A leading provider of advanced technology-based security solutions

Spectra Systems Corporation

Annual report and accounts 2014

Spectra Systems
CORPORATION

Spectra Systems Corporation is an established world leader in providing security technology, from banknotes and products to electronic gaming.

Spectra provides an integrated solution in that it supplies engineered materials for authentication and processing purposes, as well as hardware and software systems which verify the unique signatures of the authentication materials.

WE OPERATE IN 34 COUNTRIES

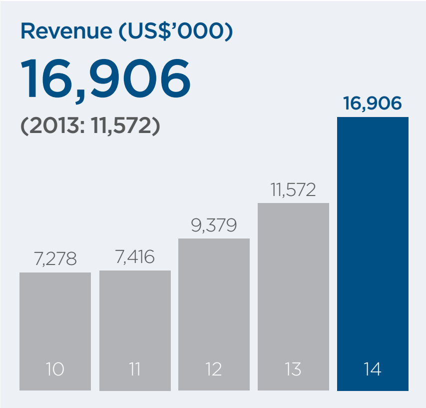
WE HAVE 32 STAFF IN OUR OFFICES

46% INCREASE IN REVENUE

THREE ACQUISITIONS SINCE 2012

Discover more online
www.spsy.com

HIGHLIGHTS



Financial highlights (all figures in 000s)

- Revenue increased 46% to US$16,906k (2013: US$11,572k)
- Adjusted EBITDA[1] before taxation of US$2,143k, compared to a prior year loss of US$(657k)
- Adjusted earnings[1] per share of US$0.05, compared to a prior year loss of US$(0.02)
- Strong balance sheet, with cash of US$9,773k (2013: US$13,435k) at 31 December

1 Before stock compensation expense and exceptional items.

Operational highlights

- Large G8 banknote authentication materials order fully fulfilled
- Shipping of sensors for US$8million contract continued through 2014, and expected to be completed by Q3 2015
- Phosphor sales at record levels in 2014
- New manufacturing facility is security cleared by our corporate partner. First deliveries shipped for sale to corporate partner's 18 central bank customers. Final material qualification for a Spectra G8 central bank customer is underway and expected to conclude by Q3 2015
- Aeris™ note cleaning testing on behalf of a G8 central bank progressing very well and testing on behalf of an Asian central bank commencing in Q3 2015. USA patents for the technology were issued in Q1 2015
- Secure Transactions Group performed in line with expectations
- Inksure asset purchase transaction closed in 2014, generating sales in line with expectations, with growth forecast in 2015

Chief Executive Officer's statement
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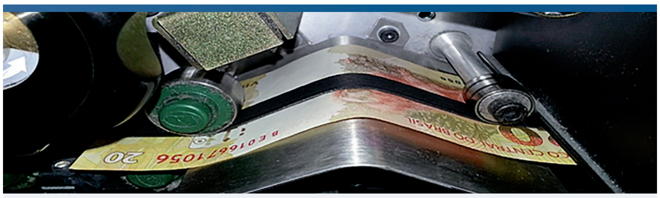
Our strategy
Page 4

SPECTRA AT A GLANCE

Spectra is a highly responsive organization that develops customized solutions for its customers.

OUR SOLUTIONS



Authentication systems

Spectra's sophisticated capabilities allow us to invent, develop and manufacture integrated solutions comprised of a system of taggant materials and sensor equipment to authenticate banknotes at high processing speeds.

Our solutions are used by:

- two G8 central banks;
- 17 other central banks for currency authentication; and
- a major G8 country for passport security.

Secure transactions

Spectra's secure transactions group is the leading supplier of real-time fraud control and risk management systems to government-sanctioned gaming operators. Currently deployed in North America, Europe, Asia and Africa, integrity systems monitor and audit more than US$20 billion in annual sales for online, internet and mobile phone-based lotteries and pari-mutuel organizations.

Our products have been engineered to provide:

- fully automated independent real-time monitoring; and
- vendor independence – designed for any gaming system.

Banknote cleaning

Spectra's new technology has the potential to substantially reduce central bank costs and environmental issues in disposing of soiled bank notes.

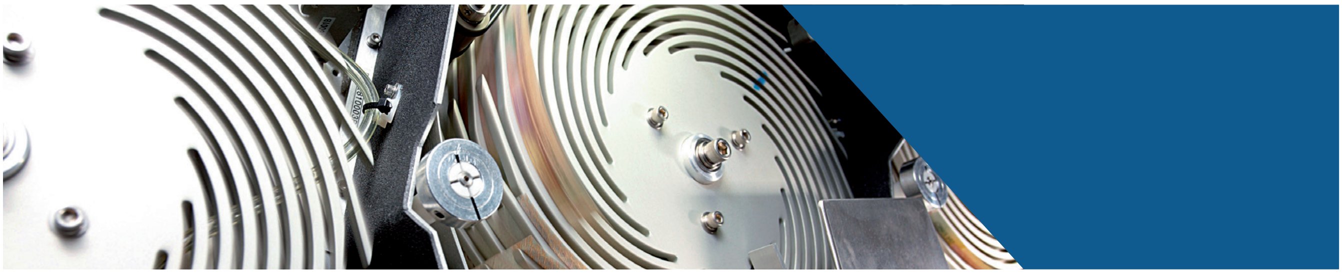
TRU BRAND

Smartphone authentication of product brands

TruBrand™

Spectra has completed the development of a new label technology and smartphone application which reliably confirms the authenticity of high value brands in the retail environment.

Customers can ensure they are buying a real product and brand owners can obtain valuable data on their customers who are using the TruBrand™ app connected to our secure servers and data mining operations.

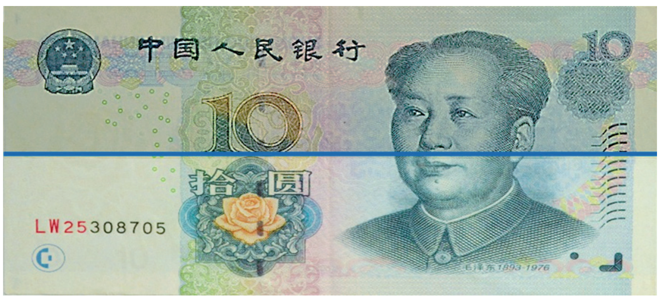


OUR CUSTOMERS

Our customers include a G8 central bank organization and one of the world's largest commercial security printers and papermakers, which supplies the Company's technology to a second G8 central bank and numerous other central banks.

Our solutions are used by:

- 19 central banks
- Commercial security printers and papermakers
- Crane & Co
- National lotteries in seven countries
- Suppliers of security threads for world currencies
- Intralot SA
- Scientific Games International
- GTECH S.p.A.



Cleaned half of bank note

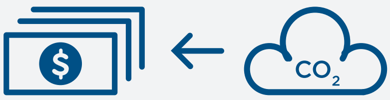
OUR PROGRESS

AERIS™
The world's first banknote cleaning system

Overview

The area of banknote fitness and cleaning continues to provide the Company with a potentially much larger target market within the banknote industry than our security activities, and will enable us to provide central banks with products which generate an immediate return on investment.

- Aeris™ extracts sebum and other contaminants that limit the useability of paper substrate banknotes through soiling.
- Dry process that does not compromise substrate, security features or print.
- Process over 1 million banknotes per day.
- Banknotes can remain strapped or bundled during processing for easy handling and high productivity.
- Lower environmental impact of shredded notes.



Aeris™ progress

Our progress with testing Aeris™ has demonstrated a strong business case which we believe will prove compelling but will require patience and continued efforts to create a level of comfort through increasingly larger volume testing.

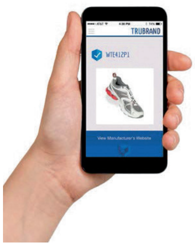
Aeris™ outlook

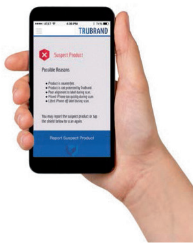
The Board continues to be particularly excited by this technology, which has the potential to substantially reduce central bank costs and environmental issues in disposing of soiled banknotes. It was therefore delighted that two US patents on the use of supercritical fluids for cleaning and decontaminating banknotes in circulation were issued to the Company in January 2015.

