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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Intelli-Check, Inc.

We have audited the accompanying balance sheet of Intelli-Check, Inc. as of December 31, 2003, and the related statements of operations, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2003. 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. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 financial position of Intelli-Check, Inc. as of December 31, 2003, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule II for the years ended December 31, 2003 and 2002 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ Grant Thornton LLP
New York, New York
March 5, 2004

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Intelli-Check, Inc.

We have audited the accompanying balance sheet of Intelli-Check, Inc. as of December 31, 2004 and the related statements of operations, stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements 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 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 statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of Intelli-Check, Inc. as of December 31, 2004 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We have also audited the financial statement schedule listed in the index at item 15(a)(2), schedule II for the year ended December 31, 2004. In our opinion, such financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/Amper, Politziner & Mattia, P.C.
New York, New York
March 4, 2005

INTELLI-CHECK, INC.

BALANCE SHEETS

DECEMBER 31, 2003 and 2004

	<u>ASSETS</u>	
	<u>2003</u>	<u>2004</u>
CURRENT ASSETS:		
Cash and cash equivalents	\$ 3,306,991	\$ 1,750,485
Certificate of deposit, restricted (Note 10)	1,007,310	-
Marketable securities and short-term investments	4,856,388	2,708,796
Accounts receivable, net of allowance of \$20,000 for 2004	249,166	454,112
Inventory	553,709	211,163
Other current assets	<u>217,387</u>	<u>314,466</u>
Total current assets	10,190,951	5,439,022
CERTIFICATE OF DEPOSIT (Note 10)	275,808	-
PROPERTY AND EQUIPMENT, net (Note 3)	210,407	132,905
PATENT COSTS, net (Notes 4 and 9)	48,798	42,589
OTHER INTANGIBLES, net (Notes 4 and 9)	<u>5,590</u>	<u>-</u>
Total assets	<u>\$10,731,554</u>	<u>\$5,614,516</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES:		
Accounts payable	\$ 183,712	\$ 759,218
Accrued expenses (Note 5)	482,464	574,043
Litigation settlement payable (Note 10)	921,700	-
Deferred revenue	252,705	476,387
Current portion of capital lease obligations (Note 10)	<u>427</u>	<u>-</u>
Total current liabilities	<u>1,841,008</u>	<u>1,809,648</u>
OTHER LIABILITIES	<u>114,898</u>	<u>97,266</u>
Total liabilities	<u>1,955,906</u>	<u>1,906,914</u>
COMMITMENTS AND CONTINGENCIES (Note 10)		
SERIES A 8% CONVERTIBLE REDEEMABLE PREFERRED STOCK, net of beneficial conversion feature, warrants issued and issuance costs - \$.01 par value; 1,000,000 shares authorized; 30,000 shares issued and outstanding - liquidation preference of \$3,000,000 (Note 7)	<u>1,874,940</u>	<u>2,839,278</u>
STOCKHOLDERS' EQUITY:		
Common stock – \$.001 par value; 20,000,000 shares authorized; 10,154,918 and 10,290,418 shares issued and outstanding as of 2003 and 2004, respectively	10,154	10,290
Deferred compensation	(377,967)	(126,469)
Additional paid-in capital	34,287,631	36,655,882
Accumulated deficit	<u>(27,019,110)</u>	<u>(35,671,379)</u>
Total stockholders' equity	<u>6,900,708</u>	<u>868,324</u>
Total liabilities and stockholders' equity	<u>\$10,731,554</u>	<u>\$ 5,614,516</u>

The accompanying notes are an integral part of these statements.

INTELLI-CHECK, INC.

STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

	<u>2002</u>	<u>2003</u>	<u>2004</u>
REVENUE	\$ 1,138,587	\$ 1,235,611	\$ 1,119,349
COST OF REVENUE	(501,429)	(454,032)	(393,584)
INVENTORY WRITEDOWN (Note 2)	<u>-</u>	<u>(990,000)</u>	<u>(357,332)</u>
Gross profit (loss)	<u>637,158</u>	<u>(208,421)</u>	<u>368,433</u>
OPERATING EXPENSES:			
Selling	1,437,509	1,352,274	1,176,911
General and administrative	3,355,549	2,386,088	5,032,207
Research and development	1,180,071	1,226,725	1,176,276
Write off of intangible assets (Notes 2 and 9)	-	363,655	-
Reserve on inventory deposit (Notes 2 and 10)	<u>600,000</u>	<u>-</u>	<u>-</u>
Total operating expenses	<u>6,573,129</u>	<u>5,328,742</u>	<u>7,385,394</u>
Loss from operations	<u>(5,935,971)</u>	<u>(5,537,163)</u>	<u>(7,016,961)</u>
OTHER INCOME (EXPENSE):			
Interest income	53,871	51,437	94,030
Interest expense	(4,878)	(43,487)	-
Other income (expense) (Note 10)	<u>336,744</u>	<u>(921,730)</u>	<u>-</u>
	<u>385,737</u>	<u>(913,780)</u>	<u>(94,030)</u>
Net loss	(5,550,234)	(6,450,943)	(6,922,931)
Accretion of convertible redeemable preferred stock costs	-	(198,540)	(964,338)
Dividend on convertible redeemable preferred stock	<u>-</u>	<u>(183,451)</u>	<u>(240,000)</u>
Net loss attributable to common stockholders	<u>\$ (5,550,234)</u>	<u>\$ (6,832,934)</u>	<u>\$ (8,127,269)</u>
PER SHARE INFORMATION:			
Net loss per common share -			
Basic and diluted	<u>\$ (0.64)</u>	<u>\$ (0.74)</u>	<u>\$ (0.79)</u>
Weighted average common shares used in computing			
per share amounts -			
Basic and diluted	<u>8,685,656</u>	<u>9,217,856</u>	<u>10,224,730</u>

The accompanying notes are an integral part of these statements.

INTELLI-CHECK, INC.

STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Deferred Compensation</u>	<u>Accumulated Deficit</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>				
BALANCE, December 31, 2001	8,470,762	\$8,470	\$19,331,004	\$ (189,000)	\$(12,120,942)	\$7,029,532
Exercise of warrants	1,250	1	3,749	-	-	3,750
Exercise of options	273,700	274	825,576	-	-	825,850
Effect on extension of expiration of options	-	-	8,500	-	-	8,500
Effect on extension of expiration of rights dividend	-	-	515,000	-	(515,000)	-
Issuance of common stock for exercise of rights	107,396	107	912,759	-	-	912,866
Purchase and retirement of common stock	(10,000)	(10)	(70,054)	-	-	(70,064)
Issuance of additional common stock for prior year's acquisition of certain assets	32,194	32	(32)	-	-	-
Recognition of deferred compensation	-	-	1,469,327	(1,469,327)	-	-
Amortization of deferred compensation	-	-	-	713,051	-	713,051
Valuation adjustment of deferred compensation	-	-	(596,800)	596,800	-	-
Net loss	-	-	-	-	(5,550,234)	(5,550,234)
BALANCE, December 31, 2002	8,875,302	8,874	22,399,029	(348,476)	(18,186,176)	3,873,251
Effect on extension of expiring options	-	-	167,000	-	-	167,000
Exercise of stock options	175,209	175	679,436	-	-	679,611
Exercise of rights	4,407	5	37,455	-	-	37,460
Issuance of common stock in connection with secondary offering	1,100,000	1,100	7,580,326	-	-	7,581,426
Effect on extension of expiring rights dividend	-	-	2,000,000	-	(2,000,000)	-
Warrants issued in connection with the issuance of convertible redeemable preferred stock	-	-	497,700	-	-	497,700
Beneficial conversion feature embedded in convertible redeemable preferred stock issued	-	-	540,000	-	-	540,000
Amortization of deferred compensation	-	-	-	357,194	-	357,194
Dividend on convertible redeemable preferred stock	-	-	-	-	(183,451)	(183,451)
Recognition of deferred compensation	-	-	319,904	(319,904)	-	-
Accretion of convertible redeemable preferred stock	-	-	-	-	(198,540)	(198,540)
Valuation adjustment of deferred compensation	-	-	66,781	(66,781)	-	-
Net loss	-	-	-	-	(6,450,943)	(6,450,943)
BALANCE, December 31, 2003	10,154,918	10,154	34,287,631	(377,967)	(27,019,110)	6,900,708
Effect on extension of expiring options	-	-	1,347,000	-	-	1,347,000
Exercise of stock options	142,700	143	427,836	-	-	427,979
Issuance of common stock under employment agreement	1,500	2	6,373	-	-	6,375
Effect on extension of expiring rights dividend	-	-	525,000	-	(525,000)	-
Purchase and retirement of common stock	(20,200)	(20)	(98,731)	-	-	(98,751)
Issuance of common stock for services rendered	11,500	11	48,864	-	-	48,875
Amortization of deferred compensation	-	-	-	363,407	-	363,407
Dividend on convertible redeemable preferred stock	-	-	-	-	(240,000)	(240,000)
Recognition of deferred compensation	-	-	542,648	(542,648)	-	-
Accretion of convertible redeemable preferred stock	-	-	-	-	(964,338)	(964,338)
Valuation adjustment of deferred compensation	-	-	(430,739)	430,739	-	-
Net loss	-	-	-	-	(6,922,931)	(6,922,931)
BALANCE, December 31, 2004	<u>10,290,418</u>	<u>\$10,290</u>	<u>\$36,655,882</u>	<u>\$ (126,469)</u>	<u>\$(35,671,379)</u>	<u>\$868,324</u>

The accompanying notes are an integral part of these statements.

INTELLI-CHECK, INC.

**STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004**

	<u>2002</u>	<u>2003</u>	<u>2004</u>
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	\$ (5,550,234)	\$ (6,450,943)	\$ (6,922,931)
Adjustments to reconcile net loss to net cash used in operating activities-			
Depreciation and amortization	451,580	436,778	111,743
Write off of intangible assets	-	363,655	-
Non cash stock based compensation expense	8,500	167,000	1,350,187
Issuance of common stock for services rendered	-	-	48,875
Amortization of deferred compensation	713,051	357,194	363,407
Writedown of inventory	-	990,000	357,332
Reserve on inventory deposit	600,000	-	-
Changes in assets and liabilities-			
(Increase) decrease in certificates of deposit, restricted	(4,823)	(1,009,801)	1,283,118
(Increase) in accounts receivable	(67,994)	(155,636)	(288,946)
Decrease (increase) in inventory	365,849	259,130	(14,786)
(Increase) decrease (increase) in other current assets	(502,890)	56,383	(97,081)
Increase (decrease) increase in accounts payable and accrued expenses	18,482	(464,354)	667,086
Increase (decrease) in litigation settlement payable	-	921,700	(921,700)
Increase (decrease) increase in deferred revenue	197,347	(84,021)	290,050
Net cash used in operating activities	<u>(3,771,132)</u>	<u>(4,612,915)</u>	<u>(3,773,646)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(29,187)	(4,352)	(22,441)
Investment in marketable securities and short-term investments	-	(4,856,388)	(10,294,803)
Sales of marketable securities and short-term investments	-	-	12,442,395
Net cash (used in) provided by investing activities	<u>(29,187)</u>	<u>(4,860,740)</u>	<u>2,125,151</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from issuance of common stock	1,742,466	717,071	431,167
Net proceeds from issuance of common stock from secondary offering	-	7,581,426	-
Net proceeds from issuance of convertible redeemable preferred stock	-	2,714,100	-
Payment of dividend to preferred stockholders	-	(122,958)	(240,000)
Repayment of capital lease obligations	(22,739)	(19,572)	(427)
Treasury stock purchased	(70,064)	-	(98,751)
Net cash provided by financing activities	<u>1,649,663</u>	<u>10,870,067</u>	<u>91,989</u>
Net (decrease) increase (decrease) in cash and cash equivalents	(2,150,656)	1,396,412	(1,556,506)
CASH AND CASH EQUIVALENTS, beginning of year	<u>4,061,235</u>	<u>1,910,579</u>	<u>3,306,991</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 1,910,579</u>	<u>\$ 3,306,991</u>	<u>\$ 1,750,485</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the year for interest	<u>\$ 4,878</u>	<u>\$ 1,487</u>	<u>\$ -</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH FINANCING ACTIVITIES:			
Stock options issued for services rendered	\$ 1,469,327	\$ 319,904	\$ 542,648
Beneficial conversion feature and warrants issued in connection with issuance of convertible redeemable preferred stock	-	1,037,700	-
Accretion of convertible redeemable preferred stock cost	-	198,540	964,338

The accompanying notes are an integral part of these statements.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

1. NATURE OF BUSINESS AND LIQUIDITY

Business

Intelli-Check ("the Company" or "we") was formed in 1994 to address a growing need for a reliable document and age verification system that could be used to detect fraudulent driver licenses and other widely accepted forms of government-issued identification documents. Since then, our technology has been further developed for application in the commercial fraud protection, access control and governmental security markets. Additionally, it is currently being used to address inefficiencies and inaccuracies associated with manual data entry. The core of Intelli-Check's product offerings is our proprietary software technology that verifies the authenticity of driver licenses, state issued non-driver and military identification cards used as proof of identity. Our patented ID-Check® software technology instantly reads, analyzes, and verifies the encoded data in magnetic stripes and barcodes on government-issue IDs from approximately 60 jurisdictions in the U.S. and Canada to determine if the content and format is valid. We have served as the national testing laboratory for the American Association of Motor Vehicle Administrators (AAMVA) since 1999 and have access to all the currently encoded driver license formats.

Our patented ID-Check™ software technology provides the ability to verify the validity of driver licenses, state issued non-driver ID cards and military ID's that contain magnetic stripes or bar codes, which in most cases conform to AAMVA/ANSI/ISO standards. The ID-Check software is contained in our platforms and some of our other software products. Our C-Link® software product, which runs on a personal computer was created to work in conjunction with the ID-Check unit, allows a user to instantly view the encoded data for further verification, analyze the data and generate various reports where permitted by law.

We recently announced two new products, ID-Traveler™ and ID-Prove™, which provide "in-person proofing" to meet the credentialing requirements of Presidential Directive HSPD-12, a policy for a Common Identification Standard for Federal Employees and Contractors and help in Patriot Act compliance. All of our new innovations and product roll-outs are designed for use with our new data capture module (DCM), a compact, self-contained two-dimensional bar code and magnetic stripe reader, which enables the new software technology applications to be used on a variety of commercially available data processing devices, including PDAs, Tablets, Laptops, Desktops and Point-of-Sale Computers.

