to an aggregate total of $3,500,000 (the "*Amendment*"). Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to $2.5 million of the outstanding balance of the Line of Credit into shares of the Company's Common Stock for $0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's Common Stock for $2.25 per share.

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

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

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

Advances under the Line of Credit 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 Qualified Financing

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 years ended December 31, 2014 and 2013, the Company recorded approximately $369,000 and $217,000 in deferred financing fee amortization expense, which is recorded as a component of interest expense in the Company's consolidated statement of operations.

The Company evaluated the Line of Credit and determined that the instrument contains a contingent beneficial conversion feature, i.e. an embedded conversion right that enables the holder to obtain the underlying Common Stock at a price below market value. The beneficial conversion feature is contingent as the terms of the conversion do not permit the Company to compute the number of shares that the holder would receive if the contingent event occurs (i.e. future borrowings under the 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). As of December 31, 2014, the Company has recognized approximately $296,000 in beneficial conversion feature as debt discount.

At December 31, 2014, advances made under the Line of Credit agreement aggregated $1,550,000 and there were no borrowings under the 500K Line of Credit. For the year ended December 31, 2014, the Company recorded approximately $56,000 in beneficial conversion feature amortization, which is recorded as a component of interest expense in the Company's consolidated statement of operations. For activity under the Lines of Credit subsequent to December 31, 2014, see Note 19, "*Subsequent Events*" below.

***Contractual Obligations***

Total contractual obligations and commercial commitments as of December 31, 2014 are summarized in the following table (in thousands):

| | Payment Due by Year | | | | |
|---|---|---|---|---|---|
| | **Total** | **Less than 1 Year** | **1-3 Years** | **3-5 Years** | **More than 5 Years** |
| Operating lease obligations | 448 | 448 | — | — | — |
| Convertible line of credit to related party | 1,550 | — | 1,550 | — | — |
| | $ 1,998 | 448 | 1,550 | — | — |

***Real Property Leases***

Our corporate headquarters are located in San Diego, California where we occupy 9,927 square feet of office space. This facility is leased through October 2017 at a cost of approximately $18,000 per month. In addition to our corporate headquarters, we also occupied the following spaces at December 31, 2014:

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

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

At December 31, 2014, future minimum lease payments are as follows:

| **($ in thousands)** | | |
|---|---|---|
| 2015 | $ | 448 |
| 2016 | $ | 422 |
| 2017 | $ | 386 |
| 2018 | $ | 168 |
| 2019 and thereafter | $ | — |
| | $ | 1,424 |

***Stock-based Compensation***

Stock-based compensation related to equity options and restricted stock has been classified as follows in the accompanying consolidated statements of operations (in thousands):

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2014** | **2013** | **2012** |
| Cost of revenues | $ 12 | 12 | 11 |
| General and administrative | 572 | 351 | 332 |
| Sales and marketing | 142 | 132 | 138 |
| Research and development | 130 | 121 | 127 |
| Total | $ 856 | 616 | 608 |

***Off-Balance Sheet Arrangements***

At December 31, 2014, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed elsewhere in this Annual Report.

**Recently Issued Accounting Pronouncements**

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

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

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

*FASB ASU No. 2014-15*. In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, which provides guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 will be effective in the fourth quarter of 2016, with early adoption permitted. The Company is currently evaluating the impact of its pending adoption of ASU 2014-15 on its consolidated financial statements.

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

*FASB ASU No. 2015-01.* In January 2015, the FASB issued ASU No. 2015-01, which amends ASC Subtopic 225-20, "*Income Statement – Extraordinary and Unusual Items*." The amendment in this ASU eliminates from GAAP the concept of extraordinary items. The amendments in this update are effective for interim and annual reporting periods beginning after December 15, 2015. We do not expect adoption of ASU No. 2015-01 to have a significant impact on our consolidated financial statements.

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

**Impact of Inflation**

The primary inflationary factor affecting our operations is labor costs and we do not believe that inflation has materially affected earnings during the past four years. Substantial increases in costs and expenses, particularly labor and operating expenses, could have a significant impact on our operating results to the extent that such increases cannot be passed along to customers and end users.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Each of our contracts require 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements as of and for the years ended December 31, 2014, 2013 and 2012 and the report of our independent registered public accounting firm are included in Item 15 of this Annual Report.

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 9A. CONTROLS AND PROCEDURES

### (a) 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 December 31, 2014. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were 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. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) in Internal Control—Integrated Framework.

### (b) Management's Annual Report on Internal Control over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes of accounting principles generally accepted in the United States.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance of achieving their control objectives.

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our internal control over financial reporting as of December 31, 2014. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) in Internal Control—Integrated Framework. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2014, our internal control over financial reporting was effective.

Mayer Hoffman McCann P.C. ("*MHM*"), our independent registered public accounting firm that audited our consolidated financial statements included in this Annual Report on Form 10-K, has issued an attestation report on the effectiveness of our internal control over financial reporting, which report is included in Part IV below.

**(c) 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, Company's internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Not applicable.

## PART III

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this item will be set forth in our definitive proxy statement for our 2015 annual meeting of stockholders to be filed within 120 days after our fiscal year end and is incorporated in this report by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item will be set forth in our definitive proxy statement for our 2015 annual meeting of stockholders to be filed within 120 days after our fiscal year end and is incorporated in this report by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDERS MATTERS**

The information required by this item will be set forth in our definitive proxy statement for our 2015 annual meeting of stockholders to be filed within 120 days after our fiscal year end and is incorporated in this report by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this item will be set forth in our definitive proxy statement for our 2015 annual meeting of stockholders to be filed within 120 days after our fiscal year end and is incorporated in this report by reference.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information required by this item will be set forth in our definitive proxy statement for our 2015 annual meeting of stockholders to be filed within 120 days after our fiscal year end and is incorporated in this report by reference

## PART IV

### ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this annual report:

| Exhibit No. | Description |
|---|---|
| 2.1 | Agreement and Plan of Merger, dated October 27, 2005 (incorporated by reference to Annex A to the Company’s Definitive Proxy Statement on Schedule 14A, filed November 15, 2005). |
| 3.1 | Certificate of Incorporation (incorporated by reference to Annex B to the Company’s Definitive Proxy Statement on Schedule 14A, filed November 15, 2005). |
| 3.2 | Certificate of Amendment to Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, filed October 14, 2011). |
| 3.3 | Bylaws (incorporated by reference to Annex C to the Company’s Definitive Proxy Statement on Schedule 14A, filed November 15, 2005). |
| 3.4 | Certificate of Designations, Preferences and Rights of the Series E Convertible Preferred Stock (incorporated by reference to Exhibit 3.1 to the Company’s Current Report on Form 8-K, filed February 2, 2015). |
| 4.1 | Form of Warrant to Purchase Common Stock dated September 5, 2008 (incorporated by reference to Exhibit 4.19 to the Company’s Annual Report on Form 10-K, filed February 24, 2010). |
| 4.2 | Warrant, dated March 12, 2014 (incorporated by reference to the Company’s Current Report on Form 8-K, filed March 13, 2014). |
| 4.3 | Warrant to Purchase Common Stock, dated February 12, 2009, issued by the Company to BET Funding, LLC (incorporated by reference to Exhibit 4.22 to the Company’s Annual Report on Form 10-K, filed February 24, 2010). |
| 4.4 | Warrant to Purchase Common Stock, dated June 22, 2009, issued by the Company to BET Funding, LLC (incorporated by reference to Exhibit 4.24 to the Company’s Annual Report on Form 10-K, filed February 24, 2010). |
| 4.5 | Warrant to Purchase Common Stock, dated October 5, 2009, issued by the Company to BET Funding, LLC (incorporated by reference to Exhibit 4.25 to the Company’s Annual Report on Form 10-K, filed February 24, 2010). |
| 4.6 | Warrant to Purchase Common Stock, dated December 12, 2011(incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on December 21, 2011). |
| 4.7 | Registration Rights Agreement, dated December 12, 2011, by and between the Company and certain accredited investors (incorporated by reference to Exhibit 10.4 to the Company’s Current Report on Form 8-K, filed December 21, 2011). |

| | |
|---|---|
| 4.8 | Form of Amendment to Warrant, dated December 14, 2011 (incorporated by reference to Exhibit 4.15 to the Company's Current Report on Form 10-K, filed January 17, 2012). |
| 4.9 | Form of Amendment to Warrant, dated March 21, 2012, (incorporated by reference to Exhibit 4.16 to the Company's Annual Report on Form 10-K, filed April 4, 2012). |
| 4.10 | Warrant to Purchase Common Stock, dated March 28, 2013 issued by the Company to Neal Goldman (incorporated by reference to Exhibit 4.15 to the Company's Annual Report on Form 10-K, filed April 1, 2013). |
| 4.11 | Warrant, dated March 12, 2014 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed March 13, 2014). |
| 10.1 | Employment Agreement, dated September 27, 2005, between the Company and S. James Miller (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed September 30, 2005). |
| 10.2 | Form of Indemnification Agreement entered into by the Company with its directors and executive officers (incorporated by reference to Exhibit 10.4 to the Company's Registration Statement on Form SB-2 (No. 333-93131), filed December 20, 1999, as amended). |
| 10.3 | Amended and Restated 1999 Stock Plan Award (incorporated by reference to Appendix B of the Company's Definitive Proxy Statement on Schedule 14A, filed November 21, 2007). |
| 10.4 | Form of Stock Option Agreement (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, filed July 14, 2005). |
| 10.5 | 2001 Equity Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-QSB, filed November 14, 2001). |
| 10.6 | Securities Purchase Agreement, dated September 25, 2007, by and between the Company and certain accredited investors (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed September 26, 2007). |
| 10.7 | Office Space Lease between I.W. Systems Canada Company and GE Canada Real Estate Equity, dated July 25, 2008 (incorporated by reference to Exhibit 10.39 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.8 | Form of Securities Purchase Agreement, dated August 29, 2008 by and between the Company and certain accredited investors (incorporated by reference to Exhibit 10.40 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.9 | Change of Control and Severance Benefits Agreement, dated September 27, 2008, between Company and Charles Aubuchon (incorporated by reference to Exhibit 10.41 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.10 | Change of Control and Severance Benefits Agreement, dated September 27, 2008, between Company and David Harding (incorporated by reference to Exhibit 10.42 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.11 | First Amendment to Employment Agreement, dated September 27, 2008, between the Company and S. James Miller (incorporated by reference to Exhibit 10.43 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.12 | Form of Convertible Note dated November 14, 2008 (incorporated by reference to Exhibit 10.45 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.13 | Second Amendment to Employment Agreement, dated April 6, 2009, between the Company and S. James Miller (incorporated by reference to Exhibit 10.50 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.14 | Office Space Lease between the Company and Allen W. Wooddell, dated July 25, 2008 (incorporated by reference to Exhibit 10.54 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.15 | Third Amendment to Employment Agreement, dated December 10, 2009, between the Company and S. James Miller (incorporated by reference to Exhibit 10.60 to the Company's Annual Report on Form 10-K, filed February 24, 2010). |
| 10.16 | Securities Purchase Agreement, dated December 12, 2011, by and between the Company and certain accredited investors (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed December 21, 2011). |