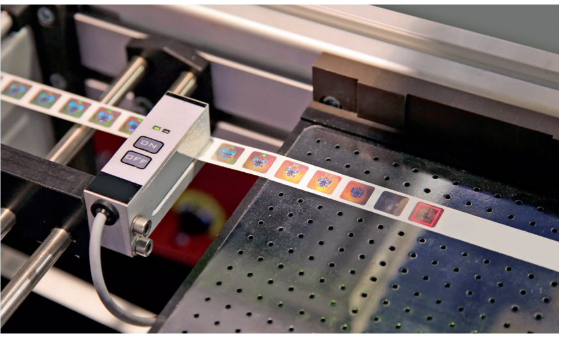
OUR STRATEGY

The Company's strategy for increasing revenue and earnings is based on:

Strategic aim	Development strategy	Progress
Integrate advanced technologies into existing security products	Integrate new machine-readable technologies into public security features for banknotes, tax stamps and brand product packaging with a focus on Asia. – Covert technologies. – No redesign of banknotes or tax stamps required for faster adoption.	– Covert machine-readable technology developed to scale up levels with central bank and available for sale worldwide. – Agreement with a large Asian central bank under review.
Enhance and upgrade our ICS product package	Increase our Secure Transactions Group revenues by: – Providing higher value product upgrades to existing customers. – Bundling our software transaction capabilities with our machine-readable features to offer authorities complete track and trace solutions for tax stamps, IDs and other government documents.	– Successful premier system conversion and go-live in Colorado. – Developed new web-portal and random number generator audit module for use by a major customer.
Advanced smartphone authentication technology	Continue to make advances on a smartphone-based physical authentication technology to allow consumers to authenticate brand products in real time using smartphone platforms.	– Beta launch and trail of TruBrand™ with major Asian spirits brand. – Cooperative development partnerships with a major, worldwide label manufacturer. – Patents filed and Pending.
Breakthrough disruptive technology for banknotes	Continue the development efforts on products that can result in significant savings for central banks with regards to note processing, replacement volumes and environmental impact.	– Technology introduced and very well received at a major industry tradeshow, Banknote 2014. – Two patents issued. – Trials underway with two major central banks.







Outlook

- Strong traction with two new covert banknote features.

Prospects include:

- G8 central bank;
- Asian central banks; and
- new five year contract for tax stamp holograms and real estate candidate in Asia.

- Growth in online lotteries in the USA.
- Pending bids in foreign lotteries.
- Higher margins for bundled devices.

- Under evaluation by Asian spirits customer.
- Opportunities for apparel and footwear.

- Commercial machine available for sale in Q3 2015.

OUR MARKETS

Spectra Systems' market opportunity has expanded dramatically with our introduction of the world's first banknote cleaning system, Aeris™. With nearly 150 billion banknotes manufactured yearly at a cost approaching US$10 billion annually along with the increasing demands that governments reduce costs, we are poised to capitalize on our banknote cleaning technology. Aeris™ machines have the potential for generating over US$1 billion of hardware sales with ongoing service revenue.

Aeris™ has no competition and, now that patents have been issued, the market is ours exclusively.

The combination of the banknote authentication market, where we are one of several competing companies, along with the Aeris™ banknote cleaning system, where we will be the sole supplier, dramatically expands the market potential of this sector of our business within the coming years.

Our high-speed, machine-readable banknote authentication technology is utilized by many central banks to prevent sophisticated counterfeiting of their currency and will facilitate our ability to introduce and sell Aeris™ systems.

Spectra's secure internal control systems (ICS) software products have been augmented with new capabilities since the acquisitions and have resulted in revenue growth potential with existing customers as well as with new ones. Our ICS software products provide methods for fraud detection and statistical analysis and have recently been adopted in internet-based lotteries, a growing sector of the gaming industry.

Spectra's suite of portable reader-based solutions including smartphone app-based products can be used for authenticating and tracking consumer and tax-bearing products, both locally and through cloud-based internet connections. The fusion of our physical products along with internet-based operations has the potential for significantly expanding this segment of our business.

CHIEF EXECUTIVE OFFICER'S STATEMENT

Through achieving key commercial milestones, Spectra Systems has increased revenues substantially over those generated in 2013.

Introduction

Through achieving key commercial milestones, Spectra Systems has increased revenues substantially over those generated in 2013, which has resulted in a return to profits, with 2013 losses transformed into a meaningful profit in 2014.

Revenue exceeded prior year by 46% at US$16,906k (2013: US$11,572k). EBITDA for the year, adjusted primarily for stock compensation expense, amounted to US$2,143k, compared to a prior year loss before exceptional items of US$(657k).

Revenue was driven by exceptionally large material orders from our G8 central bank customer. Although orders of this magnitude are unlikely in 2015, the customer is considering entering into a ten year contract which will include materials as well as quality control equipment and services. Such a contract is expected to reimburse cost incurred in building the facility and would enhance the visibility of future revenues. Improved margins from both cost-cutting initiatives and lower manufacturing costs from the in-house facility are long-lived initiatives which will contribute to profitability going forward.

Cash at the period end amounted to US$9,773k (2013: US$13,435k), which reflects the acquisition of Inksure assets for approximately US$1.4million and the settlement of the lawsuit for approximately US$2million. The Company has no debt and therefore has sufficient resources to execute on its manufacturing plans with its cash reserves.

Review of operations

Authentication Systems

The Spectra Systems Authentication Systems activities delivered a particularly strong performance compared to 2013, generating revenue of US$15,527k (2013: US$9,982k) and EBITDA of US$1,924k, compared to a prior year loss of US$(1,143k).

Particular achievements included:

- the successful completion of a very large order for a central bank customer, demonstrating our ability to deliver large volumes of machine-readable authentication consumables on time and to a consistently high quality;
- the delivery of over 115 upgraded sensors in 2014, with the remainder to be delivered in 2015 to a G8 central bank, demonstrating our capability to provide extremely sophisticated hardware systems. This order also serves to support the longevity of our future consumable sales to this customer;
- phosphor sales reaching record levels in 2014;
- the qualification of our new manufacturing facility by our partner, a major worldwide supplier of banknote printing services and paper, and first shipments from our facility to that partner; and tangible traction towards final material qualification by a G8 central bank, which is anticipated later this year; and
- the ongoing evaluation by a G8 central bank of a new covert security feature for polymer notes, which is a refinement of the second generation authentication work funded and abruptly canceled by another G8 central bank last year. In addition, discussions with a major Asian central bank for a banknote security feature based on this technology are expected to result in a development agreement in 2015.

Our Authentication Systems businesses delivered a particularly strong performance in 2014, a year in which they benefited from several significant contracts (for sensors and the very large consumables order); however, the revenues from these contracts are not expected to be replicated in 2015. The Board is, however, confident that new opportunities for consumables will compensate for these concluded revenues within several years.

In the branded goods industry, the use of mobile phones to authenticate products has been regarded as the holy grail of the authentication industry for many years. Many have tried producing security features that are easily subverted or simply only work in highly controlled environments. Spectra has solved this problem and has a label available for sale called TruBrand™, which is compatible with most, but not all, packaging. In parallel, it is continuing work on a version which will allow us to tap into the sportswear and footwear market, which requires soft fabric-based labels.

Secure Transactions Group technologies

The Secure Transactions Group, formed around the various gaming technology acquisitions made in 2012, performed in line with management expectations, generating EBITDA of US$569k (2013: US$760k) on revenue of US$1,379k (2013: US$1,590k). The decrease in revenue was anticipated as a result of certain customers transitioning to in-house control systems, as well as expected delays in contract execution gap for new customers.

The Secure Transactions Group has been particularly successful in upselling existing customers to its "Premier Integrity" package, which includes bundled licensing, integration of new games, and services. This bundling approach, with higher overall margins, allows us to maintain our revenue base as we continue to compete for new lottery and gaming customers worldwide.

46% ↑
Increase in revenues

2,143K ↑
Adjusted EBITDA (US$)

Banknote cleaning

The area of banknote fitness and cleaning continues to provide the Company with a potentially much larger target market within the banknote industry than our security activities, and will enable us to provide central banks with products which generate an immediate return on investment.

While there was no revenue contribution from the business line in 2014 or 2013, development expenses related to the product validation and marketing were US$350k (2013: US$274k).

Notwithstanding the decision of the Banco de México, which is heavily invested in polymer notes, that Spectra Systems' Aeris™ banknote cleaning technology was not appropriate for its needs, testing of the technology continues with a G8 central bank, with very positive results, and is scheduled to commence with an Asian central bank in Q3 2015.

The Board continues to be particularly excited by this technology, which has the potential to substantially reduce central bank costs and environmental issues in disposing of soiled banknotes. It was therefore delighted that two US patents on the use of supercritical fluids for cleaning and decontaminating banknotes in circulation were issued to the Company in January 2015.

Our progress with testing Aeris™ has demonstrated a strong business case which we believe will prove compelling but will require patience and continued efforts to create a level of comfort through increasingly larger volume testing.

Strategy

The Company's strategy for increasing revenue and earnings is based on:

- integrating new machine-readable technologies into public security features for banknotes, tax stamps and brand product packaging with a particular focus on Asia;
- expanding our Secure Transactions Group contributions by providing higher value product upgrades to existing customers;
- continuing to develop a smartphone-based physical authentication technology to allow consumers to authenticate branded products in real time using mobile phone platforms;
- validating our products that result in significant savings for central banks with regards to note processing and replacement volumes; and
- controlling operating costs while maintaining strong capabilities for delivery of products as well as development of technology.

This strategy will allow the Company to further exploit its largely developed expertise and technology. In the same way that machine-readable features are added to holograms in our tax stamp and brand authentication products, we are attempting to introduce high-level, covert features into banknotes within existing public features such as inks, security threads and phosphors. By doing so, we hope to overcome the long cycle note redesign process. We believe we will be able to tap into the Asian market with this approach, in both the banknote and product authentication sides of the technology.

Prospects

The Company's prospects have continued to grow through the combination of the Company's organic banknote and product authentication development efforts and the Inksure acquisition, as well as our demonstration of a breakthrough technology for cleaning banknotes.