Liquidity

Since inception, the Company has incurred significant losses and negative cash flow from operating activities, and as of December 31, 2004 we had an accumulated deficit of \$35,671,379. The Company anticipates that its current available cash on hand and marketable securities and cash resources from expected revenues from the sale of the units in inventory and the licensing of its technology will be sufficient to meet its anticipated working capital and capital expenditure requirements for at least the next twelve months. These requirements are expected to include the purchase of inventory, product development, sales and marketing expenses, working capital requirements and other general corporate purposes. The Company may need to raise additional funds to respond to business contingencies which may include the need to fund more rapid expansion, fund additional marketing expenditures, develop new markets for its ID-Check technology, enhance its operating infrastructure, respond to competitive pressures, or acquire complementary businesses or necessary technologies.

2. SIGNIFICANT ACCOUNTING POLICIES

Cash and Cash Equivalents

Cash and cash equivalents include cash and highly liquid investments with original maturities of three months or less when purchased. As of December 31, 2003 and 2004, cash equivalents included money market funds, commercial paper and other liquid short-term debt instruments (with maturities at date of purchase of three months or less) of \$3,280,691 and \$1,723,810, respectively.

Marketable Securities

The Company has classified its marketable securities as held-to-maturity as the Company has the intent and ability to hold these securities to maturity. The securities are carried at amortized cost using the specific identification method. Interest income is recorded using an effective interest rate, with the associated premium or discount amortized to interest income. All of the Company's marketable securities have maturities of less than 1 year with a weighted average interest rate of 1.97%. The carrying value of the marketable securities as of December 31, 2003 and 2004 approximated the fair market value.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

Inventory

Inventory is stated at the lower of cost or market and cost is determined using the first-in, first-out method. Inventory is primarily comprised of finished goods.

Inventory Valuation

The Company's inventory consists primarily of its ID-Check terminals that run its patented software and input devices purchased during 2004. The Company acquired its ID-Check terminals in December 1999 and, shortly thereafter, was returned to the manufacturer for upgrade and became available for sale in the fourth quarter of 2000. The Company periodically evaluates the current market value of its inventory, taking into account any technological obsolescence that may occur due to changes in hardware technology and the acceptance of the product in the marketplace. Based on the ongoing evaluation of the Company's inventory, the Company recorded an inventory write down of \$990,000 during 2003 and an additional write down of \$357,332 during 2004. Should the Company determine in a future period that an adjustment to market value of the inventory is necessary, an adjustment would be recorded at that time, which would not have a material adverse effect on the Company's results of operations. The manufacturer discontinued the production of the ID-Check terminals in 2003. The ID-Check terminal is fully capable of running the Company's patented software as it utilizes a high quality imager/scanner and magnetic stripe reader and is currently being marketed for sale.

Long-Lived Assets and Impairment of Long-Lived Assets

The Company's long-lived assets include property and equipment, acquired software, patents, goodwill and other intangibles.

As of January 1, 2002, the Company has adopted SFAS No. 142 "Goodwill and Other Intangible Assets". Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). Pursuant to the adoption of SFAS No. 142, the Company has evaluated its goodwill and other intangibles to identify additional separately identifiable intangibles; no adjustment was warranted. Intangible assets that will continue to be classified as goodwill will no longer be amortized. This provision had no material impact on the Company's financial position and results of operations. At December 31, 2003, the Company performed an impairment test of its goodwill and determined that there was an impairment of the recorded goodwill, which resulted from the Company's decision to discontinue the selling of its IDentiScan products. As a result, the Company wrote off the original recorded value of goodwill totaling \$181,447 as of December 31, 2003, which affected the results of operations for the period then ended.

As of January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets" which supersedes SFAS No. 121, "Accounting for the Impairment or Disposal of Long-lived Assets to be Disposed Of". SFAS No. 144 requires that identifiable intangible assets that are not deemed to have indefinite lives will be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may be impaired. Furthermore, these assets are evaluated for continuing value and proper useful lives by comparison to undiscounted expected future cash flow projections. The Company has determined that as a result of discontinuing the selling of its IDentiScan products, certain of its intangible assets, including patent costs, with a remaining book value of \$182,208 has been impaired and was written off as of December 31, 2003, which affected the results of operations for the period then ended.

Property and Equipment

Property and equipment are recorded at cost and are depreciated over their estimated useful lives ranging from two to ten-years using the straight-line basis. Equipment held under capital leases and leasehold improvements are amortized utilizing the straight-line method over the lesser of the term of the lease or estimated useful life of the asset.

Intangible Assets

Patent costs, primarily consisting of legal costs and allocated costs are being amortized over a period of 17 years using the straight-line method. Acquired Software was amortized over a period of 2 years using the straight-line method. Other intangibles, consisting of a covenant not to compete and copyrights were amortized over a period of 2 and 3 years, respectively using the straight-line method. As discussed above and in Note 9, certain of these intangible assets were written off as of December 31, 2003.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

Costs of Computer Software Developed or Obtained for Internal Use

The Company accounts for certain software costs under Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"), which provides guidance for determining whether computer software is internal-use software and guidance on accounting for the proceeds of computer software originally developed or obtained for internal use and then subsequently sold to the public. It also provides guidance on capitalization of the costs incurred for computer software developed or obtained for internal use.

Capitalized Software Development Costs

SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed," specifies that costs incurred internally in creating a computer software product shall be charged to expense when incurred as research and development until technological feasibility has been established for the product. Software production costs for computer software that is to be used as an integral part of a product or process shall not be capitalized until both (a) technological feasibility has been established for the software and (b) all research and development activities for the other components of the product or process have been completed. The Company has not capitalized any software costs for the years ended December 31, 2002, 2003 and 2004.

Revenue Recognition

The Company sells its products directly through its sales force and through distributors. Revenue from direct sales of the Company's product is recognized upon shipment to the customer and title has passed. The Company's products require continuing service or post contract customer support and performance by the Company; accordingly, a portion of the revenue pertaining to the service and support is deferred based on its fair value and recognized ratably over the period in which the future service, support and performance are provided, which is generally one year. Currently, with respect to sales of certain of its products, the Company does not have enough experience to identify the fair value of each element and the full amount of the revenue and related gross margin is deferred and recognized ratably over the one-year period in which the future service, support and performance are provided.

In addition, the Company recognizes sales from licensing of its patented software to customers. The Company's licensed software requires continuing service or post contract customer support and performance by the Company; accordingly, a portion of the revenue is deferred based on its fair value and recognized ratably over the period in which the future service, support and performance are provided, which is generally one year.

During the second quarter of fiscal 2003, the Company began receiving royalties from licensing its technology, which are recognized as revenues in the period they are earned.

The Company has adopted EITF 00-21, "Revenue Arrangements with Multiple Deliverables" as of fiscal year ended December 31, 2003. Revenue arrangements were allocated to the separate units of accounting based on their relative fair values and revenue is recognized in accordance with its policy as stated above. The impact of adopting EITF 00-21 on the financial statements was immaterial.

Research and Development Costs

Research and development costs are charged to expense as incurred.