| | |
|---|---|
| 10.17 | Note Exchange Agreement, dated December 12, 2011, by and between the Company and certain accredited investors (incorporated by reference to Exhibit 10.2 to the Company’s Current Report on Form 8-K, filed December 21, 2011). |
| 10.18 | Fourth Amendment to Employment Agreement, dated March 10, 2011, between the Company and S. James Miller, (incorporated by reference to Exhibit 10.40 to the Company’s Annual Report on Form 10-K, filed January 17, 2012). |
| 10.19 | Fifth Amendment to Employment Agreement, dated January 31, 2012, between the Company and S. James Miller, Jr., (incorporated by reference to Exhibit 10.44 to the Company’s Annual Report on Form 10-K, filed April 4, 2012. |
| 10.20 | Employment Agreement, dated January 1, 2013, between the Company and Wayne Wetherell (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed March 7, 2013). |
| 10.21 | Employment Agreement, dated January 1, 2013, between the Company and Charles AuBuchon (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed March 7, 2013). |
| 10.22 | Employment Agreement, dated January 1, 2013, between the Company and David Harding (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed March 7, 2013). |
| 10.23 | Convertible Promissory Note dated March 27, 2013 issued by the Company to Neal Goldman (incorporated by reference to Exhibit 10.41 to the Company's Annual Report on Form 10-K, filed April 1, 2013). |
| 10.24 | Amendment to Convertible Promissory Note, dated March 12, 2014 (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed March 13, 2014). |
| 10.25 | Note Exchange Agreement, dated January 29, 2015 (incorporated by reference to the Company’s Current Report on Form 8-K, filed February 2, 2015). |
| 10.26 | Seventh Amendment to Employment Agreement, by and between S. James Miller, Jr. and the Company, dated January 9, 2015 (incorporated by reference to the Company’s Current Report on Form 8-K, filed January 15, 2015). |
| 10.27 | Second Amendment to Employment Agreement, by and between Wayne Wetherell and the Company, dated January 9, 2015 (incorporated by reference to the Company’s Current Report on Form 8-K, filed January 15, 2015). |
| 10.28 | Second Amendment to Employment Agreement, by and between David E. Harding and the Company, dated January 9, 2015 (incorporated by reference to the Company’s Current Report on Form 8-K, filed January 15, 2015). |
| 10.29 | Amendment No. 3 to Convertible Promissory Note, dated December 8, 2014 (incorporated by reference to the Company’s Current Report on Form 8-K, filed December 10, 2014). |
| 21.1 | List of Subsidiaries (incorporated by referenced to Exhibit 21.1 to the Company’s Annual Report on Form 10-K filed February 24, 2010). |
| 23.1 | Consent of Independent valuation firm. |
| 23.2 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of CEO as Required by Rule 13a-14(a)/15d-14, filed herewith |
| 31.2 | Certification of CFO as Required by Rule 13a-14(a)/15d-14, filed herewith. |
| 32.1 | Certification of CEO as Required by Rule 13a-14(a) and Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code, filed herewith. |
| 32.2 | Certification of CFO as Required by Rule 13a-14(a) and Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code, filed herewith. |
| **101.INS*** | XBRL Instance Document |
| **101.SCH*** | XBRL Taxonomy Extention Schema |
| **101.CAL*** | XBRL Taxonomy Extention Calculation Linkbase |
| **101.DEF*** | XBRL Taxonomy Extention Definition Linkbase |
| **101.LAB*** | XBRL Taxonomy Extention Label Linkbase |
| **101.PRE*** | XBRL Taxonomy Extention Presentation Linkbase |

Table of Contents

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, there unto duly authorized.

| | |
|---|---|
| Registrant | *ImageWare Systems, Inc.* |
| Date: March 16, 2015 | /s/ S. James Miller, Jr.<br>S. James Miller, Jr.<br>Chief Executive Officer (Principal Executive Officer), President |
| Date: March 16, 2015 | /s/ Wayne Wetherell<br>Wayne Wetherell<br>Chief Financial Officer (Principal Financial Officer) |

In accordance with the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

| | |
|---|---|
| Date: March 16, 2015 | /s/ S. James Miller, Jr.<br>S. James Miller, Jr.<br>Chairman of the Board |
| Date: March 16, 2015 | /s/ David Loesch<br>David Loesch<br>Director |
| Date: March 16, 2015 | /s/ Steve Hamm<br>Steve Hamm<br>Director |
| Date: March 16, 2015 | /s/ David Carey<br>David Carey<br>Director |
| Date: March 16, 2015 | /s/ John Cronin<br>John Cronin<br>Director |
| Date: March 16, 2015 | /s/ Neal Goldman<br>Neal Goldman<br>Director |
| Date: March 16, 2015 | /s/ Charles Crocker<br>Charles Crocker<br>Director |

**IMAGEWARE SYSTEMS, INC.**
**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of
Imageware Systems, Inc.

We have audited the accompanying consolidated balance sheets of Imageware Systems, Inc. as of December 31, 2014 and 2013, and the related consolidated statements of operations, comprehensive loss, shareholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Imageware Systems, Inc. as of December 31, 2014 and 2013, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Imageware Systems, Inc.'s internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated March 16, 2015, expressed an unqualified opinion thereon.

/s/ Mayer Hoffman McCann P.C.
San Diego, California
March 16, 2015

**REPORT OF INDEPENDENT REGESTIRED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of
Imageware Systems, Inc.

We have audited Imageware Systems, Inc.'s internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (COSO). Imageware Systems, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Imageware Systems, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations, comprehensive loss, shareholders' equity (deficit), and cash flows of Imageware Systems, Inc. for the each of the three years in the period ended December 31, 2014, and our report dated March 16, 2015, expressed an unqualified opinion thereon.

/s/ Mayer Hoffman McCann P.C.
San Diego, California
March 16, 2015

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

| | December 31, 2014 | December 31, 2013 |
|---|---|---|
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 218 | $ 2,363 |
| Accounts receivable, net of allowance for doubtful accounts of $3 at December 31, 2014 and December 31, 2013 | 266 | 302 |
| Inventory, net | 916 | 505 |
| Other current assets | 86 | 148 |
| Total Current Assets | 1,486 | 3,318 |
| | | |
| Property and equipment, net | 211 | 245 |
| Other assets | 153 | 395 |
| Intangible assets, net of accumulated amortization | 144 | 172 |
| Goodwill | 3,416 | 3,416 |
| **Total Assets** | **$ 5,410** | **$ 7,546** |
| | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)** | | |
| | | |
| Current Liabilities: | | |
| Accounts payable | $ 459 | $ 486 |
| Deferred revenue | 1,827 | 1,662 |
| Accrued expenses | 1,013 | 924 |
| Derivative liabilities | — | 57 |
| Notes payable to related parties | — | 55 |
| Total Current Liabilities | 3,299 | 3,184 |
| | | |
| Convertible line of credit to related party, net of discount | 1,311 | — |
| Pension obligation | 1,834 | 1,031 |
| Total Liabilities | 6,444 | 4,215 |
| | | |
| Shareholders' Equity (Deficit): | | |
| Preferred stock, authorized 4,000,000 shares: | | |
| Series B Convertible Redeemable Preferred Stock, $0.01 par value; designated 750,000 shares, 389,400 shares issued, and 239,400 shares outstanding at December 31, 2014 and December 31, 2013, respectively; liquidation preference $607 at December 31, 2014 and December 31, 2013. | 2 | 2 |
| Common Stock, $0.01 par value, 150,000,000 shares authorized; 93,513,854 and 87,555,317 shares issued at December 31, 2014 and December 31, 2013, respectively, and 93,507,150 and 87,548,613 shares outstanding at December 31, 2014 and December 31, 2013, respectively. | 934 | 874 |
| Additional paid-in capital | 135,982 | 131,652 |
| Treasury stock, at cost 6,704 shares | (64) | (64) |
| Accumulated other comprehensive loss | (1,594) | (830) |
| Accumulated deficit | (136,294) | (128,303) |
| Total Shareholders' Equity (Deficit) | (1,034) | 3,331 |
| | | |
| **Total Liabilities and Shareholders' Equity (Deficit)** | **$ 5,410** | **$ 7,546** |

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

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2014 | 2013 | 2012 |
| **Revenues:** | | | |
| Product | $ 1,634 | $ 2,686 | $ 1,145 |
| Maintenance | 2,525 | 2,618 | 2,806 |
| | 4,159 | 5,304 | 3,951 |
| **Cost of revenues:** | | | |
| Product | 257 | 319 | 227 |
| Maintenance | 735 | 771 | 975 |
| Gross profit | 3,167 | 4,214 | 2,749 |
| **Operating expenses:** | | | |
| General and administrative | 3,818 | 3,378 | 3,430 |
| Sales and marketing | 2,471 | 2,129 | 1,830 |
| Research and development | 4,495 | 3,869 | 3,180 |
| Depreciation and amortization | 179 | 125 | 69 |
| | 10,963 | 9,501 | 8,509 |
| Loss from operations | (7,796) | (5,287) | (5,760) |
| Interest expense | 416 | 221 | 18 |
| Change in fair value of derivative liabilities | — | 4,776 | 4,712 |
| Other income, net | (297) | (443) | (322) |
| Loss before income taxes | (7,915) | (9,841) | (10,168) |
| Income tax expense | 25 | 8 | 22 |
| Net loss | $ (7,940) | $ (9,849) | $ (10,190) |
| Preferred dividends | (51) | (51) | (51) |
| Net loss available to common shareholders | $ (7,991) | $ (9,900) | $ (10,241) |
| **Basic and diluted loss per common share — see Note 2:** | | | |
| Net loss | $ (0.09) | $ (0.12) | $ (0.14) |
| Preferred dividends | (—) | (—) | (—) |
| Basic and diluted loss per share available to common shareholders | $ (0.09) | $ (0.12) | $ (0.14) |
| Basic and diluted weighted-average shares outstanding | 91,795,971 | 81,231,962 | 70,894,916 |

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

**IMAGEWARE SYSTEMS, INC.**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**
**(In thousands)**

| | Year Ended December 31, 2014 | 2013 | 2012 |
|---|---|---|---|
| Net loss | $ (7,940) | $ (9,849) | $ (10,190) |
| Other comprehensive income (loss): | | | |
| Additional minimum pension liability | (744) | (622) | 1 |
| Foreign currency translation adjustment | (20) | (69) | (75) |
| Comprehensive loss | $ (8,704) | $ (10,540) | $ (10,264) |