Particularly important avenues for revenue growth are:

- increased sales of taggants and readers to primarily Asian customers in the brand authentication sector;
- smartphone based product authentication which is gaining customers in Asia; and
- the eventual adoption of our new generation covert security feature in the polymer notes of a G8 central bank and a newly developed covert feature for a major Asian central bank by 2017.

The combination of our new manufacturing facility shipping product for use by 18 central banks and the expected material qualification and contract renewal with a G8 central bank in 2014 will have a significant impact on our machine-readable materials margins. With more aggressive marketing efforts by our licensing partner, we anticipate increasing earnings from such successes.

We are delighted that the overall business is on an upward trajectory. However, as stated above, we benefited in 2014 from several significant contracts, the revenues from which are not expected to be replicated in 2015. The Board is, however, confident that new opportunities for consumables will compensate for these concluded revenues within several years. The Board therefore believes that the Company continues to have excellent prospects.

Nabil M. Lawandy
Chief Executive Officer
April 17, 2014

BOARD OF DIRECTORS AND SENIOR MANAGEMENT

BOARD OF DIRECTORS

BJ Penn
Non-executive Chairman

Mr. Penn was Acting Secretary of the US Navy from March to May 2009, having previously been Assistant Secretary of the Navy (Installations and Environment) from March 2005. He was also Director, Industrial Base Assessments from October 2001 to March 2005, with responsibility for the overall health of the US defense industrial base. He commenced his career as a Naval Aviator, having received his BS from Purdue University, West Lafayette, and his MS from the George Washington University, Washington, DC. Mr. Penn has been a member of the Board since June 2010 and became Chairman of the Board on 7 June 2011.

Nabil M. Lawandy
President and Chief Executive Officer

Dr. Lawandy is the founder, President and Chief Executive Officer of the Company. From 1981 to 1999, Dr. Lawandy was a tenured full professor of Engineering and Physics at Brown University in Providence, Rhode Island. He holds a BA in Physics, and an MSc and PhD in Chemistry, each from the Johns Hopkins University. He has authored over 170 reviewed scientific papers and is an inventor on 52 US and 27 foreign issued patents. He has also received a Presidential Young Investigator award, an Alfred P. Sloan Fellowship, a Rolex Award for Enterprise and a Samuel Slater Award for Innovation.

Donald Stanford
Non-executive Director

Mr. Stanford, who was until 2001 the Chief Technical Officer of GTECH Corporation, is an Adjunct Professor of Computer Science and Engineering at Brown University. He holds a BA in International Relations and an MS in Computer Science and Applied Mathematics, both from Brown University. Over 30 years, he has held every technical leadership position, including Vice President of Advanced Development and Chief Technology Officer. Mr. Stanford serves on several boards including Spectra Systems, Times Squared Academy Charter School and the Business Innovation Factory. Mr. Stanford is a member of the R.I. Science and Technology Advisory Council. He is also an Adjunct Professor in the School of Engineering and is an instructor in the Program in Innovation, Management and Entrepreneurship (PRIME). He serves on the Brown advisory councils to the President and the School of Engineering. In 1999 Don received the Black Engineer of the Year Award for Professional Achievement. In 1999 he also received the Honorable Thurgood Marshall award for community service from the NAACP. In 2002 he received the Brown Graduate School's Distinguished Graduate award and the R.I. Professional Engineer's Award for Community Service.

Oussama Salam
Non-executive Director

Dr. Salam is the Chairman of the Hala Salaam Maksoud Foundation. He received a BSc in Civil Engineering from Loughborough University of Technology in 1968, an MS in Traffic and Transportation Engineering from the Department of Civil Engineering, Ohio State University, in 1969, and a PhD in the Finite Elements Method from the Department of Civil Engineering, Ohio State University, in 1974. He served as Director General of the construction department of International Center for Commerce & Contracting, a leading construction company in Saudi Arabia, from September 1978 until December 2000. In 1990 he co-founded Pillar BV, a venture capital business-consulting firm based in Paris, and remained a partner until September 1999. He also co-founded WorldCare Limited, a leading company in the emerging field of global eHealth, and served on its board of directors from 1993 until June 1998. Dr. Salam is currently a Board member of Spectra Systems Corporation. Dr. Salam is involved in the business development of these companies in Europe and the Middle East. Currently he lives in Beirut, Lebanon.

Roland Puton
Non-executive Chairman

Mr. Puton has been a member of the Company's Board of Directors since 1997. He served as the President and Chief Executive Officer of Rolex Watch USA Inc. from 1984 until his retirement in 2000. He holds a degree in business administration from the Swiss Business School. Mr. Puton is a member of the board of directors of the American Watch Association and the Fifth Avenue Association. He is a member of the Canadian 24 Karat Club and is an Honorary Director of the Explorers Club. Also, Mr. Puton is a member of the American Alpine Club, a board member of the American Swiss Foundation, and a member of the Advisory Council of the Swiss Society of New York.

Jeffrey Donohue
Non-executive Chairman

Jeffrey Donohue is Corporate Counsel for Novartis Institutes for BioMedical Research, Inc. (NIBRI), the research arm of the global healthcare products company Novartis. Mr. Donohue has provided legal guidance on NIBRI's strategic acquisitions, licensing agreements, academic and government-backed consortia, and drug discovery collaborations. Mr. Donohue is also an Adjunct Professor at Boston University School of Law, where he teaches advanced courses on licensing and intellectual property transactions. Before joining NIBRI, Mr. Donohue served as Corporate Counsel at Vertex Pharmaceuticals Incorporated, a pharmaceutical company based in Cambridge, Massachusetts. Mr. Donohue started his legal career at Kirkpatrick & Lockhart LLP (now KLGates), where he spent seven years advising clients on corporate governance, mergers and acquisitions, and securities matters. Mr. Donohue obtained his JD from Boston University and a BA from Brandeis University.

Martin Jaskel

Non-executive Director

Martin Jaskel has over 40 years of involvement in the financial services industry. He began in the UK government bond market as a broker with leading firms, latterly as a Partner in W Greenwell & Co. In 1986 as an element of the deregulation of the UK markets, W Greenwell was sold to Midland Bank and became the leading Gilt Edged Market Maker, of which he was a Director. In 1988 he was appointed Director of Global Sales and Marketing of Midland Montagu Treasury (the Treasury division of Midland Bank) after chairing a committee to redesign the distribution of Treasury products. In 1990 he was appointed Director of Global Sales at NatWest Treasury and rebuilt the neglected franchise global distribution of Treasury and Capital Markets products. In 1994 he was promoted to Managing Director of Global Trade and Banking Services. He sat on the Advisory Board of ECGD, the UK export-import bank, was responsible for several years for signing off all the UK exposure to BAE and Airbus and sat on several government and Bank of England advisory boards. In 1997 he left NatWest and founded a financial services consultancy, which included a consultancy at KPMG Corporate Finance and the corporate FX division of Travelex plc, and an interim appointment as the Managing Director of a private real estate company with a £500 million portfolio of commercial and residential property. In 2005 he joined European American Capital Limited, an FSA authorized and regulated specialized advisory bank, as Senior Advisor. He has wide experience as a Non-executive Director of both publicly quoted and private companies.

Key

- Audit Committee
- Compensation Committee
- Government Security Committee
- Nominating Committee

SENIOR MANAGEMENT

Douglas A. Anderson

Chief Financial Officer,
Company Secretary and Treasurer

Mr. Anderson joined the Company as Chief Financial Officer in December 2006 and was appointed Company Secretary in June 2011. Prior to joining the Company, Mr. Anderson was employed by Bluestreak Inc., a global marketing technology company, where he served as President. Mr. Anderson also held several financial positions including Director and Secretary of Bluestreak's wholly owned UK subsidiary, Bluestreak International Limited. Prior to Bluestreak, he was responsible for financial and account operations at Log On America, a publicly traded telecommunication company. He also spent three years at Ernst & Young advising clients on financial strategy, accounting and compliance needs. Mr. Anderson holds an MBA from Boston University and a BA from the University of Rhode Island.

William Goltsos

Vice President, Engineering

Dr. Goltsos was appointed Vice President, Engineering, in April 2000. From September 1996 to April 2000, he served as Senior Systems Engineer. Prior to that, from 1992 to 1996, he served as a staff member of the MIT/Lincoln Laboratory's Optical Communications Group. Dr. Goltsos holds a BSc in Physics from Rensselaer Polytechnic Institute and an MSc and PhD in Physics from Brown University.

James Cherry

Director of Authentication Systems

Mr. Cherry serves as Director of Authentication Systems. He joined the Company in 2002 from Auspex Systems, an enterprise network data storage system business, where he had been involved in marketing and product management for seven years. Prior to that, he had worked for five years at DuPont in product management.

Scott Tillotson

Director of Secure Transactions

Mr. Tillotson serves as Director of the Secure Transactions Group. Mr. Tillotson has held a variety of positions with Spectra for nine years and GTECH Corporation, a leader in the lottery industry, for eight years in product marketing and management. Prior to that, he worked for the IBM Corporation as an Account Executive and Systems Engineer. Scott holds a BSEE from Purdue University.

Andrei Smuk

Director of Research and Development

Dr. Smuk, who joined the Company in 2000, was appointed Director of Research and Development in 2006. He is responsible for the development of advanced materials and innovative sensor systems. He received a PhD in Physics from Brown University in 2000 and an MS in Applied Physics from the Moscow Institute of Physics and Technology in 1994.