Income Taxes

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss carryforwards. Deferred tax assets and liabilities are measured using expected tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The Company has recorded a full valuation allowance for its net deferred tax assets as of December 31, 2004, due to the uncertainty of the realizability of those assets.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

Fair Value of Financial Instruments

The Company adheres to the provisions of SFAS No. 107, "Disclosures about Fair Value of Financial Instruments." This pronouncement requires that the Company calculate the fair value of financial instruments and include this additional information in the notes to financial statements when the fair value is different than the book value of those financial instruments. The Company's financial instruments include cash and cash equivalents, certificate of deposits, marketable securities, accounts receivable and accounts payable. At December 31, 2003 and 2004, the carrying value of the Company's financial instruments approximated fair value, due to their short-term nature.

Business Concentrations and Credit Risk

Financial instruments, which subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents and marketable securities. The Company maintains cash between two financial institutions. The marketable securities consist of short term investment grade corporate bonds. The Company performs periodic evaluations of the relative credit standing of these institutions.

The Company's sales to date have been limited due to the refocus of its marketing efforts and introduction of new products to a number of clients which are concentrated in the United States of America and the long sales cycle to government entities. The Company performs ongoing credit evaluations, generally does not require collateral, and establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of customers, historical trends and other information.

The Company had one supplier for the production of its ID-Check 1400 product and one supplier for the production of its IDentiScan products. The agreements with these suppliers have terminated. The Company has modified its software to operate in windows based systems and can integrate with different hardware platforms that are readily available in the marketplace. The Company does not maintain a manufacturing facility of its own and is not dependent on maintaining its production relationships due to the flexibility of its software to run on multiple existing platforms.

Net Loss Attributable to Common Shareholders

The Company computes net loss per common share in accordance with SFAS No. 128, "Earnings Per Share". Under the provisions of SFAS No. 128, basic net loss per common share ("Basic EPS") is computed by dividing net loss by the weighted average number of common shares outstanding. Diluted net loss per common share ("Diluted EPS") is computed by dividing net loss by the weighted average number of common shares and dilutive common share equivalents then outstanding. SFAS No. 128 requires the presentation of both Basic EPS and Diluted EPS on the face of the statements of operations. Diluted EPS for the years ended December 31, 2002, 2003 and 2004, does not include the impact of stock options and warrants then outstanding, as the effect of their inclusion would be antidilutive.

The following table summarizes the equivalent number of common shares assuming the related securities that were outstanding as of December 31, 2002, 2003 and 2004 had been converted:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Stock options	2,333,866	2,701,124	2,777,474
Convertible redeemable preferred stock		454,545	454,545
Warrants	<u>10,000</u>	<u>233,636</u>	<u>323,636</u>
Total	<u>2,343,866</u>	<u>3,389,305</u>	<u>3,555,655</u>

Stock-Based Compensation

At December 31, 2004, the Company has stock based compensation plans, which are described more fully in Note 8. As permitted by the SFAS No. 123, "Accounting for Stock Based Compensation", the Company accounts for stock-based compensation arrangements with employees in accordance with provisions of Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees". Compensation expense for stock options issued to employees is based on the difference on the date of grant, between the fair value of the Company's stock and the exercise price of the option. No stock based employee compensation cost is reflected in net loss, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock at the date of grant. The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction

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With Selling Goods or Services”. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable.

In accordance with SFAS No. 148 “Accounting for Stock Based Compensation-Transition and disclosure”, the following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to employees stock based compensation:

	<u>Years Ended</u>		
	<u>December 31, 2002</u>	<u>December 31, 2003</u>	<u>December 31, 2004</u>
Net loss attributable to common stockholders, as reported	\$ (5,550,234)	\$ (6,832,934)	\$ (8,127,269)
Add:			
Total stock based employee compensation expense determined under fair value based method for all awards	<u>(2,196,369)</u>	<u>(2,970,686)</u>	<u>(2,107,593)</u>
Net loss, pro forma	\$ (7,746,603)	\$ (9,803,620)	\$ (10,234,862)
Basic and diluted loss per share, as reported	\$ (0.64)	\$ (0.74)	\$ (0.79)
Basic and diluted loss per share, pro forma	\$ (0.89)	\$ (1.06)	\$ (1.00)

Comprehensive Loss

The Company’s comprehensive net loss is equal to its net loss for the years ended December 31, 2002, 2003 and 2004.

Segment Information

The Company adheres to the provisions of SFAS No. 131, “Disclosures About Segments of an Enterprise and Related Information.” This statement establishes standards for the way public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in financial statements issued to shareholders. Management has determined that it does not have any separately reportable business segments.

Use of Estimates

The preparation of the Company’s financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the Company’s financial statements and accompanying notes. Actual results could differ materially from those estimates.

Recently Issued Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, “Consolidation of Variable Interest Entities” (FIN No. 46), which addresses consolidation by business enterprises of variable interest entities (“VIEs”). FIN No. 46 is applicable immediately for VIEs created after January 31, 2003 and are effective for reporting periods ending after December 15, 2003, for VIEs created prior to February 1, 2003. In December 2003, the FASB published a revision to FIN 46 (“FIN 46R”) to clarify some of the provisions of the interpretation and to defer the effective date of implementation for certain entities. Under the guidance of FIN 46R, public companies that have interests in VIE’s that are commonly referred to as special purpose entities are required to apply the provisions of FIN 46R for periods ending after December 15, 2003. A public company that does not have any interests in special purpose entities but does have a variable interest in a VIE created before February 1, 2003, must apply the provisions of FIN 46R by the end of the first interim or annual reporting period ending after March 15, 2004. The Company adopted FIN 46R during the quarter ended March 31, 2004. The adoption of FIN 46 had no impact on the financial condition or results of operations since the Company does not have investments in VIE’s.

In December 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 123 (revised 2004) (“123R”), “Share-Based Payment.” Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share based payment transactions be

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recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123(R) replaces SFAS No. 123, "Accounting for Stock Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in APB Opinion No. 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value based method been used. Public entities (other than those filing as small business issuers) will be required to apply SFAS No. 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. We are in the process of evaluating whether the adoption of SFAS No. 123(R) will have a significant impact on our overall results of operations or financial position.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an Amendment of ARB No. 43," Chapter 4 ("SFAS No. 151"). The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 will become effective beginning in fiscal 2006. The adoption of this Statement will not have a significant impact on our financial condition or results of operations.

In December 2004, the FASB issued SFAS No. 153, "Exchange of Nonmonetary Assets" an amendment of APB Opinion No. 29, "Accounting for Nonmonetary Transactions." The amendments made by SFAS No. 153 are based on the principle that exchanges on nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods after the date of issuance. The provisions of SFAS No. 153 shall be applied prospectively. The adoption of this Statement will not have a significant impact on our financial condition or results of operations.

3. PROPERTY AND EQUIPMENT

Property and equipment are comprised of the following as of December 31, 2003 and 2004:

	<u>2003</u>	<u>2004</u>
Computer equipment	\$ 485,989	\$ 515,982
Furniture and fixtures	155,589	152,252
Leasehold improvements	143,253	143,253
Office equipment	<u>47,552</u>	<u>43,338</u>
	832,383	854,825
Less - Accumulated depreciation and amortization	<u>(621,976)</u>	<u>(721,920)</u>
	<u>\$ 210,407</u>	<u>\$ 132,905</u>

Depreciation expense for the years ended December 31, 2002, 2003 and 2004 amounted to \$126,537, \$118,057 and \$99,944, respectively.