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

**IMAGEWARE SYSTEMS, INC.**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)**
**(In thousands, except share amounts)**

| | Series B Convertible, Redeemable Preferred | | Common Stock | | Treasury Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Loss | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | | | | |
| **Balance at December 31, 2011** | 239,400 | $ 2 | 67,995,620 | $ 679 | (6,704) | $ (64) | $ 101,720 | $ (65) | $ (107,984) | $ (5,712) |
| Issuance of Common Stock pursuant to warrant exercises | - | - | 7,052,647 | 70 | - | - | 3,457 | - | - | 3,527 |
| Issuance of Common Stock pursuant to cashless warrant exercises | - | - | 1,573,362 | 16 | - | - | 688 | - | - | 704 |
| Issuance of Common Stock pursuant to option exercises | - | - | 24,924 | - | - | - | 7 | - | - | 7 |
| Warrants issued to consultants as compensation | - | - | - | - | - | - | 27 | - | - | 27 |
| Warrants issued as consideration for asset purchase | - | - | - | - | - | - | 87 | - | - | 87 |
| Reclassification of warrants previously classified as derivative liabilities | - | - | - | - | - | - | 13,588 | - | - | 13,588 |
| Stock-based compensation expense | - | - | - | - | - | - | 608 | - | - | 608 |
| Additional minimum pension liability | - | - | - | - | - | - | - | 1 | - | 1 |
| Foreign currency translation adjustment | - | - | - | - | - | - | - | (75) | - | (75) |
| Dividends on preferred stock | - | - | - | - | - | - | - | - | (229) | (229) |
| Net loss | - | - | - | - | - | - | - | - | (10,190) | (10,190) |
| **Balance at December 31, 2012** | 239,400 | $ 2 | 76,646,553 | $ 765 | (6,704) | $ (64) | $ 120,182 | $ (139) | $ (118,403) | $ 2,343 |

**IMAGEWARE SYSTEMS, INC.**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)**
**(In thousands, except share amounts)**
**(continued)**

| | Series B Convertible, Redeemable Preferred | | Common Stock | | Treasury Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Loss | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | | | | |
| **Balance at December 31, 2012** | 239,400 | $ 2 | 76,646,553 | $ 765 | (6,704) | $ (64) | $ 120,182 | $ (139) | $ (118,403) | $ 2,343 |
| Issuance of Common Stock pursuant to warrant exercises | - | - | 6,132,779 | 61 | - | - | 3,230 | - | - | 3,291 |
| Settlement of derivitive liabilities pursuant to warrants exercised for cash | - | - | - | - | - | - | 279 | - | - | 279 |
| Issuance of Common Stock pursuant to cashless warrant exercises | - | - | 4,458,493 | 45 | - | - | 6,453 | - | - | 6,498 |
| Warrants issued to secure line of credit borrowing facility | - | - | - | - | - | - | 580 | - | - | 580 |
| Issuance of Common Stock pursuant to option exercises | - | - | 35,310 | - | - | - | 11 | - | - | 11 |
| Stock issued to consultants as compensation | - | - | 264,000 | 3 | - | - | 38 | - | - | 41 |
| Warrants issued in lieu of cash as compensation | - | - | - | - | - | - | 108 | - | - | 108 |
| Conversion of related party notes payable to Common Stock | - | - | 18,182 | - | - | - | 10 | - | - | 10 |
| Reclassification of warrants previously classified as derivative liabilities | - | - | - | - | - | - | 186 | - | - | 186 |
| Stock-based compensation expense | - | - | - | - | - | - | 575 | - | - | 575 |
| Additional minimum pension liability | - | - | - | - | - | - | - | (622) | - | (622) |
| Foreign currency translation adjustment | - | - | - | - | - | - | - | (69) | - | (69) |
| Dividends on preferred stock | - | - | - | - | - | - | - | - | (51) | (51) |
| Net loss | - | - | - | - | - | - | - | - | (9,849) | (9,849) |
| **Balance at December 31, 2013** | 239,400 | $ 2 | 87,555,317 | $ 874 | (6,704) | $ (64) | $ 131,652 | $ (830) | $ (128,303) | $ 3,331 |

**IMAGEWARE SYSTEMS, INC.**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)**
**(In thousands, except share amounts)**
**(continued)**

| | Series B Convertible, Redeemable Preferred | | Common Stock | | Treasury Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Loss | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | | | | |
| **Balance at December 31, 2013** | 239,400 | $ 2 | 87,555,317 | $ 874 | (6,704) | $ (64) | $ 131,652 | $ (830) | $ (128,303) | $ 3,331 |
| Issuance of Common Stock pursuant to warrant exercises | - | - | 4,742,632 | 47 | - | - | 2,801 | - | - | 2,848 |
| Settlement of derivative liabilities pursuant to warrants exercised for cash | - | - | - | - | - | - | 57 | - | - | 57 |
| Issuance of Common Stock pursuant to cashless warrant exercises | - | - | 868,565 | 9 | - | - | (9) | - | - | - |
| Warrants issued to secure increase in line of credit borrowing facility | - | - | - | - | - | - | 128 | - | - | 128 |
| Issuance of Common Stock pursuant to option exercises | - | - | 98,617 | 1 | - | - | 66 | - | - | 67 |
| Recognition of beneficial conversion feature on convertible debt | - | - | - | - | - | - | 296 | - | - | 296 |
| Warrants issued in lieu of cash as compensation | - | - | - | - | - | - | 53 | - | - | 53 |
| Conversion of related party notes payable to Common Stock | - | - | 154,607 | 2 | - | - | 83 | - | - | 85 |
| Stock-based compensation expense | - | - | 94,116 | 1 | - | - | 855 | - | - | 856 |
| Additional minimum pension liability | - | - | - | - | - | - | - | (744) | - | (744) |
| Foreign currency translation adjustment | - | - | - | - | - | - | - | (20) | - | (20) |
| Dividends on preferred stock | - | - | - | - | - | - | - | - | (51) | (51) |
| Net loss | - | - | - | - | - | - | - | - | (7,940) | (7,940) |
| **Balance at December 31, 2014** | 239,400 | $ 2 | 93,513,854 | $ 934 | (6,704) | $ (64) | $ 135,982 | $ (1,594) | $ (136,294) | $ (1,034) |

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

**IMAGEWARE SYSTEMS, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**

| | Year Ended December 31, | | |
|---|---|---|---|
| **Cash flows from operating activities** | **2014** | **2013** | **2012** |
| Net loss | $ (7,940) | $ (9,849) | $ (10,190) |
| Adjustments to reconcile net loss to net cash used by operating activities: | | | |
| Depreciation and amortization | 179 | 125 | 69 |
| Amortization of debt discounts and debt issuance costs | 426 | 217 | 15 |
| Stock-based compensation | 856 | 616 | 608 |
| Change in fair value of derivative liabilities | — | 4,776 | 4,712 |
| Reduction in accounts payable and accrued expenses from expiration of statute of limitations | (224) | (440) | (336) |
| Warrants issued in lieu of cash as compensation for services | 53 | 108 | 27 |
| Change in assets and liabilities | | | |
| Accounts receivable | 35 | 26 | 20 |
| Inventory | (411) | (243) | (217) |
| Other assets | 62 | (50) | (20) |
| Accounts payable | 188 | (130) | (8) |
| Accrued expenses | 130 | (116) | (737) |
| Deferred revenue | 165 | 102 | 494 |
| Pension obligation | 59 | 7 | 10 |
| Total adjustments | 1,518 | 4,998 | 4,637 |
| Net cash used by operating activities | (6,422) | (4,851) | (5,553) |
| **Cash flows from investing activities** | | | |
| Purchase of property and equipment | (117) | (193) | (181) |
| Net cash used by investing activities | (117) | (193) | (181) |
| **Cash flows from financing activities** | | | |
| Proceeds from line of credit | 1,550 | — | — |
| Repayment of notes payable | — | — | (45) |
| Proceeds from exercise of stock options | 67 | 11 | 7 |
| Dividends paid | (51) | (51) | (229) |
| Proceeds from exercised warrants to purchase stock | 2,848 | 3,291 | 3,527 |
| Net cash provided by financing activities | 4,414 | 3,251 | 3,260 |
| Effect of exchange rate changes on cash and cash equivalents | (20) | (69) | (74) |
| Net decrease in cash and cash equivalents | (2,145) | (1,862) | (2,548) |
| Cash and cash equivalents at beginning of year | 2,363 | 4,225 | 6,773 |
| Cash and cash equivalents at end of year | $ 218 | $ 2,363 | $ 4,225 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid for interest | $ 2 | $ — | $ — |
| Cash paid for income taxes | $ 1 | $ 1 | $ — |
| Summary of non-cash investing and financing activities: | | | |
| Conversion of related party notes payable into Common Stock | $ 85 | $ 10 | $ — |
| Warrants issued for intangible asset purchase | $ — | $ — | $ 87 |
| Beneficial conversion feature of convertible debt | $ 296 | $ — | $ — |
| Contingent royalty payment | $ — | $ — | $ 72 |
| Acquisition of intangible assets with warrants | $ — | $ — | $ (159) |
| Issuance of Common Stock pursuant to cashless warrant exercises | $ 9 | $ 45 | $ 704 |
| Additional minimum pension liability | $ (744) | $ (622) | $ — |
| Reclassification of warrants previously classified as derivative liabilities to additional paid-in capital | $ 57 | $ 6,684 | $ 13,588 |
| Issuance of common warrants securing line of credit borrowing facility | $ 128 | $ 580 | $ — |
| Issuance of restricted stock pursuant to achievement of vesting conditions | $ 1 | $ 1 | $ — |

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

**IMAGEWARE SYSTEMS, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**DECEMBER 31, 2014, 2013 AND 2012**

## 1. DESCRIPTION OF BUSINESS AND OPERATIONS

### *Overview*

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

### *Recent Developments*

*Series E Preferred Stock Financing*

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

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share (the "*Series E Financing*"). Approximately 2,000 shares were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit, as defined below, was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10.0 million, with net proceeds of approximately $9.925 million after deducting offering expenses of approximately $75,000.

*Amendment to 1999 Stock Option Plan*

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

*Settlement of Blue Spike Matter*

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") against the Company in the United States District Court for the Eastern District of Texas, entitled Blue Spike, LLC v. ImageWare Systems, Inc., Case No. 12-cv-688-LED. The four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

*Lines of Credit*

At December 31, 2014, the Company had two unsecured lines of credit, one with maximum available borrowings of up to $5.0 million that matures in March 2017 (the "*Line of Credit*") and another with maximum available borrowings of up to $500,000 that matures in March 2015 (the "*$500K Line of Credit*") (together, the "*Lines of Credit*"). The Lines of Credit were extended by two existing members of our Board of Directors (the "*Holders*") and, at the election of the Holders, are convertible into shares of the Company's Common Stock at prices ranging from $0.95 per share to $2.30 per share, in accordance with the terms and conditions of the Lines of Credit.

Advances under the Lines of Credit are made at the Company's request. Up to the date of the Series E Financing, the Company received $1.95 million in advances under the Line of Credit and no advances under the $500K Line of Credit. As a result of the Series E Financing, approximately 2,000 shares of Series E Preferred were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1.95 million in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

**Liquidity, Capital Resources and Going Concern Uncertainty**

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.

With the February 2015 consummation of the Series E Financing and existing Line of Credit borrowing facility, management believes that the Company's current cash and cash equivalents will be sufficient to meet working capital and capital expenditure requirements for at least the next 12 months from the date of this filing and that we will have sufficient liquidity to fund our business and meet our contractual obligations over a period beyond the next 12 months.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Principles of Consolidation***

The 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 consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("*U.S. 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 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. Accounts receivable are considered delinquent when the due date on the invoice has passed. The Company records its allowance for doubtful accounts based upon its assessment of various factors. The Company considers historical experience, the age of the accounts receivable balances, the credit quality of its customers, current economic conditions and other factors that may affect customers' ability to pay to determine the level of allowance required. Accounts receivable are written off against the allowance for doubtful accounts when all collection efforts by the Company have been unsuccessful.

