AXALTO HOLDING N.V.
Limited liability company (naamloze vennootschap) under Dutch law, with corporate seat in Amsterdam, The Netherlands and address at Koningsgracht Gebouw 1, Joop Geesinkweg 541-542, Amstel Business Park, Amsterdam, The Netherlands

2004 ANNUAL REPORT

Copies of this document are available on the company’s website (http://www.axalto.com).
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This annual report presents Axalto Holding N.V. ("Axalto" or the “Company”), the Axalto group as a whole and its card (“Cards”) and point-of-sale terminals (“POS”) divisions.

Given the method of coverage by independent companies specializing in the sectors in which Axalto operates, several sources have been used in this annual report so as to favor the most recent resources and provide both historical and future data for the sector as a whole and certain sub-segments.

Unless stated otherwise, market share, ranking, forecasts and all other market data contained in this document are based either on independent industry publications or other published independent sources which, in each case, Axalto believes to be reasonable sources of information. Unless stated otherwise, (a) data on market sizes and forecasts for all segments other than mobile communications, financial cards and point-of-sale terminals are based on the Global Smart Card Opportunities report published by Datamonitor in April 2003; (b) market share data and rankings for the overall microprocessor card and chip card markets are based on the World Smart Card IC Market Study report published by Frost & Sullivan in July 2004 (reference 6929-33) and on the Market Share: Chip Card and Semiconductor Vendors, Worldwide, 2003 report published by Gartner in April 2004; (c) market size, market shares, rankings and forecasts for the mobile communications segment are based on the World GSM Smart Card Markets report published by Frost & Sullivan in July 2004; (d) market size, market shares, rankings and forecasts for the financial cards segment are based on the World Banking Smart Cards Market — Financial & Loyalty report published by Frost & Sullivan in October 2004 (reference 6939-33); (e) market shares and rankings for all segments other than mobile communications, financial cards and point-of-sale terminals are based on The Nilson Report published in December 2003 (the ‘Nilson Report’); and (f) market size, market shares, rankings and forecasts for the point-of-sale terminals segment are based on the World Market EFT POS Terminals Markets - Market Size report published by Frost & Sullivan in 2004. In each case, Axalto believes it has used the most recent independent industry data available at the time this annual report was prepared. Axalto has also sought to use industry data which is organized as closely as possible to the way it organizes its own business.

Where independent publications or other sources were not available, Axalto has provided information based on its own knowledge of the market. This information has not been verified by an independent expert and the Company cannot guarantee that a third party using different methods to assemble, analyze or compute market data would obtain or generate the same result.

More generally speaking, market share data may change and by its very nature cannot always be verified with complete certainty.
CHAPTER I  PERSONS RESPONSIBLE FOR THE ANNUAL REPORT AND PERSONS RESPONSIBLE FOR AUDITING THE FINANCIAL STATEMENTS

1.1 PERSONS RESPONSIBLE FOR THE ANNUAL REPORT

Olivier Piou  
Chief executive officer of Axalto Holding N.V.  

John de Wit  
Chairman of the Board of Axalto Holding N.V.

Maarten Scholten  
Non-executive member of the Board of Directors  

Michel Soublin  
Non-executive member of the Board of Directors

Willem Stolwijk  
Non-executive member of the Board of Directors  

Arthur Van der Poel  
Non-executive member of the Board of Directors

1.2 STATEMENT OF THE PERSONS RESPONSIBLE FOR THE ANNUAL REPORT

"To our knowledge, the information set out in this annual report is true and correct; it includes all the information required by investors to base their opinion on Axalto Holding N.V.’s assets and liabilities, business, financial position, results and prospects; there are no omissions that could affect the significance of such information."

Olivier Piou  
Chief Executive Officer of Axalto Holding N.V.  