4. INTANGIBLE ASSETS

The following summarize the carrying amounts of intangible assets and related amortization:

	<u>As of December 31, 2003</u>		<u>As of December 31, 2004</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortized intangible assets				
Patents	105,661	56,863	105,661	63,072
Copyrights	<u>17,500</u>	<u>11,910</u>	<u>17,500</u>	<u>17,500</u>
Total	<u>\$ 123,161</u>	<u>\$ 68,773</u>	<u>\$ 123,161</u>	<u>\$ 80,572</u>

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Amortization expense for years ended December 31, 2002, 2003, and 2004 were \$325,043, \$318,724 and \$11,799, respectively.

As of December 31, 2004, estimated amortization expense for each of the succeeding five years is \$6,215.

5. ACCRUED EXPENSES

Accrued expenses are comprised of the following as of December 31, 2003 and 2004:

	<u>2003</u>	<u>2004</u>
Professional fees	\$ 184,876	\$ 302,360
Payroll	128,783	131,661
Rent	23,943	20,523
Other	<u>144,862</u>	<u>119,499</u>
	<u>\$ 482,464</u>	<u>\$ 574,043</u>

6. INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets for federal and state income taxes as of December 31, 2003 and 2004 are as follows:

	<u>2003</u>	<u>2004</u>
Deferred tax assets, net:		
Net operating loss carryforwards	\$8,904,550	\$10,682,000
Depreciation	(20,000)	(20,000)
Reserves	636,000	779,000
Less- Valuation allowance	<u>(9,520,550)</u>	<u>(11,441,000)</u>
Deferred tax assets, net	<u>\$ -</u>	<u>\$ -</u>

Realization of deferred tax assets is dependent upon future earnings, if any. The Company has recorded a full valuation allowance against its deferred tax assets since management believes that it is more likely than not that these assets will not be realized in the near future.

As of December 31, 2004 the Company had net operating loss carryforwards (NOL's) for federal income tax purposes of approximately \$27 million. There can be no assurance that the Company will realize the benefit of the NOL's. The federal NOL's are available to offset future taxable income and expire from 2018 through 2024 if not utilized. Under Section 382 of the Internal Revenue Code, these NOL's may be limited due to ownership changes.

The effective tax rate for the years ended December 31, 2002, 2003 and 2004 is different from the tax benefit that would result from applying the statutory tax rates mainly due to the additional valuation allowance that has been recognized.

7. SERIES A 8% CONVERTIBLE REDEEMABLE PREFERRED STOCK

On March 27, 2003, pursuant to a Securities Purchase Agreement, we sold 30,000 shares of our Series A 8% Convertible Redeemable Preferred Stock, par value \$.01 per share, for \$3,000,000 before expenses to Gryphon Master Fund, L.P. Each share of Preferred Stock entitles the holder to receive dividends of 8% per annum and was convertible into 15.1515 shares of our common stock. Additionally, each investor received one (1) five year warrant to purchase 3.787875 shares of common stock at an exercise price of \$6.78 with each share of Preferred Stock purchased. The total amount of shares that may be issued upon conversion of the Preferred Stock and exercise of the warrants are 454,545 and 113,636, respectively. Dividend payments of \$120,000 in cash are due semi-annually beginning September 30, 2003 and, accordingly, the Company paid \$122,958 on September 30, 2003. In connection with this financing, we paid agent fees of \$150,000 and issued warrants and options to purchase 8,854 shares of our common stock at a price of \$6.78. We also paid professional fees of approximately \$136,000. We recorded the relative fair value of all the warrants issued in connection with this transaction of \$497,700 against the amount of the Convertible Redeemable Preferred Stock as of March 27, 2003, which was calculated using the Black-Scholes valuation method, as well as \$540,000 of beneficial conversion feature in accordance with EITF 00-27 and such amounts were being accreted along with issuance cost of \$285,900 over the five year period until the mandatory redemption

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date of the Preferred Stock, the fifth anniversary of closing. We recorded dividend and accretion of \$381,991 for 2003, and dividends of \$240,000 for 2004. On February 25, 2005, Gryphon Master Fund, L.P. converted the Company's Preferred Stock into 454,545 shares of the Company's common stock at a conversion price of \$6.60 per share. A final dividend payment of \$97,315 was paid for the period up to the date of conversion. Additionally, as a result of this conversion, the period we used in estimating the accretion of all of the costs associated with the issuance of the Preferred Stock changed from 5 years to 1.9166 years. Accordingly, the accretion was increased in the fourth quarter of 2004 by \$669,618 and amounted to \$964,338 for the year ended December 31, 2004. The effect of this change in accounting estimate in 2004 was a reduction in equity. A registration statement covering the common stock issued upon conversion of the preferred stock and issuable upon the exercise of the warrants was declared effective on June 24, 2003.

8. STOCKHOLDERS' EQUITY

Series A Convertible Preferred Stock

In January 1997, the Board of Directors authorized the creation of a class of Series A Convertible Preferred Stock with a par value of \$.01. The Series A Convertible Preferred Stock is convertible into an equal number of common shares at the holder's option, subject to adjustment for anti-dilution. The holders of Series A Convertible Preferred Stock are entitled to receive dividends as and if declared by the Board of Directors. In the event of liquidation or dissolution of the Company, the holders of Series A Convertible Preferred Stock are entitled to receive all accrued dividends, if applicable, plus the liquidation price of \$1.00 per share. As of December 31, 2003 and 2004, there were no outstanding shares of Series A Convertible Preferred Stock.

Secondary Offering

On October 8, 2003, the Company successfully consummated its secondary offering of 1,100,000 shares of common stock at \$8.00 per share and received proceeds net of underwriting discounts and commissions and before other offering expenses of approximately \$7,906,000. Offering expenses totaled \$324,574 and were fully paid as of December 31, 2003. In connection with this offering, the Company granted to its underwriter an option to purchase up to an additional 165,000 shares of its common stock at \$8.00 per share less underwriter discounts and commissions for the purpose of covering over-allotments, which expired on November 16, 2003. In addition, the Company sold to the underwriter 110,000 warrants for a price of \$110 to purchase 110,000 shares of its common stock at a price of \$9.60 per share and expire on October 8, 2008.

Common Stock, Warrants and Rights

In March 2001, the Company declared a dividend distribution of one non-transferable right to purchase one share of the Company's common stock for every 10 outstanding shares of common stock continuous held from the record date to the date of exercise, as well as common stock underlying vested stock options and warrants, held of record on March 30, 2001, at an exercise price of \$8.50. The rights were due to expire on October 4, 2002, which was one year after the effective date of the registration statement related to the shares of common stock underlying the rights. We extended the expiration date until April 4, 2003, further extended the rights until December 31, 2003, June 30, 2004, and, finally, extended the expiration date again to June 30, 2005. Under certain conditions, the Company has the right to redeem the outstanding rights for \$.01 per right. Such conditions were not met as of March 25, 2005. The Company reserved 970,076 shares of common stock for future issuance under this rights offering. The Company has recorded the fair value of the rights of \$1,082,000 as a dividend during the quarter ended March 31, 2001, which was calculated using the Black-Scholes valuation method and recorded as an increase in additional paid-in capital and a reduction in accumulated deficit. The Company also recorded the fair value of the additional rights extensions of \$515,000, \$2,000,000 and \$525,000 during the years ended December 31, 2002, 2003 and 2004, respectively, using the Black-Scholes valuation method and recorded an increase in additional paid-in-capital and a reduction in accumulated deficit. As of December 31, 2004, 292,001 of these rights were exercised and the Company received cumulatively \$2,482,009 before expenses of \$133,834.