***Inventories***

Finished goods inventories are stated at the lower of cost, determined using the average cost method, or market. See Note 6.

***Property, Equipment and Leasehold Improvements***

Property and equipment, consisting of furniture and equipment, are stated at cost and are being depreciated on a straight-line basis over the estimated useful lives of the assets, which generally range from three to five years. Maintenance and repairs are charged to expense as incurred. Major renewals or improvements are capitalized. When assets are sold or abandoned, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is recognized. Expenditures for leasehold improvements are capitalized. Amortization of leasehold improvements is computed using the straight-line method over the shorter of the remaining lease term or the estimated useful lives of the improvements.

***Fair Value of Financial Instruments***

For certain of the Company's financial instruments, including accounts receivable, accounts payable, accrued expenses, deferred revenues 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 the common and preferred stock, warrants and convertible debt it issues to determine whether there are embedded derivative instruments, including embedded conversion options, which are required to 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, that is required to be bifurcated, 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
- Postcontract customer support ("*PCS*")

The Company's revenue recognition policies are consistent with U.S. 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: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable, and collectability is reasonably assured.

The Company recognizes revenue and profit as work progresses on long-term, fixed-price contracts involving significant amount of hardware and software customization using the percentage of completion method based on costs incurred to date compared to total estimated costs at 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 revenues 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, when all other significant obligations have been fulfilled and the Company has obtained vendor specific objective evidence ("VSOE") of the fair value of the undelivered element. VSOE of fair value for customer support services is determined by reference to the price the customer pays for such element when sold separately; that is, the renewal rate offered to customers. In those instances when objective and reliable evidence of fair value exists for the undelivered items but not for the delivered items, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of arrangement consideration allocated to the delivered items equals the total arrangement consideration less the aggregate fair value of the undelivered items. 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. Pricing of maintenance contracts is consistent period to period and calculated as a percentage of the software or hardware revenue. Amounts collected in advance for maintenance services are included in current liabilities under "Deferred revenue". Sales tax collected from customers is excluded from revenue.

***Goodwill***

The Company accounts for its intangible assets under the provisions of ASC 350, "*Intangibles - Goodwill and Other*". In accordance with ASC 350, intangible assets with a definite life are analyzed for impairment under ASC 360-10-05 "*Property, Plant and Equipment*" and intangible assets with an indefinite life are analyzed for impairment under ASC 360 annually, or more often if circumstances dictate. The Company performs its annual goodwill impairment test in the fourth quarter of each year, or if required, at the end of each fiscal quarter. In accordance with ASC 350, goodwill, or the excess of cost over fair value of net assets acquired is tested for impairment using a fair value approach at the "reporting unit" level. A reporting unit is the operating segment, or a business one level below that operating segment (referred to as a component) if discrete financial information is prepared and regularly reviewed by management at the component level. The Company's reporting unit is at the entity level. The Company recognizes an impairment charge for any amount by which the carrying amount of a reporting unit's goodwill exceeds its fair value. The Company uses fair value methodologies to establish fair values.

The Company did not record any goodwill impairment charges for the years ended December 31, 2014, 2013 or 2012.

***Intangible and Long Lived Assets***

Intangible assets are carried at their cost less any accumulated amortization. Any costs incurred to renew or extend the life of an intangible or long lived asset are reviewed for capitalization. The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate their net book value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. Impairment, if any, is based on the excess of the carrying amount over the fair value, based on market value when available, or discounted expected cash flows, of those assets and is recorded in the period in which the determination is made. The Company's management currently believes there is no impairment of its long-lived assets. There can be no assurance, however, that market conditions will not change or demand for the Company's products under development will continue. Either of these could result in future impairment of long-lived assets.

***Concentration of Credit Risk***

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and trade accounts receivable. The Company places its cash with high quality financial institutions and at times during the years ended December 31, 2014 and 2013 exceeded the FDIC insurance limits of $250,000 for 2014 and 2013. Sales are typically made on credit and the Company generally does not require collateral. The Company performs ongoing credit evaluations of its customers' financial condition and maintains an allowance for doubtful accounts. 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 presented net of an allowance for doubtful accounts of approximately $3,000 at December 31, 2014 and 2013.

For the year ended December 31, 2014 one customer accounted for approximately 17% or $725,000 of total revenues and had trade receivables of $0 as of the end of the year. For the year ended December 31, 2013 one customer accounted for approximately 42% or $2,211,000 of total revenues and had trade receivables of $0 as of the end of the year. For the year ended December 31, 2012, one customer accounted for approximately 15% or 611,000 of total revenues and $0 trade receivables as of the end of the year.

***Stock-Based Compensation***

At December 31, 2014, the Company had two 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 for all share-based payment awards is recognized using the straight-line single-option method. Stock-based compensation expense is reported in operating 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 $618,000, $575,000 and $571,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

ASC 718 requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the Black-Scholes option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The Company is required to make various assumptions in the application of the Black-Scholes option-pricing model. The Company has determined that the best measure of expected volatility is based on the historical weekly volatility of the Company's Common Stock. Historical volatility factors utilized in the Company's Black-Scholes computations for options granted during the years ended December 31, 2014, 2013 and 2012 ranged from 71% to 103%. 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 years ended December 31, 2014, 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 years ended December 31, 2014, 2013 and 2012 averaged 2.6%. Dividend yield is zero as the Company does not expect to declare any dividends on the Company's common shares 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 December 2014, the Company issued 94,116 shares of its Common Stock to certain members of the Company's Board of Directors as compensation for services to be rendered through December 2015. Such shares are forfeitable should the Board members' service be terminated.

In December 2013, the Company issued 144,000 shares of its Common Stock to certain members of the Company's Board of Directors as compensation for services to be rendered through December 2014. Such shares are forfeitable should the Board members' service be terminated. For the year ended December 31, 2014, the Company recorded approximately $238,000 as compensation expense.

***Income Taxes***

Current income tax expense or benefit is the amount of income taxes expected to be payable or refundable for the current year. A deferred income tax asset or liability is computed for the expected future impact of differences between the financial reporting and tax bases of assets and liabilities and for the expected future tax benefit to be derived from tax credits and loss carryforwards. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

***Foreign Currency Translation***

The financial position and results of operations of the Company's foreign subsidiaries are measured using the foreign subsidiary's local currency as the functional currency. Revenues and expenses of such subsidiaries have been translated into U.S. dollars at average exchange rates prevailing during the period. Assets and liabilities have been translated at the rates of exchange on the balance sheet date. The resulting translation gain and loss adjustments are recorded directly as a separate component of shareholders' equity, unless there is a sale or complete liquidation of the underlying foreign investments. The Company translates foreign currencies of its German, Canadian and Mexican subsidiaries. The cumulative translation adjustment, which is recorded in accumulated other comprehensive income, decreased approximately $20,000 for the year ended December 31, 2014, decreased approximately $69,000 for the year ended December 31, 2013 and decreased approximately $75,000 for the year ended December 31, 2012.

***Comprehensive Income***

Comprehensive income consists of net gains and losses affecting shareholders' equity that, under generally accepted accounting principles, are excluded from net loss. For the Company, the only items are the cumulative translation adjustment and the additional minimum liability related to the Company's defined benefit pension plan, recognized pursuant to ASC 715-30, "*Compensation - Retirement Benefits - Defined Benefit Plans – Pension*".

***Advertising Costs***

The Company expenses advertising costs as incurred. The Company incurred approximately $9,000 in advertising expenses during the year ended December 31, 2014 and $12,000 in advertising expenses during the years ended December 31, 2013 and 2012.

***Loss Per Share***

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

| (Amounts in thousands, except share and per share amounts) | Year Ended December 31, 2014 | 2013 | 2012 |
|---|---|---|---|
| Numerator for basic and diluted loss per share: | | | |
| Net loss | $ (7,940) | $ (9,849) | $ (10,190) |
| Preferred dividends | (51) | (51) | (51) |
| Net loss available to common shareholders | $ (7,991) | $ (9,900) | $ (10,241) |
| | | | |
| Denominator for basic loss per share — weighted-average shares outstanding | 91,795,971 | 81,231,962 | 70,894,916 |
| Effect of dilutive securities | — | — | — |
| Denominator for diluted loss per share — weighted-average shares outstanding | 91,795,971 | 81,231,962 | 70,894,916 |
| | | | |
| **Basic and diluted loss per share:** | | | |
| Net loss | $ (0.09) | $ (0.12) | $ (0.14) |
| Preferred dividends | (—) | (—) | (—) |
| Net loss available to common shareholders | $ (0.09) | $ (0.12) | $ (0.14) |

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

| Potential Dilutive Securities: | Common Share Equivalents at December 31, 2014 | Common Share Equivalents at December 31, 2013 | Common Share Equivalents at December 31, 2012 |
|---|---|---|---|
| Convertible notes payable and lines of credit | 1,649,548 | 101,185 | 100,018 |
| Convertible preferred stock – Series B | 46,029 | 46,139 | 47,880 |
| Stock options | 4,057,296 | 1,782,221 | 1,135,077 |
| Restricted stock grants | — | 80,932 | 324,863 |
| Warrants | 977,778 | 8,455,124 | 24,996,737 |
| Total Potential Dilutive Securities | 6,730,651 | 10,465,601 | 26,604,575 |

***Recently Issued Accounting Standards***

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

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

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

*FASB ASU No. 2014-15*. In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, which provides guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 will be effective in the fourth quarter of 2016, with early adoption permitted. The Company is currently evaluating the impact of its pending adoption of ASU 2014-15 on our consolidated financial statements.

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

*FASB ASU No. 2015-01.* In January 2015, the FASB issued ASU No. 2015-01, which amends ASC Subtopic 225-20, “*Income Statement – Extraordinary and Unusual Items*.” The amendment in this ASU eliminates from GAAP the concept of extraordinary items. The amendments in this update are effective for interim and annual reporting periods beginning after December 15, 2015. We do not expect adoption of ASU No. 2015-01 to have a significant impact on our consolidated financial statements.

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

**3. FAIR VALUE ACCOUNTING**

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

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

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

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

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

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

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

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

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

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

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

| ($ in thousands) | | Derivative Liabilities |
|---|---|---|
| Balance December 31, 2011 | $ | 11,824 |
| Included in earnings | | 4,712 |
| Settlements | | (14,292) |
| Issuances | | — |
| Transfers in and /or out of Level 3 | | — |
| Balance December 31, 2012 | $ | 2,244 |
| Included in earnings | | 4,776 |
| Settlements | | (6,963) |
| Issuances | | — |
| Transfers in and /or out of Level 3 | | — |
| Balance at December 31, 2013 | $ | 57 |
| Included in earnings | | — |
| Settlements | | (57) |
| Issuances | | — |
| Transfers in and/or out of Level 3 | | — |
| Balance at December 31, 2014 | $ | — |

All unrealized gains or losses resulting from changes in value of any Level 3 instruments are reflected as a separate line in the 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. See further disclosures regarding the Company's derivative liabilities in Note 10.