John de Wit  
Executive member of the Board of Directors

Maarten Scholten  
Non-executive member of the Board of Directors  

Michel Soublin  
Non-executive member of the Board of Directors

Willem Stolwijk  
Non-executive member of the Board of Directors  

Arthur Van der Poel  
Non-executive member of the Board of Directors

1.3 PERSONS RESPONSIBLE FOR AUDITING THE FINANCIAL STATEMENTS

1.3.1 Persons responsible for auditing the financial statements of Axalto Holding N.V.

PricewaterhouseCoopers Accountants N.V.
Oostduinlaan 2
2596 JM The Hague
The Netherlands

Appointed on January 19, 2004 for an unfixed duration subject to their dismissal at any time by the General Meeting of shareholders.

1.3.2 Persons responsible for auditing the combined financial statements of Axalto prepared in accordance with generally accepted accounting principles in the United States of America

PricewaterhouseCoopers Audit
Tour AIG
34, place des Corolles
92208 Paris La Défense Cedex
France

1.3.3 Report of the persons responsible for auditing the combined financial statements of Axalto on the audited combined financial statements to 31 December 2002, 2003 and 2004 (presented in paragraph 5.2)

“We have audited the accompanying consolidated balance sheet of Axalto N.V. and its subsidiaries as of December 31, 2004 and the related consolidated statement of income, shareholders’ equity and cash flows for the year then ended, and the accompanying combined balance sheets of Axalto and its subsidiaries as of
December 31, 2003 and 2002 and the related combined statements of income, shareholders’ equity and cash flows for the years then ended (the “financial statements”). The 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 International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Axalto and its subsidiaries as of December 31, 2004, December 31, 2003 and December 31, 2002 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Axalto was historically a fully integrated business of several indirect subsidiaries and joint ventures of Schlumberger Limited. Consequently, as indicated in Note 1, combined financial statements as of December 31, 2003 and December 31, 2002 have been derived from the consolidated financial statements and accounting records of Schlumberger Limited and reflect significant assumptions and allocations. Moreover, as indicated in Note 1, as of December 31, 2003 and December 31, 2002 Axalto relied on Schlumberger Limited and its other businesses for certain administrative, management and other services. Accordingly, combined financial statements as of December 31, 2003 and December 31, 2002 do not necessarily reflect the combined financial position, results of operations, changes in invested equity and comprehensive income/(loss) and cash flows of Axalto had it been a separate, stand-alone entity during the periods presented.

As discussed in Note 2 to the accompanying combined financial statements, in 2002 Axalto changed its method of accounting for goodwill.”

Dated April 19, 2005

PricewaterhouseCoopers Audit
Paris, France

1.4 PERSON RESPONSIBLE FOR INFORMATION

Stéphane Bisseuil
Head of investor relations

Axalto International S.A.S.
50 avenue Jean Jaurès - 92120 Montrouge, France
Telephone: 01 46 00 70 70
Fax: 01 46 00 46 96
E-mail: sbisseuil@axalto.com
In the case of a public offering, information contained in this chapter will be the object of an informational document ("note d’opération") submitted to the Autorité des Marchés Financiers for approval.
CHAPTER III  GENERAL INFORMATION ABOUT THE COMPANY AND ITS SHARE CAPITAL

3.1 GENERAL INFORMATION ABOUT THE COMPANY

3.1.1 Corporate name and corporate seat

The Company’s corporate name is Axalto Holding N.V.

The Company’s corporate seat is in Amsterdam, The Netherlands and the Company’s address is Koningsgracht Gebouw 1, Joop Geesinkweg 531-541, Amstel Business Park, Amsterdam, The Netherlands.

3.1.2 Legal form

The Company is a limited liability company (naamloze vennootschap or N.V.) with a Board of Directors governed by the laws of The Netherlands.

3.1.3 Governing legislation

The Company is governed by the laws of The Netherlands, in particular by Book 2 of the Dutch Civil Code and by its articles of association (the ‘Articles of Association’). French commercial business law does not apply to the Company. The Company’s securities are not listed on a regulated market in The Netherlands. The Company’s shares are listed on Eurolist by Euronext Paris. In this respect, certain French legislative and regulatory provisions also apply to the Company.