In March 2001, the Board of Directors authorized, subject to certain business and market conditions, the purchase of up to \$1,000,000 of our common stock. As of December 31, 2004, the Company cumulatively purchased 40,200 shares of the Company's common stock for approximately \$222,000 and subsequently retired those shares.

All warrants have been issued with an exercise price that is equal to or above the fair market value of the Company's common stock on the date of grant.

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Stock Options

In order to retain and attract qualified personnel necessary for the success of the Company, the Company adopted a Stock Option Plan (the "1998 Stock Option Plan") covering up to 400,000 of the Company's common shares, pursuant to which officers, directors, key employees and consultants to the Company are eligible to receive incentive stock options and nonqualified stock options. The Compensation Committee of the Board of Directors administers the 1998 Stock Option Plan and determines the terms and conditions of options granted, including the exercise price. The 1998 Stock Option Plan provides that all stock options will expire within ten years of the date of grant. Incentive stock options granted under the 1998 Stock Option Plan must be granted at an exercise price that is not less than the fair market value per share at the date of grant and the exercise price must not be less than 110% of the fair market value per share at the date of grant for grants to persons owning more than 10% of the voting stock of the Company. The 1998 Stock Option Plan also entitles nonemployee directors to receive grants of non-qualified stock options as approved by the Board of Directors.

In August 1999, the Company adopted the 1999 Stock Option Plan (the "1999 Stock Option Plan") covering up to 1,000,000 of the Company's common shares, pursuant to which officers, directors, key employees and consultants to the Company are eligible to receive incentive stock options and nonqualified stock options. The Compensation Committee of the Board of Directors administers the 1999 Stock Option Plan and determines the terms and conditions of options granted, including the exercise price. The 1999 Stock Option Plan provides that all stock options will expire within ten years of the date of grant. Incentive stock options granted under the 1999 Stock Option Plan must be granted at an exercise price that is not less than the fair market value per share at the date of grant and the exercise price must not be less than 110% of the fair market value per share at the date of grant for grants to persons owning more than 10% of the voting stock of the Company. The 1999 Stock Option Plan also entitles nonemployee directors to receive grants of non-qualified stock options as approved by the Board of Directors.

At the Company's Annual Meeting held on July 11, 2001, the stockholders approved the 2001 Stock Option Plan covering up to 500,000 of the Company's common shares, pursuant to which the officers, directors, key employees and consultants to the Company are eligible to receive incentive stock options and nonqualified stock options. The Compensation Committee of the Board of Directors administers the 2001 Stock Option Plan and determines the terms and conditions of options granted, including the exercise price. The 2001 Stock Option Plan provides that all stock options will expire within ten years of the date of grant. Incentive stock options granted under the 2001 Stock Option Plan must be granted at an exercise price that is not less than the fair market value per share at the date of the grant and the exercise price must not be less than 110% of the fair market value per share at the date of the grant for grants to persons owning more than 15% of the voting stock of the Company. The 2001 Stock Option Plan also entitles non-employee directors to receive grants on non-qualified stock options as approved by the Board of Directors.

At the Company's Annual Meeting held on July 10, 2003, the stockholders approved the 2003 Stock Option Plan covering up to 500,000 of the Company's common shares, pursuant to which the officers, directors, key employees and consultants to the Company are eligible to receive incentive stock options and nonqualified stock options. The Compensation Committee of the Board of Directors administers the 2003 Stock Option Plan and determines the terms and conditions of options granted, including the exercise price. The 2003 Stock Option Plan provides that all stock options will expire within ten years of the date of grant. Incentive stock options granted under the 2003 Stock Option Plan must be granted at an exercise price that is not less than the fair market value per share at the date of the grant and the exercise price must not be less than 110% of the fair market value per share at the date of the grant for grants to persons owning more than 15% of the voting stock of the Company. The 2003 Stock Option Plan also entitles non-employee directors to receive grants on non-qualified stock options as approved by the Board of Directors.

At the Company's Annual Meeting held on July 8, 2004, the stockholders approved the 2004 Stock Option Plan covering up to 850,000 of the Company's common shares, pursuant to which the officers, directors, key employees and consultants to the Company are eligible to receive incentive stock options and nonqualified stock options. The Compensation Committee of the Board of Directors administers the 2004 Stock Option Plan and determines the terms and conditions of options granted, including the exercise price. The 2004 Stock Option Plan provides that all stock options will expire within ten years of the date of grant. Incentive stock options granted under the 2004 Stock Option Plan must be granted at an exercise price that is not less than the fair market value per share at the date of the grant and the exercise price must not be less than 110% of the fair market value per share at the date of the grant for grants to persons owning more than 15% of the voting stock of the Company. The 2004 Stock Option Plan also entitles non-employee directors to receive grants on non-qualified stock options as approved by the Board of Directors.

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During 2002, the Company granted stock options to purchase 180,176 shares of common stock at exercise prices ranging from \$3.97 to \$12.10 per share to consultants under various agreements, of which 50,000 options expired. During 2003, the Company granted additional stock options to purchase 69,425 shares of common stock at exercise prices ranging from \$6.78 to \$6.97 per share to consultants under various agreements. During 2004, the Company granted warrants to purchase 100,000 shares of common stock at an exercise price of \$7.54 per share to consultants (see footnote 10). The fair market value of each option was estimated on the date of grant using the Black-Scholes option pricing model. Accordingly, we have recorded \$1,469,327, \$319,904 and \$542,648 as deferred compensation for these services as of December 31, 2002, 2003 and 2004, respectively. As a result of some of the granted options having varying vesting periods, the Company revalued certain options either as of the vesting date or as of the balance sheet date for those options unvested using the Black Scholes option pricing model. Accordingly, the Company recorded a reduction of the fair value of these options totaling \$596,800 for the year ended December 31, 2002, an increase in the fair value of \$66,781 for the year ended December 31, 2003 and a reduction of the fair value of \$430,739 for the year ended December 31, 2004. During December 31, 2002, 2003 and 2004, the Company recognized amortization of deferred compensation of \$713,051, \$357,194 and \$363,407, respectively.

Stock option activity under the 1998, 1999, 2001, 2003 and 2004 Stock Option Plans during the periods indicated below is as follows:

	Number Of <u>Options</u>	Weighted Average <u>Exercise Price</u>
Outstanding at January 1, 2002	1,946,041	\$6.26
Granted	693,176	9.86
Canceled	(31,651)	9.27
Exercised	<u>(273,700)</u>	<u>3.02</u>
Outstanding at December 31, 2002	2,333,866	7.72
Granted	713,650	7.73
Canceled	(171,183)	8.86
Exercised	<u>(175,209)</u>	<u>3.88</u>
Outstanding at December 31, 2003	2,701,124	7.97
Granted	655,550	5.07
Canceled	(436,500)	7.93
Exercised	<u>(142,700)</u>	<u>3.00</u>
Outstanding at December 31, 2004	<u>2,777,474</u>	<u>\$7.11</u>

Included in the option schedule are 824,425 non-plan options, of which 699,925 are fully vested.