**4. INTANGIBLE ASSETS AND GOODWILL**

The Company has intangible assets in the form of trademarks, trade names and patents. The carrying amount of the Company's acquired trademarks and trade names were approximately $15,000, $31,000 and $47,000 as of December 31, 2014, 2013 and 2012, respectively, which include accumulated amortization of $332,000, $316,000 and $300,000 as of December 31, 2014, 2013 and 2012, respectively. Amortization expense related to trademarks and tradenames was $16,000 for the years ended December 31, 2014, 2013 and 2012. All intangible assets are amortized over their estimated useful lives with no estimated residual values. Any costs incurred by the Company to renew or extend the life of intangible assets will be evaluated under ASC No. 350, *Intangibles – Goodwill and Other*, for proper treatment.

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 No. 805, *Business Combinations*, and determined that this transaction constituted an asset purchase.

As consideration for this asset purchase:

- The Company issued to Vocel a warrant to purchase 150,000 shares of the Company's Common Stock ("*Purchaser Warrant*"). The Purchaser Warrant is exercisable at $0.88 per share and vests 100% when the Company has derived $500,000 of gross revenue from the sale or license of the purchased intellectual property ("*Warrant Vesting Date*"). The Purchaser Warrant is exercisable for a period of three years from the Warrant Vesting Date; and

- The Company agreed to pay Vocel a royalty of 7.5% of gross revenue received by the Company from any third party sale or license of the purchased intellectual property.

The Company determined the aggregate fair value of the consideration issued to be approximately $159,000 and 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.

The carrying amounts of the Company's patent intangible assets were $129,000, $141,000 and $147,000 as of December 31, 2014, 2013 and 2012, respectively, which includes accumulated amortization of $530,000, 518,000, and $512,000 as of December 31, 2014, 2013 and 2012, respectively. Amortization expense for patent intangible assets was $12,000 for the years ended December 31, 2014 and 2013 and $6,000 for the year ended December 31, 2012. Patent intangible assets are being amortized on a straight-line basis over their remaining life of approximately 11.5 years.

The following table presents the changes in the carrying amounts of the Company's acquired intangible assets for the years ended December 31, 2014, 2013 and 2012. All intangible assets are being amortized over their estimated useful lives with no estimated residual values.

| ($ in thousands) | | Total |
|---|---|---|
| Balance of intangible assets as of December 31, 2011 | $ | 63 |
| Intangible assets acquired | | 159 |
| Amortization | | (22) |
| Impairment losses | | — |
| Balance of intangible assets as of December 31, 2012 | $ | 200 |
| Intangible assets acquired | | — |
| Amortization | | (28) |
| Impairment losses | | — |
| Balance of intangible assets as of December 31, 2013 | $ | 172 |
| Intangible assets acquired | | — |
| Amortization | | (28) |
| Impairment losses | | — |
| Balance of intangible assets as of December 31, 2014 | $ | 144 |

The Company annually, or more frequently if events or circumstances indicate a need, tests the carrying amount of goodwill for impairment. The Company performs its annual impairment test in the fourth quarter of each year. 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 December 31, 2014, 2013 and 2012.

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

| Fiscal Year Ended December 31, | | Estimated Amortization Expense ($ in thousands) |
|---|---|---|
| 2015 | $ | 27 |
| 2016 | | 12 |
| 2017 | | 12 |
| 2018 | | 12 |
| 2019 | | 12 |
| Thereafter | | 69 |
| Totals | $ | 144 |

**5. RELATED PARTIES**

*Related Party Convertible Notes*. As more fully described in Note 9 to these consolidated financial statements, on November 14, 2008, the Company entered into Related-Party Convertible Notes in the principal aggregate amount of $110,000, with certain officers and members of the Company's Board of Directors. The Related-Party Convertible Notes bear interest at 7.0% per annum and were due February 14, 2009. The principal amount of the Related-Party Convertible Notes plus accrued but unpaid interest is convertible at the option of the holder into Common Stock of the Company. The number of shares into which the Related-Party Convertible Notes are convertible shall be calculated by dividing the outstanding principal and accrued but unpaid interest by $0.50 (the "*Conversion Price*").

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

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

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

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

In June 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of $55,000 into 100,000 shares of Common Stock of the Company. The holders also elected to convert approximately $30,000 in accrued interest into 54,607 shares of the Company's Common Stock and in August 2014 the holders exercised 136,364 warrants, on a cashless basis, resulting in the issuance of 105,451 shares of the Company's Common Stock.

*Cronin Agreement*. During the year ended December 31, 2012 the Company entered into a series of professional service contracts with an entity that a member of the Company's Board of Directors has an ownership interest in. The aggregate contract value was $370,000 for the year ended December 31, 2012. The Company paid the professional services firm $0 in 2014, $0 in 2013 and approximately $188,000 in 2012.

*Lines of Credit*. The Company currently has two unsecured lines of credit, the Line of Credit with maximum available borrowings of up to $3,050,000 (reduced to $3,050,000 from $5,000,000 as a result of the February 2015 Series E financing) that matures in March 2017 and the $500K Line of Credit with maximum available borrowings of up to $500,000 that matures in March 2015. The Lines of Credit were extended by two existing members of our Board of Directors and, at the election of the Holders, are convertible into shares of the Company's Common Stock at prices ranging from $0.95 per share to $2.30 per share, in accordance with the terms and conditions of the Lines of Credit.

In February 2015 the Company consummated the Series E Financing, resulting in the issuance of 12,000 shares of Series E Preferred Stock to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company's Common Stock at $1.90 per share. Approximately 2,000 shares of Series E Preferred were issued in consideration for the exchange by the Company's largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing the Company's borrowing capacity under the Line of Credit agreement was reduced to $3,050,000 with the maturity date unchanged and the $500K Line of Credit was terminated in accordance with its terms.

Advances under the Lines of Credit are made at the Company's request. As of December 31, 2014, the Company has received $1,550,000 in advances under the Line of Credit and no advances under the $500K Line of Credit. See Note 9, "*Notes Payable and Lines of Credit*", below for a complete description of the Lines of Credit and related transactions.

**6. INVENTORY**

Inventories of $916,000 as of December 31, 2014 were comprised of work in process of $909,000. Work in process inventories are comprised of direct labor costs on in-process projects of $881,000 and equipment on in-process projects of $28,000. Finished goods inventories were $7,000 net of reserves for obsolete and slow-moving items of $3,000. Inventories of $505,000 as of December 31, 2013 were comprised of work in process of $499,000 representing direct labor costs on in-process projects and finished goods of $6,000 net of reserves for obsolete and slow-moving items of $3,000. Appropriate consideration is given to obsolescence, excessive levels, deterioration and other factors in evaluating net realizable value and required reserve levels.

**7. PROPERTY AND EQUIPMENT**

Property and equipment at December 31, 2014 and 2013, consists of:

| **($ in thousands)** | **2014** | **2013** |
|---|---|---|
| Equipment | $ 818 | $ 700 |
| Leasehold improvements | 5 | 5 |
| Furniture | 103 | 103 |
| | 926 | 808 |
| Less accumulated depreciation | (715) | (563) |
| | $ 211 | $ 245 |

Total depreciation expense for the years ended December 31, 2014, 2013 and 2012 was approximately $152,000, $97,000 and $47,000, respectively.

**8. ACCRUED EXPENSES**

Principal components of accrued expenses consist of:

| **($ in thousands)** | **December 31, 2014** | **December 31, 2013** |
|---|---|---|
| Compensated absences | $ 290 | $ 241 |
| Wages, payroll taxes and sales commissions | 4 | 4 |
| Customer deposits | 68 | 38 |
| Liquidated damages | 200 | 200 |
| Royalties | 147 | 147 |
| Pension and employee benefit plans | 35 | 33 |
| Income and sales taxes | 171 | 142 |
| Interest and dividends | 38 | 52 |
| Other | 60 | 67 |
| | $ 1,013 | $ 924 |

**9. NOTES PAYABLE AND LINES OF CREDIT**

Outstanding notes payable and line of credit consist of the following:

| **($ in thousands)** | **December 31, 2014** | **December 31, 2013** |
|---|---|---|
| Notes payable to related parties: | | |
| 7% convertible promissory notes. Face value of notes $0 and $55 at December 31, 2014 and 2013, respectively. Discount on notes is $0 at December 31, 2014 and 2013. In January 2013, the Company received an extension to June 30, 2014. Notes were converted in their entirety as of June 30, 2014. | $ — | $ 55 |
| Line of Credit to a related party | | |
| 8% convertible line of credit. Face value of advances under line of credit $1,550 at December 31, 2014 and $0 at December 31, 2013. Discount on advances under line of credit is $239 at December 31, 2014 and $0 at December 31, 2013. Maturity date is March 27, 2017. | 1,311 | — |
| | | |
| Total notes payable and line of credit to related parties | 1,311 | 55 |
| Less current portion | (—) | (55) |
| Long-term notes payable and line of credit to related parties | $ 1,311 | $ — |

*7% Convertible Promissory Notes to Related Parties*

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

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

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

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

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

In June 2014 the holders of the remaining Related-Party Convertible Notes converted the remaining principal balance of $55,000 into 100,000 shares of Common Stock of the Company. The holders also elected to convert approximately $30,000 in accrued interest into 54,607 shares of the Company's Common Stock and in August 2014 the holders exercised 136,364 warrants, on a cashless basis, resulting in the issuance of 105,451 shares of the Company's Common Stock.

*Lines of Credit*

In March 2013, the Company entered into a new unsecured line of credit agreement with available borrowings of up to $2,500,000 (the "*Line of Credit*"). The Line of Credit was extended by an existing shareholder and member of our Board of Directors (the "*Holder*"). In March 2014, the Line of Credit's borrowing was increased to an aggregate total of $3,500,000 (the "*Amendment*"). Pursuant to the terms and conditions of the Amendment, the Holder has the right to convert up to $2.5 million of the outstanding balance of the Line of Credit into shares of the Company's Common Stock for $0.95 per share. Any remaining outstanding balance will be convertible into shares of the Company's Common Stock for $2.25 per share.

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

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

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

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

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 years ended December 31, 2014 and 2013, the Company recorded approximately $369,000 and $217,000 in deferred financing fee amortization expense which is recorded as a component of interest expense in the Company's consolidated statements of operation.

The Company evaluated the lines of credit agreements 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). As of December 31, 2014, the Company had recognized approximately $296,000 in beneficial conversion feature as debt discount.

As of December 31, 2014, advances made under the Line of Credit agreement aggregated $1,550,000 and there were no borrowings under the 500K Line of Credit. During the year ended December 31, 2014, the Company recorded approximately $56,000 in beneficial conversion feature amortization expense which is recorded as a component of interest expense in the Company's consolidated statement of operations. For activity under the Lines of Credit subsequent to December 31, 2014, see Note 19, "*Subsequent Events*" below.

**10. 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 valuation 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 valuation model is affected by the Company's stock prices as well as assumptions regarding the expected stock price volatility of the term of the derivative liabilities in addition to interest rates and dividend yields.

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

**11. INCOME TAXES**

The Company accounts for income taxes in accordance with ASC 740, *Accounting for Income Taxes,* (ASC 740). Deferred income taxes are recognized for the tax consequences related to temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for tax purposes at each year-end, based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. A valuation allowance is established when necessary based on the weight of available evidence, if it is considered more likely than not that all or some portion of the deferred tax assets will not be realized. Income tax expense is the sum of current income tax plus the change in deferred tax assets and liabilities. The Company has established a valuation allowance against its deferred tax asset due to the uncertainty surrounding the realization of such asset.