Dutch law

The Company is subject to various legal provisions of the Dutch Securities Market Supervision Act 1995 (Wet Toezicht Effectenverkeer 1995) (the ‘Securities Act’), in particular: (i) the prohibition (unless exempt) to offer and to commence an issuance of marketable securities unless a prospectus has been prepared in accordance with Dutch law, (ii) the prohibition (unless exempt) to proceed with any transaction concerning the Company’s shares admitted to trading on a regulated market (or any financial instruments or securities whose value is dependent on these shares), with the assumption that the Company would hold insider information and (iii) the obligation (unless exempt) of the Company to notify the Dutch Financial Markets Authority (Autoriteit Financiële Markten) of any transactions carried out in respect of its shares or financial instruments.

The provisions of Dutch law relating to declarations of stakes held in the Company’s capital are described in paragraph 3.1.11 – Disclosure of holdings.

Article 6a of the Securities Act stipulates that an offering document must be issued in the case of a tender offer involving the Company’s shares and that the parties involved must comply with the code of conduct described in the 1995 decree on the supervision of securities transactions (Besluit Toezicht Effectenverkeer). This decree defines the information that must be included in the offering document.

Regarding the information that must be included in the annual report, the Company is governed by Book 2, Title 9 of the Dutch Civil Code. This information is provided in chapters IV – INFORMATION ABOUT THE COMPANY’S ACTIVITIES, V – ASSETS, FINANCIAL POSITION AND RESULTS, VI – CORPORATE GOVERNANCE and VII – RECENT EVENTS AND OUTLOOK.

French law

As the Company’s shares are admitted to trading on Eurolist by Euronext Paris, certain provisions of French stock exchange law apply to the Company.

The Company is subject to provisions concerning foreign issuers pursuant to (i) articles 222-1 to 222-11 and 632-1 of the General Regulations of the Autorité des Marchés Financiers (the ‘AMF’) concerning the obligation to provide information to the public, (ii) articles 631-1 to 631-10 of the General Regulations of the AMF relating to market manipulation, (iii) articles 611-1, 621-1 to 622-2 of the General Regulations of the AMF relating to insider trading, (iv) articles 241-1 to 241-8 of the General Regulations of the AMF relating to programs to
repurchase shares admitted to trading on a regulated market and the declaration of transactions, (v) articles 211-1 to 211-42 of the General Regulations of the AMF relating to information to be provided on the admission to trading on a regulated market and issuing of financial instruments and (vi) articles 214-1 to 214-21 of the General Regulations of the AMF relating to information to be provided in the case of a public offer without the admission to trading of financial instruments on a regulated market. The organization and operational principles of Euronext Paris are generally applicable to the Company.

Regarding the regulation of public offerings, articles 231-1 et seq. of the General Regulations of the AMF relating to takeover bids are applicable to the Company, with the exception of the provisions concerning the standing market offer, the mandatory filing of a draft public offer and compulsory buyout. Other provisions of French stock exchange law are not applicable to the Company.

Under French law, a foreign issuer is required to make the necessary provisions to allow shareholders to ensure management of their investments and to exercise their rights. As the Company’s shares are admitted to trading on Eurolist by Euronext Paris and in accordance with articles 211-1 to 211-42 and 222-1 et seq. of the General Regulations of the AMF and the aforementioned organization and operational principles of Euronext Paris:

- The Company is required to inform its shareholders of: (a) all forthcoming General Meetings of shareholders and the various ways for them to exercise their voting rights at least 15 days before the date of the General Meeting of shareholders, (b) payments of dividends, (c) the issuance of new shares, subscriptions, allocations, renunciations and, if applicable, conversions;
- The Company is also required: (a) to inform the public and the AMF of any changes in its shareholding structure compared with previously published data, (b) to provide, via the French financial press, information relating to its activities and results for the first half of each financial year within four months of the end of the first half of the financial year, (c) to publish its annual company and consolidated financial statements and its management report within six months of the end of the financial year and to translate into French this management report or significant extracts of the report, (d) to publish, via the French financial press, its consolidated quarterly revenues as soon as possible after the end of each quarter of the financial year, (e) to inform the public of any changes in the rights attached to the various share categories, (f) to publish, as soon as possible, any information concerning new developments that may have a significant impact on the share price and to keep the AMF informed, (g) to notify the AMF of the Company’s annual and interim financial statements, (h) to inform the French public of decisions to change the Company’s activities or members of the Board of Directors, (i) to inform the AMF of any declarations of passing thresholds received in accordance with the legal requirements described in paragraph 3.1.11 – Disclosure of holdings, (j) to update the name and contact details of the person responsible for company information in France, and (k) to provide the AMF with any information requested within the framework of its authority and laws and regulations applicable to the Company;
- The Company is required to inform the AMF and Euronext Paris of any proposed changes to its Articles of Association;
- The Company is required to inform the AMF of any resolutions by the General Meeting of shareholders authorizing the Company to trade in its own shares on the stock market and to send the AMF periodic statements of purchases or sales of shares carried out by the Company in respect of this authorization;
- The Company must ensure that identical information is provided in France, at the same time, to that provided in other countries, particularly in The Netherlands;
- All publications and public information mentioned in this chapter shall be effected by any means and, in particular, by the publication of a notice or press release in a national financial daily newspaper distributed in France.

Information intended for the public in France shall be communicated in French.

The Company intends to pursue an active policy towards all of its shareholders, including those who hold their shares through Euroclear France, by endeavoring to allow them to participate in capital increases open to the public carried out on the international markets, or any other operations open to the public concerning its share capital.
3.1.4 Date of incorporation and term

The Company was incorporated for an indefinite period on December 10, 2002 as a B.V. (besloten vennootschap met beperkte aansprakelijkheid). It was converted into an N.V. (naamloze vennootschap) on February 17, 2004.

3.1.5 Corporate purpose

In accordance with article 2 of the Articles of Association, the corporate purpose of the Company is:

- to manufacture, import, export, sell, distribute, lease, trade, market and advise in the area of chip cards and point-of-sale terminals or related products, as well as any other products of interest or which may be of interest for the Company;
- to acquire, take a stake in, finance, manage or participate in another form in other companies or businesses operating in the design, development, manufacturing and marketing of chip cards, security devices, security software and point-of-sale terminals;
- to raise funds by way of marketable securities, bank loans, bonds or any other debt securities and borrowing in any other form, lending, providing guarantees and security, including guarantees and security relating to debts of other persons, and in general to provide commercial and financial services;
- to invest in marketable securities, savings certificates and any other financial instruments;
- to acquire, develop, hold, turn to account, create charges over or sell or utilize in any other way property assets or other registered properties;
- to conduct design, research and development activities, as well as to carry out the factoring and invoicing of trade receivables and the netting of payables and receivables;
- to market licenses, copyrights, patents, designs, secret processes or formulas, trademarks and similar intellectual property rights, and to promote the purchase, sale and trading, including the use, of these rights and receiving royalties and any other income relating to these activities;
- to perform all acts that are recommended, necessary, usual or related to the aforementioned purposes.

The purposes mentioned in the above paragraph shall be construed in their widest sense and, in particular, include any activity or purpose which is incidental or may be conducive thereto.

In pursuing its corporate purpose, the Company may participate in transactions that will benefit companies or businesses with which it is affiliated.

3.1.6 Place of registration

The Company is registered with the trade register of the Amsterdam Chamber of Commerce and Industry under number 27255026.

It is identified by the Dutch Ministry of Justice under number NV1224482.

3.1.7 Legal documents available for inspection

A certified translation in French of the Company’s Articles of Association was filed with the registry of the Paris Commercial Court on April 27, 2004 under number 00009787.

The Company’s Articles of Association are available for inspection in Dutch, English (unofficial translation) and French (unofficial translation) at the Company’s address at Koningsgracht Gebouw 1, Joop Geesinkweg 531-541, Amstel Business Park, Amsterdam, The Netherlands, at Axalto International S.A.S., the Company’s French subsidiary, whose registered office is located at 50 avenue Jean Jaurès, 92120 Montrouge, France, and on the Company’s website (www.axalto.com).
Minutes of the Company’s General Meetings of shareholders, annual financial statements and the annual report are available for inspection at the above addresses.