The weighted-average remaining life of the options outstanding at December 31, 2002, 2003 and 2004 is 3.54 years, 2.89 years and \$4.42 respectively, and the weighted-average fair value of the options granted during the year ended December 31, 2002, 2003 and 2004 is \$6.62, \$5.58 and \$2.97 respectively.

As of December 31, 2002, 2003 and 2004, the fair market value of each option grant has been estimated on the date of grant using the Black-Scholes option pricing model based upon expected option lives of 5, 5 and 5 years; risk free interest rates of 4.50%, 4.50% and 4.0%; expected volatility of 90%, 90% and 60% and a dividend yield of 0%, 0% and 0%, respectively.

As of December 31, 2004, the Company had 2,093,724 options exercisable with a weighted average exercise price of \$7.18. As of December 31, 2004, the Company had 774,842 options available for future grant under the 1998, 1999, 2001, 2003 and 2004 Stock Option Plans.

On November 12, 2003, a member of the Company's Board of Directors resigned. The Company agreed to extend the expiration date of his options to November 11, 2004, which originally were due to expire on February 10, 2004. As a result, the Company recorded the fair value of the extension of \$138,000 as a non cash expense during the fourth quarter ended December 31, 2003, which was calculated using the Black-Scholes valuation method.

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On July 8, 2004, the Company's Board of Directors agreed to extend the expiration date of the Chief Executive Officer's options to July 15, 2008, which originally were due to expire on July 15, 2004. As a result, the Company recorded the fair value of the extension of \$1,347,000 as a non cash expense during the second quarter ended December 31, 2004, which was calculated using the Black-Scholes valuation method.

In the opinion of management, all stock options have been issued with an exercise price that is equal or above the fair market value of the Company's Common Stock on the date of grant.

9. ACQUISITION

On December 18, 2001, the Company acquired substantially all of the assets of the IDentiScan Company, LLC, which was accounted for under the purchase method. The aggregate purchase price totaled \$1,032,947 which consisted of 59,774 of the Company's restricted common stock valued at \$980,000 based on the fair market value at the date of acquisition and transaction costs of \$52,947, plus additional incentives upon meeting specific objectives over the next three years. The purchase agreement provided that if after one year from closing, the aggregate current market price of the shares issued at closing is less than \$750,000, the Company would pay additional cash or additional common stock for the short fall. The Company computed the market value of the original 59,774 shares issued as of December 18, 2002 and it was valued at \$487,457. As a result, the Company issued an additional 32,194 shares to the owners of IDentiScan in accordance with the Asset Purchase Agreement. The allocation of the purchase price was \$430,000 to acquired technology, \$230,000 to patents/trademarks, \$181,447 to goodwill, \$167,500 for other intangible assets, and \$24,000 to tangible assets. All Intangible assets except goodwill were being amortized on a straight-line basis of between 2-10 years, which represents the estimated future period to be benefited.

As of December 31, 2003, the Company decided to discontinue the selling of its IDentiScan products. The Company has determined that there is no future benefit from these intangibles related to the IDentiScan acquisition and, accordingly, all of its intangible assets, except for \$5,590 of copyrights, with a remaining book value of \$363,655, were written off as of December 31, 2003, which affected the results of operations for the period then ended.

10. COMMITMENTS AND CONTINGENCIES

Operating Leases

During July 2000, the Company entered into a 10-year lease agreement for its new office. The lease provides for monthly rental payments of \$17,458 beginning December 15, 2000 with immaterial annual increases. In connection with this lease, the Company provided an irrevocable unconditional letter of credit in the amount of \$250,000 as security, which was cancelled and replaced with a cash security payment of \$34,916 for the remaining lease term.

In addition, the Company has entered into various leases for office equipment and office space expiring through December 2010. Future minimum lease payments under these lease agreements are as follows:

Year Ending December 31:	
2005	247,552
2006	252,991
2007	261,444
2008	271,842
2009	282,660
Thereafter	<u>293,454</u>
	<u>\$1,609,943</u>

Rent expense for the years ended December 31, 2002, 2003 and 2004 amounted to \$242,083, \$252,386 and \$243,577, respectively.

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Capital Lease Obligations

The Company leased computer and office equipment under several capital leases that expired in 2004. As of December 31, 2004, the Company had no outstanding Capital Lease obligations.

Royalty and License Agreements

The Company entered into an agreement with a former officer of the Company during 1996 to license certain software. The agreement stipulated, among other provisions, that the officer would receive royalties equal to a percentage of the Company's gross sales. This agreement was terminated in May 1999 and was superceded by a new agreement which calls for payment of royalties of .005% on gross sales from \$2,000,000 to \$52,000,000 and .0025% on gross sales in excess of \$52,000,000. As of December 31, 2004, total fees payable under this agreement amounted to \$148.

Employment Agreements

On November 9, 2004, the Company entered into a new one-year employment contract with its Chairman and Chief Executive Officer, Frank Mandelbaum, effective January 1, 2005. The agreement provides for an annual base salary of \$250,000. In addition, the Company granted to Mr. Mandelbaum an option to purchase 75,000 shares of common stock at an exercise price of \$4.37 per share, of which 25,000 options became exercisable on January 1, 2005; 25,000 options shall become exercisable on January 1, 2006 and the remaining 25,000 options shall become exercisable on January 1, 2007.

If there shall occur a change of control, as defined in the employment agreement, the employee may terminate his employment at any time and be entitled to receive a payment equal to 2.99 times his average annual compensation, including bonuses, during the three years preceding the date of termination, payable in cash to the extent of three months salary and the balance in shares of the Company's common stock based on a valuation of \$2.00 per share.

On November 9, 2004, the Company entered into a new employment agreement with our Senior Executive Vice President and Chief Financial Officer, Edwin Winiarz, effective January 1, 2005. The agreement, which expires December 31, 2006, provides for a fixed annual base salary of \$162,086. In addition, the Company granted to Mr. Winiarz an option to purchase 50,000 shares of common stock at an exercise price of \$4.37 per share, of which 25,000 options became exercisable on January 1, 2005 and the remaining 25,000 options shall become exercisable on January 1, 2006.

Each of the employment agreements requires the executive to devote substantially all his time and efforts to our business and contains non-competition and nondisclosure covenants of the officer for the term of his employment and for a period of two years thereafter. Each employment agreement provides that we may terminate the agreement for cause.

Supplier Agreements

In connection with the acquisition of certain assets of the IDentiScan Company, LLC, on December 17, 2001, the Company entered into a product supply agreement with Accu-Time Systems, Inc. ("ATS"). ATS agreed to manufacture the IDentiScan line of products for an initial period of three (3) years and provides for automatic renewal periods of one year. As a result of the Company discontinuing the sale of these products, the product supply agreement was not renewed.

On January 2, 2004, the Company entered into a 2 year product supply agreement with a manufacturer of input devices. Under the terms of the agreement, the Company purchased the minimum required number of units during 2004. These devices, which were private labeled, are programmed to work in conjunction with the ID-Check technology.