ASC 740 requires a company to first determine whether it is more-likely-than-not (defined as a likelihood of more than fifty percent) that a tax position will be sustained based on its technical merits as of the reporting date, assuming that taxing authorities will examine the position and have full knowledge of all relevant information. A tax position that meets this more-likely-than-not threshold is then measured and recognized at the largest amount of benefit that is greater than fifty percent likely to be realized upon effective settlement with a taxing authority. The amount accrued for uncertain tax positions was zero at December 31, 2014, 2013 and 2012, respectively.

The Company's uncertain position relative to unrecognized tax benefits and any potential increase in these liabilities relates primarily to the allocations of revenue and costs among the Company's global operations and the impact of tax rulings made during the period affecting its tax positions. The Company's existing tax position could result in liabilities for unrecognized tax benefits. The Company recognizes interest and/or penalties related to uncertain tax positions in income tax expense. The amount of interest and penalties accrued as of December 31, 2014 and 2013 was $11,000 and $12,000, respectively.

Significant judgment is required in evaluating the Company's uncertain tax positions and determining the Company's provision for income taxes. No assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in the Company's historical income tax provisions and accruals. The Company adjusts these items in light of changing facts and circumstances. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made.

The significant components of the income tax provision are as follows:

| **($ in thousands)** | **Year Ended December 31,** | | |
|---|---|---|---|
| **Current** | **2014** | **2013** | **2012** |
| Federal | $ — | $ — | $ — |
| State | — | — | — |
| Foreign | 25 | 8 | 22 |
| **Deferred** | | | |
| Federal | — | — | — |
| State | — | — | — |
| Foreign | — | — | — |
| | $ 25 | $ 8 | $ 22 |

The principal components of the Company’s deferred tax assets at December 31, 2014, 2013 and 2012 are as follows:

| ($ in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Net operating loss carryforwards | $ 14,200 | $ 12,703 | $ 11,554 |
| Intangible and fixed assets | 427 | 538 | 653 |
| Stock based compensation | 1,565 | 1,319 | 1,089 |
| Reserves and accrued expenses | 6 | 6 | 6 |
| Other | (85) | (121) | (140) |
| | 16,113 | 14,445 | 13,162 |
| Less valuation allowance | (16,113) | (14,445) | (13,162) |
| Net deferred tax assets | $ — | $ — | $ — |

A reconciliation of the provision for income taxes to the amount computed by applying the statutory income tax rates to loss before income taxes is as follows:

| | 2014 | 2013 | 2012 |
|---|---|---|---|
| Amounts computed at statutory rates | $ (2,699) | $ (3,349) | $ (3,465) |
| State income tax, net of federal benefit | (212) | (47) | (81) |
| Expiration of net operating loss carryforwards | 708 | 75 | 473 |
| Non-deductible interest and change in fair value of derivative liabilities | 145 | 1,698 | 1,602 |
| Foreign taxes | 386 | 370 | 473 |
| Other | 4 | 4 | 4 |
| Net change in valuation allowance on deferred tax assets | 1,693 | 1,257 | 1,016 |
| | $ 25 | $ 8 | $ 22 |

The Company has established a valuation allowance against its deferred tax assets due to the uncertainty surrounding the realization of such assets.

At December 31, 2014, 2013 and 2012, the Company had federal and state net operating loss carryforwards, a portion of which may be available to offset future taxable income for tax purposes. The federal net operating loss carryforwards expire at various dates from 2015 through 2033. The state net operating loss carryforwards expire at various dates from 2015 through 2023.

The Internal Revenue Code (the *"Code"*) limits the availability of certain tax credits and net operating losses that arose prior to certain cumulative changes in a corporation’s ownership resulting in a change of control of the Company. The Company’s use of its net operating loss carryforwards and tax credit carryforwards will be significantly limited because the Company believes it underwent “ownership changes”, as defined under Section 382 of the Internal Revenue Code, in 1991, 1995, 2000, 2003, 2004, 2011 and 2012, though the Company has not performed a study to determine the limitation. The Company has reduced its deferred tax assets to zero relating to its federal and state research credits because of such limitations. The Company continues to disclose the tax effect of the net operating loss carryforwards at their original amount in the table above as the actual limitation has not yet been quantified. The Company has also established a full valuation allowance for substantially all deferred tax assets due to uncertainties surrounding its ability to generate future taxable income to realize these assets. Since substantially all deferred tax assets are fully reserved, future changes in tax benefits will not impact the effective tax rate. Management periodically evaluates the recoverability of the deferred tax assets. If it is determined at some time in the future that it is more likely than not that deferred tax assets will be realized, the valuation allowance would be reduced accordingly at that time.

Tax returns for the years 2010 through 2014 are subject to examination by taxing authorities.

**12. COMMITMENTS AND CONTINGENCIES**

*Employment Agreements*

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

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

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

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

*Litigation*

On August 21, 2012, a complaint for patent infringement was filed by Blue Spike, LLC ("*Blue Spike*") against the Company in the United States District Court for the Eastern District of Texas, entitled Blue Spike, LLC v. ImageWare Systems, Inc., Case No. 12-cv-688-LED. The four patents-in-suit were related to digital signal abstracting technology (the "*Patents*"). On October 20, 2014, the Company and Blue Spike entered into a Settlement and License Agreement (the "*Settlement Agreement*), wherein Blue Spike agreed to release the Company from all present and/or future claims in exchange for the Company's purchase of a license to the Patents for a one-time $40,000 royalty payment. In connection with the Settlement Agreement and Blue Spike's release of all claims against the Company, on October 23, 2014, the Court dismissed all claims against the Company with prejudice.

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

*Leases*

The Company's corporate headquarters are located in San Diego, California where we occupy 9,927 square feet of office space. This facility is leased through October 2017 at a cost of approximately $18,000 per month. In addition to our corporate headquarters, we also occupied the following spaces at December 31, 2014:

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

At December 31, 2014, future minimum lease payments are as follows:

| **($ in thousands)** | |
|---|---|
| 2015 | $ 448 |
| 2016 | 422 |
| 2017 | 386 |
| 2018 | 168 |
| 2019 and thereafter | — |
| | $ 1,424 |

Rental expense incurred under operating leases for the years ended December 31, 2014, 2013 and 2012 was approximately $430,000, $418,000 and $521,000, respectively.

**13. EQUITY**

The Company's Articles of Incorporation, as amended, authorize 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 Preferred outstanding as of December 31, 2014 and 2013. At December 31, 2014 and 2013, the Company had cumulative undeclared dividends of approximately $8,000 ($0.03 per share). There were no conversions of Series B Preferred into Common Stock during the year ended December 31, 2014 or 2013.

*Common Stock*

The following table summarizes outstanding Common Stock activity for the following periods:

| | Common Stock |
|---|---|
| Shares outstanding at December 31, 2011 | 67,988,916 |
| Shares issued pursuant to warrants exercised for cash | 7,052,647 |
| Shares issued pursuant to cashless warrants exercised | 1,573,362 |
| Shares issued pursuant to option exercises | 24,924 |
| Shares outstanding at December 31, 2012 | 76,639,849 |
| Shares issued pursuant to warrants exercised for cash | 6,132,779 |
| Shares issued pursuant to cashless warrants exercised | 4,458,493 |
| Conversion of related-party notes payable into Common Stock | 18,182 |
| Shares issued as compensation in lieu of cash | 264,000 |
| Shares issued pursuant to option exercises | 35,310 |
| Shares outstanding at December 31, 2013 | 87,548,613 |
| Shares issued pursuant to warrants exercised for cash | 4,742,632 |
| Shares issued pursuant to cashless warrants exercised | 868,565 |
| Conversion of related-party notes payable into Common Stock | 154,607 |
| Shares issued as compensation in lieu of cash | 94,116 |
| Shares issued pursuant to option exercises | 98,617 |
| Shares outstanding at December 31, 2014 | 93,507,150 |

During the year ended December 31, 2014, the Company issued 98,617 shares of Common Stock pursuant to the exercise of 98,617 options for cash proceeds of approximately $67,000. During the year ended December 31, 2014, the Company issued 4,742,632 shares of Common Stock pursuant to the exercise of 4,742,632 warrants for cash proceeds of approximately $2,848,000. During the year ended December 31, 2014, the Company issued 868,565 shares of Common Stock pursuant to the cashless exercise of 1,125,784 warrants. Also during the year ended December 31, 2014, the Company issued 154,607 shares of Common Stock pursuant to the conversion of $55,000 of Related-Party Convertible notes payable principal and $30,000 of accrued interest. The Company also issued 94,116 shares of its Common Stock to certain members of the Company's Board of Directors as compensation for services to be rendered through December 31, 2015. Such shares are forfeitable should the Board members' service be terminated.

*Warrants*

As of December 31, 2014, warrants to purchase 977,778 shares of Common Stock at prices ranging from $0.50 to $2.25 were outstanding. All warrants are exercisable as of December 31, 2014 and expire at various dates through December 2016, with the exception of an aggregate of 380,000 warrants, which become exercisable only upon the attainment of specified events.

The following table summarizes warrant activity for the following periods:

| | Warrants | Weighted-Average Exercise Price |
|---|---|---|
| Balance at December 31, 2011 | 28,453,760 | $ 0.52 |
| Granted | 305,000 | $ 0.92 |
| Expired / Canceled | (12,000) | $ 0.50 |
| Exercised | (9,958,275) | $ 0.50 |
| Balance at December 31, 2012 | 18,788,485 | $ 0.56 |
| Granted | 1,232,632 | $ 1.01 |
| Expired / Canceled | (688,749) | $ 1.49 |
| Exercised | (12,733,952) | $ 0.52 |
| Balance at December 31, 2013 | 6,598,416 | $ 0.63 |
| Granted | 302,778 | $ 2.02 |
| Expired / Canceled | (55,000) | $ 1.10 |
| Exercised | (5,868,416) | $ 0.58 |
| Balance at December 31, 2014 | 977,778 | $ 1.22 |

During the year ended December 31, 2014, the Company issued to certain consultants warrants to purchase an aggregate of 125,000 shares of the Company's Common Stock. Such warrants have exercise prices ranging from $1.10 to $1.83 per share and have terms ranging from one to three years from the date of issuance. An aggregate of 380,000 of these warrants become exercisable only upon the attainment of specified events. No such events were obtained during the year ended December 31, 2014.

During the year ended December 31, 2014, the Company issued to an existing shareholder and member of our Board of Directors warrants to purchase 177,778 shares of the Company's Common Stock. Such warrants have an exercise price of $2.25 per share and a term of two years from the date of issuance.

During the year ended December 31, 2014, there were 1,125,784 warrants exercised pursuant to cashless transactions and 55,000 warrants expired. During the year ended December 31, 2014, there were 4,742,632 warrants exercised for cash resulting in cash proceeds to the Company of approximately $2,848,000. The Company issued 865,565 shares of its Common Stock pursuant to cashless warrant exercises and 4,742,632 shares of its Common Stock pursuant to warrants exercised for cash.