Minutes of the General Meeting of shareholders shall be made available to shareholders, at their request, within a maximum of three months of the date of the General Meeting of shareholders.

3.1.8 Fiscal year

In accordance with article 30 of the Articles of Association, the Company’s fiscal year has a duration of 12 months and begins on January 1 and ends on December 31 of each year.

3.1.9 Distribution of profits

Stipulations relating to the distribution of profits and dividends by the Company to its shareholders are provided in articles 32 to 35 of the Articles of Association.

Following adoption of the annual Company and consolidated financial statements by the General Meeting of shareholders, the Company may distribute profits, provided that the financial statements show that this is permissible. The Company may only pay dividends insofar as its equity exceeds the sum of the issued share capital and the mandatory statutory reserves.

The Board of Directors determines, with due observance of the Company’s policy on additions to reserves and on distribution of profits, and taking into account the legal provisions relating to mandatory statutory reserves, what portion of the profit shall be retained by way of reserve. The portion of the profits that shall not be reserved shall be at the free disposal of the General Meeting of shareholders. The General Meeting of shareholders may also resolve, upon the recommendation of the Board of Directors, to make distributions charged to the share premium reserve or charged to the other reserves shown in the annual accounts which are not prescribed by the law.

The Board of Directors determines the terms of distributions to shareholders. Subject to having obtained, in accordance with the Articles of Association, the authorization of the General Meeting of shareholders to issue shares, the Board of Directors may decide to pay dividends in shares or grant shareholders the option to choose distribution in cash or in shares. If no such approval is given, this power is passed on to the General Meeting of shareholders, on the recommendation of the Board of Directors.

The Board of Directors will propose to the forthcoming annual General Meeting of shareholders to appropriate the profits to the retained earnings.

Before the annual financial statements are adopted by the General Meeting of shareholders, the Board of Directors may, at its own discretion and subject to the provisions of Section 105, subsection 4 of Book 2 of the Dutch Civil Code and with due observance of the Company’s policy on additions to reserves and on distribution of profits, resolve to distribute one or more interim dividends to shareholders.

The Articles of Association state that the Board of Directors determines the date and the place or places of the distribution of dividends, it being stipulated that there will be at least one place of payment in each country in which the Company’s shares are admitted to trading on a regulated market (officiële notering). Persons entitled to a dividend are those registered on the Company’s shareholder register at a date determined by the Board of Directors. The payment of dividends and the place of payment are published in a daily national newspaper in each country where the shares are admitted to trading on a regulated market.

3.1.10 General Meetings of shareholders

Articles 20 to 28 of the Articles of Association contain the statutory requirements relating to General Meetings of shareholders.

Any person authorized to attend the General Meeting of shareholders may attend the meeting or appoint a proxy, in writing, to represent it. If necessary, this person is authorized to exercise the shareholder’s voting rights provided that the Company has been informed in writing of this person’s intention to attend the General Meeting
of shareholders under the conditions indicated in the notice convening the General Meeting of shareholders within the applicable deadline. This deadline may not be earlier than seven days prior to the day of the General Meeting of shareholders. The Company must have received this notification by the deadline stated in the notice convening the General Meeting of shareholders. Shareholders, usufructuaries and pledgees of shares with voting rights, as well as persons holding depository receipts of shares (certificaten van aandelen) issued with the cooperation of the Company are entitled to attend General Meetings of shareholders, in accordance with the law and the Articles of Association.

The Board of Directors may limit attendance to General Meetings of shareholders to shareholders who are registered as such in a register designated for this purpose and provided that these persons are, on the day of the General Meeting of shareholders, authorized to attend General Meetings of shareholders or not at a given date to be determined by the Board of Directors (the ‘Record Date’).