DIRECTORS' REPORT
for the year ended December 31, 2014

The Directors present their report and the audited consolidated financial statements for the year ended December 31, 2014.

Domicile

Spectra Systems Corporation is a C corporation and is registered and domiciled in the United States.

Principal activity

The principal activities of the Company are to invent, develop and sell integrated optical systems that provide customers with increased efficiency, security tracking and product life. The integrated systems combine consumables and engineered optical materials with software and hardware for use in applications. The Company also provides software tools to the lottery and gaming industries for fraud detection, money laundering, match fixing and statistical analysis.

Results and dividends

The Company's statement of comprehensive income is set out on page 16 and shows the result for the year.

The Company reported a US$257,000 provision for income taxes in 2014. There is no federal or state income tax liability on the respective income tax returns due to timing differences arising between items of income and expenses recorded on the books and those reported on the tax returns. Additionally, the Company has approximately $25,500,000 in federal and state net operating loss carryforwards to offset future income reported on the respective tax returns.

The Directors do not recommend the payment of a dividend (2013: US$nil).

Review of business and future developments

A review of the operations of the Group is contained in the Group at a glance review on pages 2–3.

Principal risks and uncertainties and financial risk management

Complex products

Certain of the products produced by the Company are highly complex and are designed to be used in complex systems. Failure to correct errors or other problems identified after deployment could result in events that may have a negative effect on the Company's business and financial conditions.

The Company's markets may become impacted by technological change

Markets for the Company's products may become characterized by rapidly changing technology, evolving industry standards and increasingly sophisticated customer requirements. The introduction of products embodying new technology and the emergence of new industry standards could render the Company's existing products obsolete and unmarketable and may exert price pressures on exiting products. If the Company could not then develop products that remain competitive in terms of technology and price and that meet customer needs, this could have a negative impact on the business.

Expiry of patents

All patents have a limited duration of enforceability. US patents generally have a duration of 20 years from the filing date. Once a patent expires, the invention disclosed in the patent may be freely used by the public without accounting to the patent owner, as long as there are no other unexpired patents that embrace an aspect of the invention. There is no certainty that any improvement, new use or new formulation will be patented to extend the protection of the underlying invention, or provide additional coverage to adequately protect the invention. As a result, the public may have the right to freely use the invention described in and previously protected by an expired patent.

Dependence on key personnel

The success of the Company's revenues are dependent on a limited number of employees, and in particular the Chief Executive Officer and other managers with technological and development input. The Company has endeavored to ensure its key employees are incentivized but cannot guarantee the retention of these staff. It also has the benefit of key-man insurance.

Forward-looking statements

All statements other statements of historical fact, contained in this document constitute "forward-looking statements". In some cases, forward-looking statements can be identified by terms such as "may", "intend", "might", "will", "should", "could", "would", "believe", or the negative of these terms and similar expressions. Such forward-looking statements are based on assumptions and estimates and involve risks, uncertainties and other factors which may cause the actual results, financial condition, performance or achievements of the Company, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. New factors may emerge from time to time that could cause the Company's business not to develop as it expects and it is not possible for the Company to predicts all such factors. Given these uncertainties, investors are cautioned not to place any undue reliance on such forward-looking statements. Except as required by law, the Company disclaims any obligation to update any such forward-looking statements in this document to reflect future events or developments.

Key performance indicators (in thousands)

- Revenue US$16,906 (2013: US$11,572)
- Adjusted EBITDA before taxation of US$2,143 (2013: US($657))
- Adjusted EBITDA per share, in cents, of US$0.05 (2013: US($0.02))
- Basic earnings/(loss) per share, in cents, of US$0.02 (2013: US($0.07))

Post reporting date events

None.

Financial instruments

Details of the use of financial instruments by the Company are contained in note B of the financial statements.

Directors' responsibilities

The Directors are responsible for preparing the Directors' report and the financial statements on the basis of preparation set out in note A of the financial statements and in accordance with United States Generally Accepted Accounting Principles (US GAAP). The Directors of the Company are responsible for the document in which the financial information is included.

In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and accounting estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with US GAAP, subject to any material departures disclosed and explained in the financial statements.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with all legal requirements. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Directors' interests

The Directors' beneficial interests in the common stock of the Company were as follows:

	December 31,	
Ordinary shares	**2014**	2013
O. Salam	**3,594,464**	3,594,464
N. Lawandy	**1,833,570**	1,833,570
R. Puton	**314,514**	314,514
M. Jaskel	**9,960**	9,960
	5,752,508	5,752,508

Substantial shareholdings

The following shareholders held 3% or more of the issued common stock of the Company at December 31, 2014:

	Ordinary shares	% of issued
HSBC Client Holdings Nominee (UK) Limited	5,507,740	12.17
O. Salam	3,594,464	7.94
Albany International	3,160,526	6.98
The Bank of New York (Nominees) Limited	2,650,000	5.86
Commerz Nominees LTD	2,157,115	4.77
Rock (Nominees) Limited	2,137,478	4.72
N. Lawandy	1,883,570	4.16
Clearwater Capital Group	1,813,850	4.01
Fitel Nominees Limited	1,526,112	3.37
	24,430,855	53.98

Directors' compensation

The following table details Directors' earned compensation for the year ended December 31, 2014:

		Salary and bonus		Benefits		Board fees		Total compensation
Executive Directors								
N. Lawandy	$	475,000	$	27,437	$	—	$	502,437
Non-executive Directors								
B. Penn		—		—		12,000		12,000
O. Salam		—		—		12,000		12,000
M. Jaskel		—		—		12,000		12,000
R. Puton		—		—		12,000		12,000
D. Stanford		—		—		12,000		12,000
J. Donohue		—		—		12,000		12,000
Total	**$**	**475,000**	**$**	**27,437**	**$**	**72,000**	**$**	**574,437**

Directors' share options

At December 31, 2014, Directors had options or warrants to purchase ordinary shares under the Company's stock option plan as follows:

	Options held at December 31, 2014		Weighted average exercise price	Options vested at December 31, 2014
N. Lawandy	2,449,229	$	0.69	2,374,229
B. Penn	120,000		0.60	120,000
O. Salam	129,000		0.63	129,000
M. Jaskel	120,000		0.60	120,000
R. Puton	133,000		0.63	133,000
D. Stanford	120,000		0.60	120,000
	3,071,229	**$**	**0.67**	**2,996,229**

Corporate governance

The Board comprises one Executive Director, Nabil M. Lawandy, and six independent Non-executive Directors: BJ Penn, as Chairman, Jeffrey Donohue, Martin Jaskel, Roland Puton, Oussama Salam, and Donald Stanford. The Board usually meets at least every three months to closely monitor the progress of the Company towards the achievement of budgets, targets and strategic objectives.

The Board also operates four committees, the Audit Committee, the Compensation Committee, the Nominating Committee, and the Government Security Committee.

The Audit Committee comprises Roland Puton, as Chairman, Jeffrey Donohue, and Martin Jaskel. It has primary responsibility for monitoring the quality of internal controls and ensuring that the financial performance of the Company is properly measured and reported on. It will receive and review reports from the Company's management and auditors relating to the interim and annual accounts and the accounting and internal control systems in use throughout the Company. The Audit Committee intends to meet no less than three times each financial year and has unrestricted access to the Company's auditors.

The Compensation Committee comprises Roland Puton, as chairman, Martin Jaskel, Oussama Salam and Donald Stanford. It reviews the performance of Executive Directors and makes recommendations to the Board on matters relating to their remuneration and terms of employment. The Committee also makes recommendations to the Board on proposals for the granting of shares options and other equity incentives pursuant to any share options scheme or equity incentive scheme in operation from time to time.

The Nominating Committee comprises Martin Jaskel, as Chairman, BJ Penn, Oussama Salam and Donald Stanford. The Committee seeks and nominates qualified candidates for election or appointment to Spectra's Board of Directors.

The Government Security Committee comprises BJ Penn, as Chairman, and Nabil M. Lawandy. It is responsible for ensuring the implementation within the Company of all procedures, organizational matters and other aspects pertaining to the security and safeguarding of information, including the exercise of appropriate oversight and monitoring of operations to ensure that protective measures are effectively maintained and implemented.

The Board intends to comply with Rule 21 of the AIM Rules relating to directors' dealings and will also take all reasonable steps to ensure compliance by the Company's applicable employees and the Company has adopted a share dealing code for this purpose on substantially the same terms as the Model Code.

Website publication

The Directors are responsible for ensuring the annual report and the financial statements are made available on a website. Financial statements are published on the Company's website in accordance with legislation in the United Kingdom governing the preparation and dissemination of financial statements, which may vary from legislation in other jurisdictions. The maintenance and integrity of the Company's website is the responsibility of the Directors. The Directors' responsibility also extends to the ongoing integrity of the financial statements contained therein.

Auditors

All of the current Directors have made themselves aware of any information needed by the Company's auditors for the purposes of its audit and to establish that the auditors are aware of that information. The Directors are not aware of any relevant information of which the auditors are unaware.

Miller Wachman LLP have expressed their willingness to continue as the Company's auditors and a resolution to reappoint Miller Wachman LLP will be proposed at the Annual General Meeting.