The following table summarizes information regarding the warrants outstanding as of December 31, 2014:

| Exercise Price | Number Outstanding | Weighted—Average Remaining Life (Years) | Weighted—Average Exercise Price |
|---|---|---|---|
| $ 0.50 | 250,000 | 2.0 | $ 0.50 |
| $ 0.80 | 150,000 | 3.0 | $ 0.80 |
| $ 0.98 | 100,000 | 1.0 | $ 0.98 |
| $ 1.10 | 100,000 | 1.4 | $ 1.10 |
| $ 1.14 | 30,000 | 0.0 | $ 1.14 |
| $ 1.72 | 70,000 | 0.7 | $ 1.72 |
| $ 1.83 | 100,000 | 1.0 | $ 1.83 |
| $ 2.25 | 177,778 | 0.2 | $ 2.25 |
| | 977,778 | | |

## 14. STOCK-BASED COMPENSATION

***Stock Options***

As of December 31, 2014, the Company had two active stock-based compensation plans: the 1999 Stock Option Plan (the "*1999 Plan*") and the 2001 Equity Incentive Plan (the "*2001 Plan*").

*1999 Plan*

The 1999 Plan was adopted by the Company's Board of Directors on December 17, 1999. Under the terms of the 1999 Plan, the Company could, originally, issue up to 350,000 non-qualified or incentive stock options to purchase Common Stock of the Company. During the year ended December 31, 2014, the Company subsequently amended and restated the 1999 Plan whereby it increased the share reserve for issuance to approximately 7.0 million shares of the Company's Common Stock. The 1999 Plan prohibits the grant of stock option or stock appreciation right awards with an exercise price less than fair market value of Common Stock on the date of grant. The 1999 Plan also generally prohibits the "re-pricing" of stock options or stock appreciation rights, although awards may be bought-out for a payment in cash or the Company's stock. The 1999 Plan permits the grant of stock based awards other than stock options, including the grant of "full value" awards such as restricted stock, stock units and performance shares. The 1999 Plan permits the qualification of awards under the plan (payable in either stock or cash) as "performance-based compensation" within the meaning of Section 162(m) of the Internal Revenue Code. The number of options issued and outstanding and the number of options remaining available for future issuance are shown in the table below.

*2001 Plan*

The 2001 Plan was adopted by the Company's Board of Directors on September 12, 2001. Under the terms of the 2001 Plan, the Company could issue stock awards to employees, directors and consultants of the Company, and such stock awards could be given for non-statutory stock options (options not intended to qualify as an "incentive stock option" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended), stock bonuses, and rights to acquire restricted stock. The 2001 Plan is administered by the Board of Directors or a Committee of the Board. The Company originally reserved 1,000,000 shares of its Common Stock for issuance under the 2001 Plan. Options granted under the 2001 Plan shall not be less than 85% of the market value of the Company's Common Stock on the date of the grant, and, in some cases, may not be less than 110% of such fair market value. The term of options granted under the 2001 Plan as well as their vesting are determined by the Board and to date, options have been granted with a ten year term and vesting over a three year period. While the Board may suspend or terminate the 2001 Plan at any time, if not terminated earlier, it will terminate on the day before its tenth anniversary of the date of adoption. As of December 31, 2014, the Company does not anticipate issuing any additional stock awards under this plan. Any shares not issued in connection with the awards outstanding under the 2001 Plan will become available for issuance under the 1999 Plan. The number of options issued and outstanding and the number of options remaining available for future issuance are shown in the table below.

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

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) |
|---|---|---|---|
| Balance at December 31, 2011 | 1,707,713 | $ 0.76 | 7.6 |
| Granted | 1,437,500 | $ 0.89 | — |
| Expired/Cancelled | (89,068) | $ 0.92 | — |
| Exercised | (24,924) | $ 0.29 | — |
| Balance at December 31, 2012 | 3,031,221 | $ 0.82 | 7.9 |
| Granted | 817,500 | $ 1.39 | — |
| Expired/Cancelled | (30,000) | $ 0.74 | — |
| Exercised | (35,310) | $ 0.31 | — |
| Balance at December 31, 2013 | 3,783,411 | $ 0.94 | 7.4 |
| Granted | 435,000 | $ 2.13 | — |
| Expired/Cancelled | (62,498) | $ 1.96 | — |
| Exercised | (98,617) | $ 0.68 | — |
| Balance at December 31, 2014 | 4,057,296 | $ 1.06 | 6.8 |

At December 31, 2014, a total of 4,057,296 options were outstanding of which 3,063,392 were exercisable at a weighted average price of $0.87 per share with a remaining weighted average contractual term of approximately 6.1 years. The Company expects that, in addition to the 3,063,392 options that were exercisable as of December 31, 2014, another 978,347 will ultimately vest resulting in a combined total of 4,041,739. Those 4,041,739 shares have a weighted average exercise price of $1.06, an aggregate intrinsic value of approximately $5,423,380 and a weighted average remaining contractual life of 6.8 years as of December 31, 2014.

During the year ended December 31, 2014, there were 98,617 options exercised for cash resulting in the issuance of 98,617 shares of the Company's Common Stock and proceeds of approximately $67,000. During the year ended December 31, 2013, there were 35,310 options exercised which resulted in proceeds of approximately $11,000 to the Company.

The intrinsic value of options exercised during the years ended December 31, 2014 and 2013 was approximately $170,000 and $59,000, respectively. The intrinsic value of options exercisable at December 31, 2014 and 2013 was approximately $4,696,000 and $2,648,000, respectively. The aggregate intrinsic value for all options outstanding as of December 31, 2014 and 2013 was approximately $5,427,000 and $3,786,000, respectively.

The following table summarizes information about employee stock options outstanding and exercisable at December 31, 2014:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| **Exercise Price** | **Number Outstanding** | **Weighted-Average Remaining Life (Years)** | **Weighted-Average Exercise Price** | **Number Exercisable** | **Weighted-Average Exercise Price** |
| $ 0.17–0.24 | 420,221 | 4.0 | $ 0.19 | 420,221 | $ 0.19 |
| $ 0.54-0.74 | 752,580 | 5.7 | $ 0.72 | 716,346 | $ 0.72 |
| $ 0.77-1.15 | 2,047,495 | 7.1 | $ 0.95 | 1,740,144 | $ 0.96 |
| $ 1.45-2.74 | 837,000 | 8.7 | $ 2.07 | 186,681 | $ 2.10 |
| **Total** | 4,057,296 | | | 3,063,392 | |

During the year ended December 31, 2014, 864,157 shares vested with a weighted-average grant-date fair value of approximately $0.80 and approximately 62,498 shares forfeited or expired, of which 15,000 were vested and exercisable, with a weighted-average grant-date fair value of $1.75 resulting in 3,063,392 shares exercisable, with a weighted-average grant-date fair value of approximately $0.70 as of December 31, 2014.

During the year ended December 31, 2013, 951,610 shares vested with a weighted-average grant-date fair value of approximately $0.75 and approximately 30,000 shares forfeited or expired, of which 17,504 were vested and exercisable, with a weighted-average grant-date fair value of $0.88 resulting in 2,309,865 shares exercisable, with a weighted-average grant-date fair value of approximately $0.67 as of December 31, 2013.

At December 31, 2012, there were 1,473,546 shares outstanding and un-exercisable as they had not yet met the vesting criteria. Those options had a weigtted-average grant-date fair value of approximately $0.86.

The weighted-average grant-date fair value per share of options granted to employees during the years ended December 31, 2014, 2013 and 2012 was $1.37, $0.97 and $0.71, respectively. At December 31, 2014, the total remaining unrecognized compensation cost related to unvested stock options amounted to approximately $990,000, which will be amortized over the weighted-average remaining requisite service period of 1.3 years.

***Restricted Stock Awards***

In December 2014, the Company issued 94,116 shares of its Common Stock to certain members of the Company's Board of Directors as compensation for services to be rendered through December 2015. Such shares are forfeitable should the Board members' services be terminated. For this share issuance, the Company will begin recording compensation expense as the services are provided.

In December 2013, the Company issued 144,000 shares of its Common Stock to certain members of the company's Board of Directors as compensation for services to be rendered through December 2014. Such shares are forfeitable should the Board members' services be terminated. For the year ended December 31, 2014, the Company recorded approximately $238,000 as compensation expense.

In January of 2010, the Company issued 847,258 shares of restricted stock to members of management and the Board. These shares vested 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 approximately $0, $0 and $37,000 for the year ended December 31, 2014, 2013 and 2012, respectively.

***Stock Appreciation Rights***

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 on January 30, 2012.

***Common Stock Reserved for Future Issuance***

The following table summarizes the Common Stock reserved for future issuance as of December 31, 2014:

| | Common Stock |
|---|---|
| Convertible preferred stock – Series B | 46,029 |
| Convertible lines of credit | 1,649,548 |
| Stock options outstanding | 4,057,296 |
| Warrants outstanding | 977,778 |
| Restricted stock grants | — |
| Authorized for future grant under stock option plans | 2,651,932 |
| | 9,382,583 |

**15. EMPLOYEE BENEFIT PLAN**

During 1995, the Company adopted a defined contribution 401(k) retirement plan (the "*Plan*"). All U.S. based employees aged 21 years and older are eligible to become participants after the completion of 60 days employment. The Plan provides for annual contributions by the Company of 50% of employee contributions not to exceed 8% of employee compensation. Effective April 1, 2009, the Plan was amended to provide for Company contributions on a discretionary basis. Participants may contribute up to 100% of the annual contribution limitations determined by the Internal Revenue Service.

Employees are fully vested in their share of the Company's contributions after the completion of five years of service. In 2012, the Company authorized a discretionary contribution of approximately $87,000 for the 2012 plan year. Such contribution was paid in January, 2013. In 2013, the Company authorized contributions of approximately $107,000 for the 2013 plan year of which $79,000 were paid prior to December 31, 2013. In 2014, the Company authorized contributions of approximately $118,000 for the 2014 plan year of which $88,000 were paid prior to December 31, 2014.