Customer Agreement

Effective January 30, 2002, the Company mutually agreed with Sensormatic Electronics Corporation not to renew its non-exclusive Master Distributor agreement which was due to expire on March 31, 2002. The Company received \$412,000 from Sensormatic Electronics Corporation and additionally Sensormatic agreed to return to the Company all units previously purchased and unsold in their inventory as settlement of its obligations under the agreement. The Company did not assign any value to these units. The Company recognized the income, net of refurbishment costs, totaling \$336,744 and it was recorded as other income on the Company's Statements of Operations for the year ended December 31, 2002.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

Investment Firm Relationships

Effective March 28, 2002, the Company entered into an agreement with KPMG Corporate Finance LLC to act as an exclusive financial advisor to the Company. The fee for such services was \$100,000 of which \$50,000 was paid as of March 31, 2002 and the balance paid by June 30, 2002. This amount was expensed in the second quarter of 2002 as services were rendered. In connection with financing described in Note 7, KPMG agreed to receive 2.0% in cash and 1% of funds drawn in warrants. Effective January 5, 2004, the Company terminated this agreement.

On January 21, 2004, the Company entered into a one year agreement with Alexandros Partners LLC to act as consultants in advising the Company in financial and investor relation matters. The Company agreed to pay a consulting fee of \$50,000 payable in 12 equal monthly installments. In addition, the Company issued a warrant granting the right to purchase 100,000 shares of the Company's common stock at a purchase price of \$7.54 per share, which vested ratably over the 12 month period. A principal of Alexandros Partners LLC is currently a member of the Company's Board of Directors. Effective January 1, 2005, the Company renewed its agreement with Alexandros Partners LLC for an additional year and agreed to pay a consulting fee of \$50,000 payable in 12 equal monthly installments.

On December 7, 2004, the Company entered into a one year agreement with a consulting firm to help with our investor relations activities. The Company agreed to pay a consulting fee of \$100,000 payable in 12 monthly installments. In addition, the Company issued 11,500 restricted shares of its common stock.

On November 2, 2004, the Company entered into an exclusive agreement with an investment banking firm for the purpose of investigating the opportunities in raising additional capital for the Company. There can be no assurances that the Company will be successful in raising additional capital on acceptable terms.

Legal Proceedings

On February 19, 2003, the Company filed a summons and complaint upon CardCom Technology, Inc. alleging infringement on its patent. During September 2003, the Company settled this case with CardCom Technology, Inc. The Company granted CardCom a three year royalty license to use certain of the Company's patents in connection with the manufacture, use and sale of CardCom's age verification products in the United States and Canada. It also provides that CardCom will pay royalties of approximately 10% on its net sales. For the years ended December 31, 2003 and 2004, the Company received \$65,165 and \$67,113, respectively in royalty fees pursuant to this agreement.

On April 9, 2003, the Company received notification from the American Arbitration Association that it had awarded Early Bird Capital \$921,730 on the settlement of their demand. The Company had filed with the New York State Supreme Court an application for setting aside the confirmation of the award. On October 14, 2003, the court confirmed the award with interest at a rate of 9% per annum beginning April 9, 2003. The Company recorded a charge of \$921,730 in its Statements of Operations for the three month period ending March 31, 2003. The Company secured a one year letter of credit for the full amount of the charge along with interest in the form of a certificate of deposit. On March 5, 2004, the Company paid \$950,000, which included interest expense recorded in the year ended December 31, 2003, to Early Bird Capital as full settlement in this matter.

On August 1, 2003, the Company filed a summons and complaint against Tricom Card Technologies, Inc. alleging infringement on its patent seeking injunctive and monetary relief. On October 23, 2003, the Company amended its complaint to include infringement on an additional patent. On May 18, 2004, the Company filed a Second Amended Complaint alleging infringement and inducement to infringe against certain principals of Tricom in their personal capacities, as well as alleging in the alternative false advertising claims under the Lanham Act against all the defendants. These principals have moved to dismiss the claims against them, and Tricom has moved to dismiss the false advertising claims. The Company has opposed the motions. The Joint Pretrial Order is due for filing on November 19, 2004. The Company filed the proposed Joint Pretrial Order on November 19, 2004, which has not yet been executed and a conference is scheduled for April, 1, 2005.

We are not aware of any infringement by our products or technology on the proprietary rights of others.

Other than as set forth above, we are not currently involved in any legal or regulatory proceeding, or arbitration, the outcome of which is expected to have a material adverse effect on our business.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

11. QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table sets forth unaudited financial data for each of Intelli-Check's last eight fiscal quarters.

	<u>Year Ended December 31, 2003</u>				<u>Year Ended December 31, 2004</u>			
	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
	(Dollars in thousands)							
Income Statement Data:								
Revenues	\$ 264	\$ 342	\$ 345	\$ 285	\$ 298	\$ 260	\$ 233	\$ 328
Gross profit	160	(596) ⁽²⁾	243	(15) ⁽³⁾	195	144	(57) ⁽⁵⁾	86 ⁽⁶⁾
Loss from operations	(1,101)	(2,061)	(1,042)	(1,333)	(1,106)	(2,663) ⁽⁷⁾	(1,694)	(1,554)
Net loss	(2,019) ⁽¹⁾	(2,050)	(1,078) ⁽⁴⁾	(1,304)	(1,075)	(2,642)	(1,669)	(1,537)
Net loss attributable to Common stockholders	(2,018)	(2,178)	(1,204)	(1,433)	(1,201)	(2,768)	(1,796)	(2,362) ⁽⁸⁾
Net loss per share attributable to Common stockholders:								
Basic and diluted	(0.23)	(0.24)	(0.13)	(0.15)	(0.12)	(0.27)	(0.17)	(0.23)

- (1) During the first quarter, a litigation reserve of \$921,730 was recorded.
- (2) During the second quarter, an inventory reserve of \$800,000 was recorded.
- (3) During the fourth quarter, an additional inventory reserve of \$190,000 was recorded.
- (4) Third quarter net loss was reduced by \$126,000 to reflect additional considerations which resulted in determining that adopting FASB No.150 had no effect on our financial position and results of operations. This adjustment had no effect on net loss attributable to common stockholders.
- (5) During the third quarter, an inventory reserve of \$200,000 was recorded.
- (6) During the fourth quarter, an inventory reserve of \$157,000 was recorded.
- (7) During the second quarter, a non cash expense of \$1,347,000 was recorded for extension of options
- (8) Effective in the fourth quarter, due to the conversion of the Convertible Redeemable Preferred Stock on February 25, 2005, the amortization of the accretion costs was increased by \$669,618.

We have not experienced seasonality in our sales volume or operating expenses.

INTELLI-CHECK, INC.

NOTES TO FINANCIAL STATEMENTS

Schedule II – Valuation and Qualifying Accounts

Year Ended December 31, 2004, 2003 and 2002

Year ended December 31, 2004	Balance at Beginning of Period	Additions	Net Deductions and Other	Balance at End of Period
Doubtful accounts and allowances	-	\$20,000	-	\$20,000
Deferred tax assets valuation allowance	\$9,520,550	1,920,450	-	11,441,000

Year ended December 31, 2003	Balance at Beginning of Period	Additions	Net Deductions and Other	Balance at End of Period
Doubtful accounts and allowances	-	-	-	-
Deferred tax assets valuation allowance	\$6,722,540	\$2,798,010	-	\$9,520,550

Year ended December 31, 2002	Balance at Beginning of Period	Additions	Net Deductions and Other	Balance at End of Period
Doubtful accounts and allowances	-	-	-	-
Deferred tax assets valuation allowance	\$4,647,652	\$2,074,888	-	\$6,722,540