By order of the Board

Douglas A. Anderson
Company Secretary
May 11, 2015

FINANCIAL STATEMENTS

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders
Spectra Systems Corporation
Providence, Rhode Island

We have audited the accompanying financial statements of Spectra Systems Corporation, which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income and other comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Spectra Systems Corporation as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Miller Wachman LLP

Miller Wachman LLP
Certified Public Accountants
Boston, Massachusetts
May 11, 2015

Financial statements

BALANCE SHEETS
December 31, 2014 and 2013

		2014		2013
Assets				
Current assets				
Cash and cash equivalents	**$**	**9,772,846**	$	13,434,737
Accounts receivable, net of allowance for doubtful accounts of $20,000 at December 31, 2014		**1,702,438**		2,284,111
Other receivables		**50,653**		4,947
Deferred contract costs		**—**		10,263
Inventory		**4,195,180**		2,968,718
Prepaid expenses		**111,319**		156,678
Deferred tax assets		**215,000**		344,000
Total current assets		**16,047,436**		19,203,454
Property, plant and equipment, net		**2,824,282**		2,903,144
Other assets				
Intangible assets, net		**4,092,210**		3,075,082
Restricted cash and investments		**2,500,000**		2,500,000
Deferred tax assets		**774,000**		902,000
Other assets		**183,941**		73,682
Total other assets		**7,550,151**		6,550,764
Total assets	**$**	**26,421,869**	$	28,657,362
Liabilities and stockholders' equity				
Current liabilities				
Accounts payable	**$**	**738,878**	$	1,633,323
Accrued expenses and other liabilities		**1,223,676**		926,424
Deferred revenue		**2,165,744**		3,040,203
Total current liabilities		**4,128,298**		5,599,950
Non-current liabilities				
Deferred revenue		**292,653**		103,087
Contingent liability		**—**		2,000,000
Total non-current liabilities		**292,653**		2,103,087
Total liabilities		**4,420,951**		7,703,037
Stockholders' equity				
Common stock, $0.01 par value, 125,000,000 shares authorized				
45,251,370 shares issued and outstanding		**452,514**		452,514
Additional paid – in capital – common stock		**54,913,613**		54,855,662
Accumulated other comprehensive loss		**(60,063)**		(4,897)
Accumulated deficit		**(33,305,146)**		(34,348,954)
Total stockholders' equity		**22,000,918**		20,954,325
Total liabilities and stockholders' equity	**$**	**26,421,869**	$	28,657,362

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

STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME
for the years ended December 31, 2014 and 2013

	2014	2013
Revenues		
Product	**$ 14,163,982**	$ 7,956,291
Service	**1,928,431**	3,154,532
Royalty	**813,936**	461,219
Total revenues	**16,906,349**	11,572,042
Cost of sales	**8,208,984**	6,006,729
Gross profit	**8,697,365**	5,565,313
Operating expenses		
Research and development	**3,033,934**	2,850,812
General and administrative	**3,775,627**	3,437,237
Sales and marketing	**659,322**	641,971
Total operating expenses	**7,468,883**	6,930,020
Income/(loss) from operations	**1,228,482**	(1,364,707)
Other income/(expense)		
Interest income	**69,727**	138,759
Other income	**250**	250
Contingent liability	**—**	(1,789,040)
Foreign currency gain	**2,349**	12,634
Total other income/(expense)	**72,326**	(1,637,397)
Income/(loss) before provision for income	**1,300,808**	(3,002,104)
Provision for income taxes	**257,000**	—
Net income/(loss)	**$ 1,043,808**	$ (3,002,104)
Earnings/(loss) per share		
Earnings/(loss) per share, basic and diluted	**$ 0.02**	$ (0.07)
Weighted average number of common shares	**45,251,370**	45,251,370
Other comprehensive loss		
Unrealized (loss)/gain on currency exchange	**$ (52,817)**	$ 10,478
Reclassification for realized gain in net income	**(2,349)**	(12,634)
Total other comprehensive loss	**(55,166)**	(2,156)
Comprehensive income/(loss)	**$ 988,642**	$ (3,004,260)

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

Financial statements

STATEMENTS OF CASH FLOWS
for the years ended December 31, 2014 and 2013

	2014	2013
Cash flows from operating activities		
Net income/(loss)	$ 1,043,808	$ (3,002,104)
Adjustments to reconcile net income/(loss) to net cash from operating activities:		
Depreciation and amortization	801,889	428,589
Stock-based compensation expense	57,951	116,239
Allowance for doubtful accounts	20,000	—
Allowance for Solaris note	—	94,392
Provision for income taxes	257,000	—
Changes in operating assets and liabilities:		
Accounts receivable	539,244	416,362
Other receivable	(45,706)	117,791
Due from Solaris	—	(4,748)
Unbilled revenue on contracts in progress	—	354,577
Deferred contract costs	9,892	333,557
Inventory	(1,226,462)	(1,894,198)
Prepaid expenses	45,542	(28,725)
Other assets	49,014	22,106
Accounts payable	(894,010)	249,761
Accrued expenses and other liabilities	264,732	(4,916)
Deferred revenue	(668,455)	783,056
Contingent liability	(2,000,000)	1,729,236
Net cash used in operating activities	(1,745,561)	(289,025)
Cash flows from investing activities		
Increase in restricted cash and investments	—	(1,450,000)
Deposits for property, plant, and equipment	(162,000)	—
Payment of patent and trademark costs	(308,863)	(225,983)
Sales of investments	—	6,560,224
Asset acquisitions	(1,042,441)	—
Purchases of property, plant, and equipment	(354,859)	(771,835)
Net cash (used in)/provided by investing activities	(1,868,163)	4,112,406
Effect of exchange rate changes on cash and cash equivalents	(48,167)	(5,799)
Net (decrease)/increase in cash and cash equivalents	(3,661,891)	3,817,582
Cash and cash equivalents at beginning of the year	13,434,737	9,617,155
Cash and cash equivalents at end of the year	$ 9,772,846	$ 13,434,737
Supplemental disclosure of cash flow information		
Income taxes paid	$ 500	$ 500

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

STATEMENTS OF STOCKHOLDERS' EQUITY
for the years ended December 31, 2014 and 2013

	Common stock					
	Shares	Amounts	Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive loss	Total stockholders' equity
Balance at December 31, 2012	**45,251,370**	**$ 452,514**	**$54,739,423**	**$ (31,346,850)**	**$ (2,741)**	**$23,842,346**
Compensation cost related to amortization of stock options			116,239			116,239
Reclassification for realized gain in net loss					(12,634)	(12,634)
Unrealized gain on currency exchange					10,478	10,478
Net loss				(3,002,104)		(3,002,104)
Balance at December 31, 2013	**45,251,370**	**$ 452,514**	**$54,855,662**	**$ (34,348,954)**	**$ (4,897)**	**$20,954,325**
Compensation cost related to amortization of stock options			57,951			57,951
Reclassification for realized gain in net income					(2,349)	(2,349)
Unrealized loss on currency exchange					(52,817)	(52,817)
Net income				1,043,808		1,043,808
Balance at December 31, 2014	**45,251,370**	**$ 452,514**	**$ 54,913,613**	**$ (33,305,146)**	**$ (60,063)**	**$22,000,918**

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

NOTES TO THE FINANCIAL INFORMATION
for the years ended December 31, 2014 and 2013

Note A – Corporate Information

Spectra Systems Corporation (the "Company") develops and sells integrated optical systems that provide customers with increased efficiency, security tracking and product life. The integrated systems combine consumables and engineered optical materials with software and hardware for use in applications. The Company develops and sells its integrated solutions across a spectrum of markets, including currency manufacturing and cleaning, branded products, industrial logistics, and other highly sensitive documents. The Company also provides software tools to the lottery and gaming industries for fraud detection, money laundering, match fixing and statistical analysis.

The Company was incorporated on July 3, 1996 in Delaware as Spectra Acquisition Corporation. On August 26, 1996, the Company purchased substantially all of the assets of SSC Science Corporation (SSCSC) and changed its name to Spectra Science Corporation. The assets were purchased for US$1,654,000 in cash plus common stock warrants. The acquisition was accounted for using the purchase method of accounting.

On June 8, 2001, the Company changed its name to Spectra Systems Corporation.

On July, 25 2011, the Company raised US$20,241,179, net of offering costs, on the London Stock Exchange in a placing of 18,592,320 common shares at a placing price of £0.753 per new common share (the "Placing Price"), representing 41.09% of the enlarged common share capital of the Company. As a result of the offering, anti-dilution provisions found in the Company's Amended and Restated Certificate of Incorporation converted all of the issued and outstanding preferred shares into 17,185,052 common shares, giving 26,659,050 common shares in issue at the time of the placing.

On June 6, 2012, the Company acquired, all of the assets of ESI Integrity, Inc., including its proprietary source codes, multi-year contracts, long-standing customer relationships and assumed liabilities. US$1,425,000 was paid in consideration for the assets.

On September 14, 2012, the Company acquired certain assets of Lapis Software Associates, including its proprietary source codes, multi-year contracts and long-standing customer relationships, and assumed liabilities. US$726,000 was paid in consideration for the assets.

On February 28, 2014, the Company acquired certain assets of Inksure Technologies, Inc., including its long-standing customer relationships and authentication technology. US$1,356,000 was paid in consideration for the assets (see note O).