**16. PENSION PLAN**

One of the Company's foreign subsidiaries maintains a defined benefit pension plan that provides benefits based on length of service and final average earnings. The following table sets forth the benefit obligation, fair value of plan assets, and the funded status of the Company's plan; amounts recognized in the Company's consolidated financial statements; and the assumptions used in determining the actuarial present value of the benefit obligations as of December 31:

| **($ in thousands)** | **2014** | **2013** | **2012** |
|---|---|---|---|
| **Change in benefit obligation:** | | | |
| Benefit obligation at beginning of year | $ 2,821 | $ 2,031 | $ 1,846 |
| Service cost | — | 2 | 2 |
| Interest cost | 106 | 94 | 87 |
| Actuarial (gain) loss | 1,003 | 577 | (7) |
| Effect of exchange rate changes | (442) | 117 | 103 |
| Effect of curtailment | — | — | — |
| Benefits paid | — | — | — |
| Benefit obligation at end of year | 3,488 | 2,821 | 2,031 |
| | | | |
| Change in plan assets: | | | |
| Fair value of plan assets at beginning of year | 1,790 | 1,630 | 1,455 |
| Actual return of plan assets | 47 | 41 | 36 |
| Company contributions | 43 | 43 | 42 |
| Benefits paid | — | — | — |
| Effect of exchange rate changes | (226) | 76 | 97 |
| Fair value of plan assets at end of year | 1,654 | 1,790 | 1,630 |
| Funded status | (1,834) | (1,031) | (401) |
| Unrecognized actuarial loss (gain) | 1,911 | 922 | 317 |
| Unrecognized prior service (benefit) cost | — | — | — |
| Additional minimum liability | (1,911) | (922) | (317) |
| Unrecognized transition (asset) liability | — | — | |
| Net amount recognized | $ (1,834) | $ (1,031) | $ (401) |
| | | | |
| Plan Assets | | | |
| Pension plan assets were comprised of the following asset categories at December 31, | | | |
| Equity securities | 6.4% | 10.4% | 11.55% |
| Debt securities | 87.4% | 83.1% | 81.05% |
| Other | 6.2% | 6.5% | 7.5% |
| Total | 100% | 100% | 100% |
| | | | |
| Components of net periodic benefit cost are as follows: | | | |
| Service cost | $ — | $ 2 | $ 2 |
| Interest cost on projected benefit obligations | 106 | 94 | 87 |
| Expected return on plan assets | — | — | — |
| Amortization of prior service costs | — | — | — |
| Amortization of actuarial loss | — | — | — |
| Net periodic benefit costs | $ 106 | $ 96 | $ 89 |
| | | | |
| The weighted average assumptions used to determine net periodic benefit cost for the years ended December 31, were | | | |
| Discount rate | 2.2% | 3.9% | 4.6% |
| Expected return on plan assets | 4.0% | 4.0% | 4.0% |
| Rate of pension increases | 2% | 2% | 1% |
| Rate of compensation increase | N/A | N/A | N/A |
| | | | |
| The following discloses information about the Company's defined benefit pension plan that had an accumulated benefit obligation in excess of plan assets as of December 31, | | | |
| Projected benefit obligation | $ 3,488 | $ 2,821 | $ 2,031 |
| Accumulated benefit obligation | $ 3,488 | $ 2,821 | $ 2,031 |
| Fair value of plan assets | $ 1,654 | $ 1,790 | $ 1,630 |

As of December 31, 2014, the following benefit payments are expected to be paid as follows:

| | | |
|---|---|---|
| 2015 | $ | 16 |
| 2016 | $ | 16 |
| 2017 | $ | 88 |
| 2018 | $ | 90 |
| 2019 | $ | 92 |
| 2020 — 2024 | $ | 607 |

The Company made contributions to the plan of approximately $43,000 during years 2014 and 2013 and approximately $42,000 during 2012.

The investment objectives for the plan are the preservation of capital, current income and long-term growth of capital. The Company's pension assets are classified within Level 1 of the fair value hierarchy, as defined under ASC 820, 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 measurement date used to determine the benefit information of the plan was January 1, 2015.

**17. ACCUMULATED OTHER COMPREHENSIVE LOSS**

Accumulated other comprehensive income is the combination of the additional minimum liability related to the Company's defined benefit pension plan, recognized pursuant to ASC 715-30, "*Compensation - Retirement Benefits - Defined Benefit Plans – Pension*" and the accumulated gains or losses from foreign currency translation adjustments. The Company translates foreign currencies of its German, Canadian and Mexican subsidiaries into U.S. dollars using the period end exchange rate. Revenue and expenses were translated using the weighted-average exchange rates for the reporting period.  All items are shown net of tax.

As of December 31, 2014, 2013 and 2012, the components of accumulated other comprehensive loss were as follows:

| **($ in thousands)** | **2014** | **2013** | **2012** |
|---|---|---|---|
| Additional minimum pension liability | $ (1,323) | $ (579) | $ 43 |
| Foreign currency translation adjustment | (271) | (251) | (182 ) |
| Ending balance | $ (1,594) | $ (830) | $ (139 ) |

Table of Contents

## 18. QUARTERLY INFORMATION (UNAUDITED)

The following table sets forth selected quarterly financial data for 2014, 2013 and 2012 (in thousands, except share and per share data):

| | 2014 (by quarter) | | | |
|---|---|---|---|---|
| | 1 | 2 | 3 | 4 |
| Revenues | $ 1,063 | $ 937 | $ 919 | $ 1,240 |
| Cost of Sales | 251 | 232 | 248 | 261 |
| Operating expenses | 2,706 | 2,667 | 2,793 | 2,797 |
| Loss from Operations | (1,894) | (1,962) | (2,122) | (1,818) |
| Interest expense (income), net | 79 | 105 | 104 | 128 |
| Other expense (income), net | (283) | (5) | (1) | (8) |
| Income tax expense (benefit) | — | 12 | 3 | 10 |
| Net loss | $ (1,690) | $ (2,074) | $ (2,228) | $ (1,948) |
| | | | | |
| Net loss per share: | | | | |
| Net loss | $ (0.02) | $ (0.02) | $ (0.02) | $ (0.02) |
| Preferred dividends | $ (0.00) | $ (0.00) | $ (0.00) | $ (0.00) |
| Basic loss per share to common shareholders | $ (0.02) | $ (0.02) | $ (0.02) | $ (0.02) |
| Basic weighted-average shares outstanding | 88,604,221 | 91,930,400 | 93,162,548 | 93,384,834 |

| | 2013 (by quarter) | | | |
|---|---|---|---|---|
| | 1 | 2 | 3 | 4 |
| Revenues | $ 856 | $ 1,024 | $ 2,496 | $ 928 |
| Cost of Sales | 237 | 296 | 299 | 258 |
| Operating expenses | 2,316 | 2,306 | 2,375 | 2,504 |
| Loss from Operations | (1,697) | (1,578) | (178) | (1,834) |
| Interest expense (income), net | 1 | 73 | 73 | 74 |
| Change in fair value of derivative liabilities | 1,176 | 3,973 | (470) | 97 |
| Other expense (income), net | (104) | (4) | (123) | (212) |
| Income tax expense (benefit) | 3 | (1) | 3 | 3 |
| Net income (loss) | $ (2,773) | $ (5,619) | $ 339 | $ (1,796) |
| | | | | |
| Net income (loss) per share: | | | | |
| Net income (loss) | $ (0.04) | $ (0.07) | $ 0.00 | $ (0.02) |
| Preferred dividends | $ (0.00) | $ (0.00) | $ (0.00) | $ (0.00) |
| Basic income (loss) per share to common shareholders | $ (0.04) | $ (0.07) | $ 0.00 | $ (0.02) |
| Basic weighted-average shares outstanding | 76,846,563 | 78,581,502 | 83,750,636 | 85,594,118 |

| | 2012 (by quarter) | | | |
|---|---|---|---|---|
| | 1 | 2 | 3 | 4 |
| Revenues | $ 1,121 | $ 966 | $ 938 | $ 926 |
| Cost of Sales | 322 | 355 | 256 | 269 |
| Operating expenses | 2,084 | 2,084 | 2,025 | 2,316 |
| Loss from Operations | (1,285) | (1,473) | (1,343) | (1,659) |
| Interest expense (income), net | 4 | 5 | 5 | 4 |
| Change in fair value of derivative liabilities | 7,536 | (2,441) | 1,378 | (1,761) |
| Other expense (income), net | (235) | (91) | (2) | 6 |
| Income tax expense (benefit) | — | 3 | 2 | 17 |
| Net income (loss) | $ (8,590) | $ 1,051 | $ (2,726) | $ 75 |
| | | | | |
| Net income (loss) per share: | | | | |
| Net income (loss) | $ (0.13) | $ 0.02 | $ (0.04) | $ 0.00 |
| Preferred dividends | $ (0.00) | $ (0.00) | $ (0.00) | $ (0.00) |
| Basic income (loss) per share to common shareholders | $ (0.13) | $ 0.02 | $ (0.04) | $ 0.00 |
| Basic weighted-average shares outstanding | 67,988,916 | 68,554,014 | 70,308,374 | 76,561,858 |

**19. SUBSEQUENT EVENTS**

During the month ended January 31, 2015, the Company borrowed $750,000 under its existing Line of Credit facility, bringing total borrowings as of January 31 2015 to $2,300,000.

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

On January 29, 2015, the Company’s Board of Directors approved the elimination of the Company’s Series C 8% Convertible Preferred Stock (“*Series C Preferred*”) and Series D 8% Convertible Preferred Stock (“*Series D Preferred*”), which eliminations were completed by filing certificates of elimination for both the Series C Preferred and Series D Preferred (the “*Certificates of Elimination*”) with the Delaware Secretary of State on January 30, 2015. No shares of either the Series C Preferred or Series D Preferred were outstanding at the time of the Board’s approval or the filing of the Certificates of Elimination.

In February 2015 the Company consummated a registered direct offering conducted without an underwriter or placement agent. In connection therewith, the Company issued 12,000 shares of Series E Preferred to certain investors at a price of $1,000 per share, with each share convertible into 526.32 shares of the Company’s Common Stock at $1.90 per share (the ”*Series E Financing*”). Approximately 2,000 shares were issued in consideration for the exchange by the Company’s largest shareholder and a director of certain indebtedness of the Company totaling $1,950,000 in principal borrowing plus approximately $28,000 in accrued interest. As a result of the Series E Financing, the Company’s borrowing capacity under the Line of Credit, as defined below, was reduced to $3,050,000, and the $500K Line of Credit, as defined below, was terminated.

The Series E Financing resulted in gross proceeds to the Company of approximately $10.0 million, with net proceeds of approximately $9.925 million after deducting offering expenses of approximately $75,000.

On February 2, 2015 the Company repaid approximately $351,000 in principal and accrued interest under its Line of Credit.

During January and February 2015, the Company issued 7,915 shares of its Common Stock pursuant to 7,915 option exercises resulting in proceeds to the Company of approximately $7,000.

**Exhibit 23.1**

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 Annual Report on Form 10-K of ImageWare Systems, Inc. for the year ended December 31, 2014.

/s/ Vantage Point Advisors, Inc.
Vantage Point Advisors, Inc.
San Diego, California
March 16, 2015

**Exhibit 23.2**

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

As independent registered public accountants, we hereby consent to the incorporation by reference in Registration Statement No. 333-180809 on Form S-8 and Registration Statement No. 333-201442 on Form S-3, of our report dated March 16, 2015, relating to the financial statements of Imageware Systems, Inc. as of and for the year ended December 31, 2014, included in this Annual Report on Form 10-K for the year ended December 31, 2014.

/s/ Mayer Hoffman McCann P.C.
San Diego, California
March 16, 2015

**Exhibit 31.1**

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

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

1. I have reviewed this Annual Report on Form 10-K 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: March 16, 2015

ImageWare Systems, Inc.

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

**Exhibit 31.2**

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

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

1. I have reviewed this Annual Report on Form 10-K 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: March 16, 2015

ImageWare Systems, Inc.

By: /s/ Wayne Wetherell

Wayne Wetherell
Chief Financial Officer
(Principal Financial Officer)

**Exhibit 32.1**

**CERTIFICATION**

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

1. The Annual Report on Form 10-K of the Company for the year ended December 31, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and

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

**IN WITNESS WHEREOF,** the undersigned have set their hands hereto as of the 16th day of March, 2015.

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

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

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