This date cannot be earlier than seven days and not later than three days prior to the day of the General Meeting of shareholders.

Shareholders, usufructuaries and pledgees of shares who wish to exercise their right to attend the General Meeting of shareholders and, where applicable, to vote, must sign an attendance list.

The General Meeting of shareholders may be held in Amsterdam, The Hague, Haarlemmermeer (Schiphol Airport), Utrecht or Rotterdam (The Netherlands).

The annual General Meeting of shareholders must be held each year within six months of the close of the fiscal year. The General Meeting of shareholders addresses such matters as (i) the report of the Board of Directors discussing the Company’s business and the conduct of its affairs during the past financial year; (ii) the adoption of the annual financial statements, (iii) the Company’s policy on additions to reserves and distributions of profits (the amount and the object of additions to the reserves as well as the amount and form of the distribution of profits), as well as the respective reasons; (iv) any proposal to distribute profits; (v) any substantial change in the Company’s corporate structure and in its compliance with the Dutch corporate governance code (De Nederlandse Corporate Governance Code); (vi) vacancies within the Board of Directors; and (vii) any other proposals placed on the agenda by the Board of Directors (notably the final discharge of the directors for their management of the Company during the past year) and proposals made by shareholders in accordance with Dutch law and the Articles of Association.

A General Meeting of shareholders may also be held as often as deemed necessary by the Board of Directors or the Chairman of the Board of Directors or, if the Chairman of the Board of Directors is absent or not able to call a General Meeting of shareholders, by the Chief Executive Officer. A General Meeting of shareholders may be held upon written request to the Board of Directors by one or more shareholders holding, individually or collectively, at least 10% of the Company’s issued share capital. In the case of a refusal or if the General Meeting of shareholders is not held within six weeks of such a request, the shareholder or shareholders making the request may be authorized by a Dutch court to hold a General Meeting of shareholders.

In accordance with the applicable law, if the Board of Directors becomes aware that its shareholders’ equity has decreased to an amount equal to or less than one-half of its issued share capital, a General Meeting of shareholders must be held within three months in order to decide which measures should be taken.

The Articles of Association state that notice of each General Meeting of shareholders must be given by an advertisement published in a daily national newspaper in The Netherlands and in at least one daily newspaper in each country where the shares are admitted to trading on a regulated market. The advertisement must be published at least 15 days before the date of the General Meeting of shareholders.

The Company’s shares may be held in two ways:

- as registered shares (the shareholders are registered on the Company’s shareholder register);
- in an account via Euroclear France through an account holder or a financial intermediary. These shares are entered in the Company’s shareholder register in the name of Euroclear France.

Only shareholders registered in the Company’s shareholder register are authorized to attend the General Meeting
of shareholders or to appoint a proxy, in writing, to represent them.

The names of persons holding shares through Euroclear France are not entered in the Company’s shareholder register. Upon the request of such persons, Euroclear France may attend the General Meeting of shareholders and exercise the voting rights attached to the shares held on their behalf. These persons may also request power of attorney from Euroclear France to allow them to attend the General Meeting of shareholders in person.

Registered shares

In order to exercise their voting rights in respect of shares in their possession, registered shareholders must express their desire to do so by completing and signing the applicable attendance form and returning it to the Company’s registrar, Netherlands Management Company B.V. (the ‘Registrar’). Otherwise, the shareholder will not be entitled to vote. Receipt of the duly completed and signed attendance form within the stipulated deadline constitutes notification to the Company of the shareholder’s intention to exercise his voting rights.

If a registered shareholder wants to be represented by a proxy, he must inform the Registrar by sending a duly completed and signed proxy form. Receipt of this duly completed and signed proxy form by the Registrar within the stipulated deadline constitutes notification to the Company of the shareholder’s intention to be represented at the General Meeting of shareholders by a proxy.

Persons holding shares through Euroclear France

Persons holding shares through Euroclear France who want to attend the General Meeting of shareholders may obtain a power of attorney from Euroclear France by completing the form provided by their financial intermediary on request.