Note B – Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. The accounting estimates that require the management's most difficult and subjective judgments include the assessment of recoverability of property, plant, and equipment; the valuation of inventory; intangible assets; and the recognition and measurement of income tax assets and liabilities. The actual results may differ materially from management's estimates.

Cash and Cash Equivalents

The Company considers highly liquid investment purchases with a maturity of 90 days or less at date of acquisition to be cash equivalents.

Restricted Cash and Investments

Restricted cash and investments represents money market investments held as collateral for certain performance agreements entered into by the Company in 2014 and 2013 as required in accordance with terms of a services contract. At December 31, 2014 and 2013, the agreement required US$2,500,000 be maintained as collateral. The collateral will be released as the Company meets contractual milestones. Included in the US$2,500,000 as of December 31, 2014 is a certificate of deposit of US$1,055,053 which is considered an investment.

Concentration of Credit Risk and Significant Customers

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents and trade accounts receivable. The Company's cash management policies restrict investments to low-risk highly liquid securities, and the Company restricts its transactions to financial institutions with good credit standing. The Company has cash, including restricted, on deposit with two financial institutions that are insured by the Federal Deposit Insurance Corporation (FDIC) up to US$250,000 per institution. As of December 31, 2014, the amount in excess of the FDIC limit was US$5,265,275. Also included in cash at December 31, 2014 is US$6,532,950 of cash in bank accounts in the United Kingdom and Canada. The foreign bank account in Canada with a balance of US$536,850 is subject to exchange rate changes. Neither account is FDIC insured.

Concentrations of credit risk with respect to trade accounts receivable are limited due to the concentration of business with government entities.

Note B – Significant Accounting Policies continued

Concentration of Credit Risk and Significant Customers continued

The following table summarizes the number of customers that individually comprise greater than 10% of total revenues and their aggregate percentage of the Company's total revenues:

Year ended December 31,	Number of significant customers	Percentage of total revenues
2014	**3**	**78%**
2013	3	82%

The following table summarizes the number of customers that individually comprise greater than 10% of total accounts receivable and their aggregate percentage of the Company's total accounts receivable:

Year ended December 31,	Number of significant customers	Percentage of total receivables
2014	**2**	**59%**
2013	2	58%

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, accounts receivable and accounts payable, are carried in the financial statements at amounts that approximate their fair market values at December 31, 2014 and 2013.

Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Inputs that are generally unobservable and typically reflect management's estimate of assumptions that market participants would use in pricing the asset or liability.

As of December 31, 2014 and 2013, the Company has a certificate of deposit of US$1,055,053 and US$1,036,867, respectively, which is included in restricted cash and investments of US$2,500,000. The Company considers this certificate of deposit as a Level 2 investment.

Foreign Currency Translation

The functional currency of the Company's foreign operations is the applicable local currency, the Canadian dollar. The functional currency is translated into US Dollars for balance sheet accounts using currency exchange rates in effect as of the balance sheet date and for revenue and expense accounts using an average exchange rate in effect during the applicable period. The translation adjustments are deferred as a separate component of stockholders' equity in accumulated other comprehensive loss.

Accounts Receivable

At December 31, 2014, the Company had a US$20,000 allowance for doubtful accounts. There is no allowance for doubtful accounts at December 31, 2013.

Inventory

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. The Company regularly reviews inventory quantities on hand and records a provision to write down excess and obsolete inventory to its estimated net realizable value if less than cost.

Intangible Assets

Intangible assets are recorded at the purchase price. Amortization is calculated using the straight-line method over the estimated useful lives of assets ranging from 7 to 15 years. The Company evaluates the possible impairment of long-term assets annually and/or whenever events or circumstances indicate the carrying value of the asset may not be recoverable.

NOTES TO THE FINANCIAL INFORMATION continued
for the years ended December 31, 2014 and 2013

Note B – Significant Accounting Policies continued

Property and Equipment

Property and equipment is stated on the basis of purchase price. Depreciation is calculated using the straight-line method over the following estimates useful lives:

Laboratory equipment	three–seven years
Computer and office equipment	three–five years
Furniture and fixtures	seven years
Leasehold improvements	Shorter of lease term or estimated useful life
Software	three–five years
Manufacturing equipment	five–seven years

Maintenance and repairs are charged to expense as incurred. When assets are retired or otherwise disposed of, the assets and related allowances for depreciation and amortization are eliminated from accounts and any resulting gain or loss is reflected in net income.

Computer Software

The Company capitalizes certain costs in connection with developing new internal software once certain criteria are met. Overhead, general, administrative and training costs are expensed as incurred.

Investment in Affiliates

The Company accounts for investments in affiliates under the cost method of accounting if the Company owns less than 20% of the affiliate's outstanding capital. As of December 31, 2014, the Company held a 19% ownership in an affiliate (SpectraMed) and a 10% ownership in an affiliate (Solaris). These affiliates have had significant losses in prior years and the Company had previously reduced its investments in these affiliates to US$nil.

Accounting for Stock-based Compensation

In accounting for the Employee Stock Option Plan, the Company uses the Black-Scholes option pricing model to calculate compensation costs associated with options granted to employees. Total compensation costs are recorded over the option vesting period, generally three years. The Company recorded compensation costs of US$57,951 and US$116,239 for 2014 and 2013, respectively, under the Plan.

Revenue Recognition

Product revenue includes sales of pigments and security taggants, delivery of prototypes, and contracts with multiple elements including nonrecurring engineering and follow-on manufacturing. Service revenue includes research and development services provided for a fixed price or provided for a specific period.

Revenues related to sales of pigments and security taggants and research and development services provided for a specific period are generally recognized when products are shipped or services are provided, the risk of loss has passed to the customer, the sales price is fixed or determinable and collectability is reasonably assured.

Revenue from multiple element arrangements is deferred until all elements of the contract are delivered unless all of the following criteria have been met: (1) the product or service has been delivered; (2) the fee for the delivered element is not subject to forfeiture, refund or concession based on performance or delivery of the undelivered element; and (3) the fair value of the delivered element is determined based upon the price charges by the Company or the price charged by competitors when similar services or products are sold separately, in which case the revenues for each element will be recognized independently in accordance with the Company's policy.

The Company enters into arrangements that can include various combinations of software, services and hardware. Where elements are delivered over different periods of time, and when allowed under US GAAP, revenue is allocated to the respective elements based on their relative selling prices at the inception of the arrangement and revenue is recognized as each element is delivered.

Revenue from fixed-price development contracts is recognized on the percentage-of-completion method, measured by the percentage of effort incurred to date compared to estimated total effort for each contract. That method is used because management considers total effort to be the best available measure of progress on the contracts. Because of inherent uncertainties in estimating effort, it is at least reasonably possible that the estimates used will change within the near term.

Royalties are recognized when they are earned based on sales or use of technologies by third parties, except where future income is not anticipated to cover non-refundable advances received when the excess royalty is taken to income.

Note B – Significant Accounting Policies continued

Research and Development

Internal research and development costs are expensed as incurred. Certain third party research and development costs are capitalized in connection with contracted work. These costs are expensed as certain milestones are achieved. Overhead, general administrative and training costs are expensed as incurred. At December 31, 2012, the Company had an outstanding contract with a third party to adapt an existing capability to certain specific requirements. Such costs totaling US$343,820 have been capitalized as deferred contract costs and are being expensed as certain milestones are met. The milestones were met in 2013 and these costs were expensed.

Advertising Costs

Advertising costs are charged to expense when incurred. No advertising expense was incurred in 2014 or 2013.

Income Tax

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 taxes. The benefits from net operating losses carried forward may be impaired or limited in certain circumstances. In addition, a valuation allowance can be provided for deferred tax assets when it is more likely than not that all or some portion of the deferred tax asset will not be realized. The Company has a deferred tax asset of US$989,000 and US$1,246,000, respectively, at December 31, 2014 and 2013. The change of US$257,000 represents the provision for income tax expense. For 2014, there is no federal or state income tax liability on those respective income tax returns.

Shipping and Handling

The Company reports the cost of shipping and handling as an operating expense. Shipping and handling expense was US$231,356 and US$105,184 for 2014 and 2013, respectively.

Reclassification

Certain reclassifications have been made to prior period amounts in order to conform to current period presentation.

Subsequent Events

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through May 11, 2015, the date the financial statements were available to be issued.

Note C – Related Party Transactions

100% of the sales of the Company's phosphor products, which amounted to approximately US$1,650,000 and US$463,000 for the years ended December 31, 2014 and 2013, respectively, are to a company owned by a shareholder.

Note D – Inventories

Inventories consist of the following:

	December 31,	
	2014	2013
Raw materials	**$ 3,952,203**	$ 2,621,159
Finished goods	**242,977**	347,559
	$ 4,195,180	$ 2,968,718

Note E – Property and Equipment

Property and equipment consists of the following:

	December 31, 2014	December 31, 2013
Laboratory equipment	**$ 963,950**	$ 723,370
Computer and office equipment	**611,911**	565,425
Furniture and fixtures	**136,850**	116,961
Leasehold improvements	**1,802,635**	1,801,059
Software	**361,621**	349,711
Manufacturing equipment	**2,151,154**	2,121,167
Total	**6,028,121**	5,677,693
Less: accumulated depreciation	**(3,203,839)**	(2,774,549)
	$ 2,824,282	$ 2,903,144

Depreciation expense amounted to US$429,290 and US$154,590 for the years ended December 31, 2014 and 2013, respectively.

Note F – Intangible Assets

Intangible assets consist of the following:

	December 31, 2014	December 31, 2013
Patents	**$ 1,531,013**	$ 1,239,890
Customer relationships	**1,730,000**	1,130,000
Non-compete agreements	**177,440**	110,000
Developed technology	**510,000**	390,000
Tradename	**30,000**	—
Trademarks	**17,739**	—
Goodwill	**1,536,946**	1,276,946
Total	**5,533,138**	4,146,836
Less: accumulated amortization	**(1,440,928)**	(1,071,753)
	$ 4,092,210	$ 3,075,083

Amortization expense amounted to US$369,175 and US$273,998 for the years ended December 31, 2014 and 2013, respectively.

Estimated amortization expense for the next five years are as follows:

Year ending December 31,	
2015	$ 372,125
2016	359,357
2017	339,932
2018	305,258
2019	267,997
Thereafter	910,593
	$ 2,555,262

Note G – Other Assets

Other assets consist of the following:

	December 31, 2014	2013
Rental deposits	$ 19,453	$ 19,836
Other deposits	—	2,344
License agreements	2,488	4,477
Equipment deposits	162,000	47,025
	$ 183,941	$ 73,682

Note H – Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities consist of the following:

	December 31, 2014	2013
Royalties	$ 668,019	$ 352,148
Employee compensation	269,723	338,228
Professional fees	64,793	98,235
Property and sales taxes	101,086	82,245
Product warranty	25,000	25,000
Other	95,055	30,568
	$ 1,223,676	$ 926,424

Note I – Income Taxes

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

	December 31, 2014	2013
Income tax provision (benefit) computed at:		
Federal statutory rate – current	$ (50,000)	$ (300,000)
State statutory rate – current	(9,000)	(53,000)
Federal deferred	726,000	(640,000)
State deferred	128,000	(113,000)
Change in valuation allowance	(538,000)	1,106,000
Provision for income taxes	$ 257,000	$ —

A reconciliation of the statutory federal income tax rate with our effective income tax rate was as follows:

	December 31, 2014	2013
Statutory federal rate	34.0%	34.0%
State income taxes, net of income tax benefit	3.0%	0.0%
Non-deductible expenses and other	7.8%	(3.2%)
Change in valuation allowance	(18.2%)	(30.8%)
Federal credits	(6.8%)	0.0%
Effective tax rate	19.8%	0.0%

Financial statements

NOTES TO THE FINANCIAL INFORMATION continued
for the years ended December 31, 2014 and 2013

Note I – Income Taxes continued

Approximate deferred income tax assets are as follows:

	December 31, 2014	December 31, 2013
Depreciation and amortization	**$ (94,000)**	$ 102,000
Deferred revenue	**(471,000)**	344,000
Deferred rent	**8,000**	12,000
Federal and state tax credits	**1,039,000**	1,046,000
Inventory	**240,000**	178,000
Bad debts	**8,000**	—
Contingent liability	**—**	825,000
Net operating loss carryforward	**8,985,000**	8,002,000
Valuation allowance	**(8,726,000)**	(9,263,000)
Total deferred income tax assets	**$ 989,000**	$ 1,246,000

The Company uses an effective tax rate of 40% consisting of a federal rate of 34% and a state rate of 6% net of federal effect.

As of December 31, 2013, the Company has net operating loss carryforwards expiring between 2018 and 2034 for US federal income tax purposes of approximately US$25,450,000 and US$1,756,000 expiring between 2017 and 2018 for state income tax purposes. A valuation allowance has been established for US$8,726,000 and US$9,263,000 as of December 31, 2014 and 2013, respectively, for the deferred tax benefit related to those loss carryforwards and other deferred tax assets.

At December 31, 2014, the Company also had approximately US$731,000 and US$308,000 of tax credit carryforwards that are available to offset federal and state liabilities, respectively. The credits will begin to expire between 2015 and 2028 for federal and between 2018 and 2020 for state.

The utilization of the tax carryforwards described above are dependent upon future profitability prior to any expiration dates. Additionally, alternative minimum taxes, if any, and substantial changes in ownership and tax laws and regulations may substantially limit their realization.

Note J – Accounting for Uncertainty in Income Taxes

The Company accounts for the effect of any uncertain tax positions based on a "more likely than not" threshold to the recognition of the tax positions being sustained based on the technical merits of the position under scrutiny by the applicable taxing authority. If a tax position or positions are deemed to result in uncertainties of those positions, the unrecognized tax benefit is estimated based on a "cumulative probability assessment" that aggregates the estimated tax liability for all uncertain tax positions. The Company is not currently under examination by any taxing jurisdiction. The Company's federal and state income tax returns are generally open for examination for three years following the date filed.

Note K – Commitments

Lease Commitments

The Company holds four real estate leases. The Company's lease agreement for corporate office space expired September 30, 2012 and is now in a month-to-month arrangement. The Company signed a five-year lease agreement for a new space in East Providence beginning in November 2013 and expiring in October 2017. To support our ICS business, the Company signed a two-year lease beginning in February 2013 through January 2015. In 2014, the Company renewed the lease for another two years from February 2015 through January 2017. The Company's lease for laboratory space in East Providence was extended through May 31, 2017. Rent expense was US$434,592 and US$423,376 for the years ended December 31, 2014 and 2013, respectively.

Future minimum lease payments are as follows:

Year ending December 31,	
2015	$ 337,615
2016	337,615
2017	198,559
	$ 873,789

Note K – Commitments continued

License and Supply Agreements

In 1996, and subsequently amended in 1999 and 2002, the Company entered into a license agreement under which the Company obtained a nonexclusive right to use certain technology through the term of the licensor's patents on such technology. The license agreement contains provisions for royalties to be paid on sales of products developed under the agreement. For the years ended December 31, 2014 and 2013, the Company recorded US$461,095 and US$335,220, respectively in royalty expense.

In 2002, the Company entered into a supply agreement whereby the Company agreed to purchase a certain quantity of laser materials at the established price. Under the terms of the agreement, the Company is required to purchase all materials from one vendor. The Company met its obligations under that agreement. The Company was required to purchase all spare parts for the laser materials from that vendor until December 2013. During 2013, the Company had purchased US$79,581 of materials.

Note L – Stockholders' Equity

Common and Preferred Stock

The Company's Certificate of Incorporation, as amended in 2007, authorizes the Company to issue 125,000,000 shares of common stock (the "Common Stock"), US$0.01 par value, and 17,882,179 shares of preferred stock (the "Preferred Stock"), US$0.01 par value, of which 2,000,000 shares are undesignated. The Board designated 4,167,000 shares of preferred stock as Series A Convertible Preferred Stock ("Series A"), 1,700,000 as Series B Convertible Preferred Stock ("Series B"), 2,000,000 as Series B-1 Convertible Preferred Stock ("Series B-1"), 600,000 as Series B-2 Convertible Preferred Stock ("Series B-2"), 150,000 as Series B-3 Convertible Preferred Stock ("Series B-3"), 100,000 as Series B-4 Convertible Preferred Stock ("Series B-4"), 100,000 as Series B-5 Convertible Preferred Stock ("Series B-5"), 1,777,778 as Series C Convertible Preferred Stock ("Series C"), 2,362,400 as Series D Convertible Preferred Stock ("Series D"), and 2,925,000 as Series E-1 Convertible Preferred Stock ("Series E-1").

On July 25, 2011, the Company raised US$20,241,179, net of offering costs, on the London Stock Exchange in a placing of 18,592,320 common shares at a placing price of £0.753 per new common share (the "Placing Price"), representing 41.09% of the enlarged Common Share capital of the Company. As a result of the offering, anti-dilution provisions found in the Company's Amended and Restated Certificate of Incorporation converted all of the issued and outstanding preferred shares into 17,185,052 common shares giving 26,659,050 common shares in issue at the time of the placing. At December 31, 2014, there were 45,251,370 common shares issued and outstanding and no preferred shares in issue.

Warrants

- 2008 Common Stock Warrants

  On April 7, 2008, the Company raised US$600,000 in exchange for 1,000,000 common shares valued at US$0.60 each. The Company paid a 10% commission and also provided the agent with warrants to purchase 275,000 common shares at an exercise price of US$0.60 per share. The warrants expired on April 7, 2013.

- WH Ireland Warrant Agreement

  Pursuant to a warrant agreement dated July 19, 2011, the Company created and issued warrants to WH Ireland under Regulation D of the US Securities Act, which entitles the holder to subscribe for up to 452,514 common shares at an exercise price of £0.753 per share. The warrants expired on July 25, 2014. Under the Black-Scholes pricing model, the Company estimated the fair value of the warrants to be US$273,318. These costs have been included as part of the 2011 offering costs.

Stock Option Plan

In December 1996, the Company's Board of Directors, who control a majority of the shares of the Company, approved the 1997 Stock Option Plan (the "1997 Plan").