Persons holding shares through Euroclear France who want Euroclear France to vote on their behalf must provide Euroclear France with their voting instructions by completing the voting form provided by their financial intermediary on request.

Persons holding shares through Euroclear France who want to attend the General Meeting of shareholders within the framework of the procedure described above may vote in person at the General Meeting of shareholders up to the number of shares declared for this purpose.

Persons holding shares through Euroclear France who want to attend the General Meeting of shareholders or who want to give voting instructions to Euroclear France must complete and sign the applicable forms and return them to their financial intermediary within the stipulated deadline.

The shares of registered shareholders and persons holding shares through Euroclear France who decide to attend the General Meeting of shareholders or to exercise their voting rights will be blocked until the day after the General Meeting of shareholders, unless the Board of Directors decides to implement the relative procedure at the Record Date. If a shareholder withdraws his voting instructions in the meantime, his shares will be unblocked and the shareholder’s right to attend the General Meeting of shareholders will be withdrawn.

Conversion to registered shareholder

Persons holding shares through Euroclear France may have their shares put in their own name so that they are registered as shareholders directly in the Company’s shareholder registry kept by the Registrar and may exercise certain rights attached to shares directly.

Persons holding shares through Euroclear France who want to convert their shares directly via the Registrar in The Netherlands must send their request to the account holder or appropriate financial intermediary.

Holding of General Meetings of shareholders

The agenda shall contain questions registered by the persons entitled to hold the General Meeting of shareholders and questions asked by one or more shareholders representing at least 1% of the issued share capital or representing a value of at least €50 million (or any other amount as determined by governmental decree), calculated according to the official list price of the stock exchange where they are admitted to trading. The
shareholder or shareholders must make a written request at least 60 days prior to the date of the General Meeting of shareholders, provided the request is not contrary to an overriding interest of the Company.

Resolutions can only be adopted if the notice procedure described above and defined by Dutch law has been properly followed, unless the resolution has been adopted unanimously by a General Meeting of shareholders at which all persons authorized to attend are present or represented by proxy.

General Meetings of shareholders are presided over by the Chairman of the Board of Directors or, in his or her absence, the Chief Executive Officer or, in his or her absence, another person nominated by the Board of Directors. The Company Secretary acts as secretary of the General Meeting of shareholders. In his or her absence, the Chairman of the General Meeting of shareholders shall appoint the secretary.

Each share confers the right to cast one vote.

Unless otherwise stated in the law or the Articles of Association, resolutions shall be adopted by an absolute majority of votes cast in an ordinary or extraordinary General Meeting of shareholders where at least one-quarter of the issued share capital is represented. If the required issued share capital is not represented, the Board of Directors may hold a further General Meeting of shareholders, to be held within four weeks after the first General Meeting of shareholders, at which resolutions may be adopted by an absolute majority of the votes cast, irrespective of the share capital represented. Blank and void votes are not taken into account.

**Identification of shareholders**

The Board of Directors may ask a central depository of the Company’s shares to identify in writing persons holding shares via such a central depository, provided that this is allowed by the charters applicable to such bodies and within the limitations prescribed.

When trading of the Company’s shares on the Premier Marché of Euronext Paris began in May 2004, the shares were admitted for trading with Euroclear France. Euroclear France may identify persons holding shares in the Company registered in an account with it. Euroclear France will collect this information from the account holders, who are not required to respond to such a request, as no legal obligation of this kind exists in France.

3.1.11 Disclosure of holdings

The Company’s Articles of Association do not state any specific statutory thresholds. The provisions of Dutch company law apply.

Holders of shares may be subject to notification obligations under the 1996 Dutch Act on Disclosure of Holdings in Listed Companies (Wet melding zeggenschap in ter beurze genoteerde vennootschappen 1996) (the ‘Disclosure Act’), as well as the Dutch Securities Market Supervision Act, as mentioned in paragraph 3.1.3 – Governing legislation.

The following description contains a summary of these obligations. Holders of shares or other securities in the Company are advised to consult their own legal advisers to determine whether the notification obligations apply to them.