The 1997 Plan provided that key employees, non-employee Directors, and certain consultants and advisors may be granted either nonqualified or incentive stock options for the purchase of the Company's common stock at the fair market value on the date of the grant. Stock options generally vest over three years. The options would be exercisable over a period up to ten years from the date of grant.

Note L – Stockholders' Equity continued

Stock Option Plan continued

In February 2002, the Company adopted the 2002 Stock Plan (the "2002 Plan") which provided for the grant of incentive stock options and nonqualified stock options, stock awards and stock purchase rights for the purchase of up to 1,500,000 shares of the Company's common stock to officers, employees, consultants and Directors of the Company. The Board of Directors is responsible for the administration of the 2002 Plan. The Board determines the term of each option, the option exercise price, the number of shares for which each option is granted and the rate at which each option is exercisable. Incentive stock options may be granted to an officer or employee at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of fair value in the case of holders of more than 10% of the Company's voting stock) and with a term not to exceed ten years from the date of the grant (five years for incentive stock options granted to holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted to consultants or Directors at an exercise price per share of not less than 85% of the fair value of the common stock.

Upon the effective date of the 2002 Plan, the 1997 Plan was terminated. The termination did not affect the previously issued options.

In 2007, the number of shares available for grant under the 2002 Plan increased from 1,500,000 to 3,500,000.

In May 2007, the Company adopted the 2007 Stock Plan (the"2007 Plan") which provided for the grant of incentive stock options and nonqualified stock options, stock awards and stock purchase rights for the purchase of up to 14,100,000 shares of the Company's common stock to officers, employees, consultants and Directors of the Company. The Board of Directors is responsible for administration of the 2007 Plan. The Board determines the term of each option, the option exercise price, the number of shares for which each option is granted and the rate at which each option is exercisable.

The 2007 Plan and the 2002 Plan existed at December 31, 2014.

At December 31, 2014, 32,700 options were issued under the 1997 Plan, 2,202,864 options were issued under the 2002 Plan and 3,561,476 options were issued under the 2007 Plan. 344,451 options were issued without a plan. 7,958,509 options were available for grant under the 2007 Plan.

Information related to stock options granted by the Company is summarized as follows (including certain options granted outside of the Plan):

	December 31, 2014			December 31, 2013		
	Number of shares under option		Weighted average exercise price	Number of shares under option		Weighted average exercise price
Outstanding at beginning of year	**6,533,103**	**$**	**0.74**	6,586,803	$	0.76
Granted	**45,000**	**$**	**0.36**	81,000	$	0.30
Exercised	**—**		**—**	—		—
Forfeited/canceled	**(436,612)**	**$**	**0.58**	(134,700)	$	1.54
Outstanding at end of year	**6,141,491**	**$**	**0.74**	6,533,103	$	0.74

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

	Options outstanding				Options exercisable		
Exercise price range	Number of outstanding shares	Weighted average contractual life (years)		Weighted average exercise price	Number of shares		Weighted average exercise price
US$0.30–US$0.84	**3,574,425**	**4.83**	**$**	**0.56**	**3,378,064**	**$**	**0.57**
US$0.85–US$1.23	**2,567,066**	**2.28**	**$**	**1.00**	**2,567,066**	**$**	**1.00**
	6,141,491				**5,945,130**		

Note L – Stockholders' Equity continued

Stock Option Plan continued

The Company currently uses the Black-Scholes option pricing model to determine the fair value of our stock options. The valuations determined using this model are affected by assumptions regarding a number of complex and subjective variables including stock price, volatility, expected life of options, risk free interest rates, and expected dividends, if any. The assumptions used to value stock option grants for the year ended December 31, 2014 are as follows:

Risk free rate	0.09% – 0.10%
Expected life	five years
Assumed volatility	52.80% – 53.63%
Expected dividends	None
Expected forfeitures	75%

Unrecognized Compensation Costs

As of December 31, 2014, there was approximately US$26,000 of unrecognized compensation costs, adjusted for estimated forfeitures, related to unvested stock-based payments granted to our employees, Directors and consultants. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures and recognized over the remaining vesting periods of the stock grants.

Note M – Employee Retirement Plan

During 1999, the Company adopted a defined contribution Plan, established under the guidelines of Section 401(k) of the Internal Revenue Code (IRC), which covers all employees. Employees are eligible to participate in the Plan at the beginning of the first month following the date of hire. Employees may contribute up to the maximum allowed by the (IRC) of eligible pay on a pretax basis. The Company made a matching contribution of 50% of employee contributions up to 4% of eligible salary. Company matching contributions vest at 25% after one year of service, 50% at the end of two years of service and 100% at the end of three years of service. For the years ended December 31, 2014 and 2013, the Company's matching contribution was US$53,792 and US$38,416, respectively.

Note N – Contingent Liability

In December 2011, the Company was notified by a corporate shareholder regarding a license agreement between the Company and the shareholder dated March 8, 1999. The shareholder had stated that the Company owed the shareholder approximately US$2,100,000 in total for the years 2004 through 2010 based on their interpretation of the license agreement. The Company disagreed with the shareholder's interpretation of the license agreement.

In 2014, the Company and the shareholder reached a settlement that terminated the agreement and liabilities that would otherwise have continued through the remainder of the agreement. To settle the dispute for all past amounts due and all future amounts that may be due, the Company agreed to pay US$2,000,000 plus the relief of a receivable owed to the Company from the shareholder in the amount of approximately US$129,000. Accordingly, the Company recorded a contingent liability expense of US$1,789,040 in 2013 after offsetting accruals.

Note O – Business Combinations

Acquisition of Certain Assets from Inksure Technologies, Inc.

On February 28, 2014, the Company acquired certain assets from Inksure Technologies, Inc., a leader in brand protection and tax stamp authentication headquartered in New York City, NY. The acquisition was strategic for the Company, allowing us to extend our reach into tax stamps and the authentication of commercial product brands. The Company will support the customers with resources existing in its banknote authentication division. The total purchase price was US$1,356,000 in cash with deferred consideration of US$35,000, dependent upon achieving a commercial milestone. The purchase price included Inksure's long-standing customer relationships and authentication technology. We report Inksure as part of our authentication systems.

Note O – Business Combinations continued

Acquisition of Certain Assets from Inksure Technologies, Inc. continued

The following tables provide further details of this acquisition:

		Inksure
Date of acquisition		February 28, 2014
Reporting business segment		Authentication systems
Cash consideration paid to former owners	$	1,356,000
Allocation of purchase price:		
Accounts receivable		136,000
Inventories		246,000
Property, plant and equipment		—
Goodwill		260,000
Identifiable intangible assets		817,000
Total assets acquired	**$**	**1,459,000**
Deferred revenue		—
Other liabilities		(103,000)
Total liabilities acquired	**$**	**(103,000)**
Net assets assumed	**$**	**1,356,000**

	Inksure			
		Weighted average amortization period		Total
Identifiable intangible assets				
Customer relationships	$	10.00	$	600,000
Developed technology		10.00		120,000
Trade name		5.00		30,000
Non-compete agreements		3.00		67,000
Weighted average amortization period and total	**$**	**9.06**	**$**	**817,000**

Note P – Segment reporting

In accordance with ASC 280, management has identified three operating segments. The first is the Authentication Systems Group, which captures the hardware, software, and materials related to banknote, tax stamp, and other high value goods. The second segment is the Secure Software Transactions Group. This group is characterized as providing an Internal Control System (ICS) software offering to the lottery and gaming industries. ICS provides tools for fraud detection, money laundering, match fixing, and statistical analysis. The third group is the Banknote Cleaning Group. This group captures the technology related to cleaning soiled banknotes.

Information for each reportable segment as of December 31, 2014 and 2013 is as follows:

		Gross sales	Income (loss) from operations	Depreciation and amortization	Capital expense	Segment assets
2013	Secure Software Transactions	$ 1,590,299	$ 192,887	$ 181,228	$ 17,099	$ 3,800,729
	Authentication Systems	9,981,743	(1,286,394)	247,361	754,736	24,762,583
	Banknote Cleaning	—	(271,200)	—	—	94,050
	Total Segment	**$ 11,572,042**	**$ (1,364,707)**	**$ 428,589**	**$ 771,835**	**$ 28,657,362**
2014	Secure Software Transactions	$ 1,378,849	$ 106,471	$ 188,075	$ 4,152	$ 3,663,548
	Authentication Systems	15,527,500	1,455,180	600,156	186,688	22,359,111
	Banknote Cleaning	—	(333,169)	13,668	164,019	399,210
	Total Segment	**$ 16,906,349**	**$ 1,228,482**	**$ 801,899**	**$ 354,859**	**$ 26,421,869**

Note Q – Income/(Loss) Per Share

The calculation of income (loss) per share figures for the years ended December 31, 2014 and 2013 is based on the profit/(loss) attributable to ordinary shareholders of US$1,043,808 and (US$3,002,l04), respectively, divided by the weighted average number of shares in issue, shown in the table below. Since the year ended December 31, 2013 reflected a loss, including the potential conversion of warrants and options in the diluted EPS calculation would decrease the loss per share. Accordingly, they are considered anti-dilutive and are not included in the calculation of loss per share. For 2014, the exercise price of all options exceeded the average market price of the shares in issue and therefore are not considered in the calculations.

SHAREHOLDER AND CORPORATE INFORMATION

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