Pursuant to the Disclosure Act, any person who, directly or indirectly, acquires or disposes of an interest in the Company’s capital or voting rights must immediately give written notice to the Company and the Dutch Financial Markets Authority if, as a result of such acquisition or disposal, the percentage of capital interest or voting rights held by this person falls within a different range to that before the acquisition or disposal. The holding ranges stipulated in the Disclosure Act are currently 0-5%, 5-10%, 10-25%, 25-50%, 50-66\(2/3\)% and above 66\(2/3\)% and above 66\(2/3\)%. This measure also applies if the capital interest or voting rights held exceeds or falls below one of the above thresholds. The holding ranges stipulated in the Disclosure Act are planned to be changed to the following: 0-5%, 5-10%, 10-15%, 15-20%, 20-25% and 25% and over. Above 25%, notification must be given of any acquisition or disposal. Furthermore, under the draft bill to amend the Disclosure Act, it is proposed that any person holding more than 5% of the Company’s share capital or voting rights should renew the notification made annually to reflect changes in the stake held, in particular changes resulting from a variation in the issued share capital.
The following factors are taken into consideration in calculating the above thresholds: (i) the shares (or share certificates) held (or acquired or sold) directly by this person; (ii) the shares (or share certificates) held (or acquired or sold) by a subsidiary of this person or by a third party, on his behalf, or by a third party with which this person has reached a voting agreement either orally or in writing and (iii) the shares (or share certificates) that this person, subsidiary or third party is entitled to acquire in respect of an option or another right held (or acquired or sold) by this person. The shares (or share certificates) and voting rights that form part of a co-ownership are allocated to those entitled proportional to their shares.

The following are also taken into consideration: (i) the voting rights that the person may exercise as holder, usufructuary or pledgee of shares (or of share certificates), (ii) the voting rights that may be exercised as holder, usufructuary or pledgee of shares (or of share certificates) by a subsidiary of this person or by a third party holding these voting rights on behalf of this person or with which this person has reached a voting agreement either orally or in writing, (iii) the voting rights attached to the shares (or share certificates) that this person, its subsidiary or third party is entitled to acquire and (iv) the voting rights that this person may exercise in respect of a contract.

Failure to make this declaration constitutes an offence which may result in penalties (imprisonment or fines) or disciplinary action (fines or other). Failure to do so may also result in civil sanctions, notably the suspension of voting rights relating to the shares held by the offender, or the shares underlying any depositary receipts held by the offender, for a period of not more than three years and a prohibition on the offender to acquire shares or voting rights for a period of not more than five years.

The Dutch Financial Markets Authority (i) publishes the declarations it receives in daily national newspapers in all member states of the European Economic Community where its shares are admitted to trading on a regulated market, as well as on its website, and (ii) keeps a public register of all notifications received.

The Company is required to inform the AMF of any declarations of holdings received in accordance with the aforementioned declaration requirements laid down in Dutch law.

In addition, pursuant to the Securities Act, a shareholder that directly or indirectly holds an interest of more than 25% in the Company’s capital must notify the Dutch Financial Markets Authority of any transactions in the Company’s shares and securities linked to the Company’s shares within 10 days after the end of the month in which the transaction occurs, using the applicable form. The Dutch Financial Markets Authority keeps a public register of all notifications made in accordance with the Securities Act. Failure to make a compulsory declaration under the Securities Act constitutes an offence which may result in penalties or disciplinary action. If the shareholder holding an interest of at least 25% is a company, this obligation also applies to members of its board of directors or supervisory board. This obligation also applies to spouses, ascendants, descendants and relations by marriage, as well as to other persons with whom these shareholders share the same address. For ascendants, descendants and relations by marriage with whom the shareholders do not share the same address, this obligation still applies if these ascendants, descendants and relations by marriage hold or would hold, after the transaction, at least 5% of shares or share certificates in the Company.

### 3.1.12 Public offers

Contrary to French law, under Dutch law, there is currently no statutory obligation for a shareholder whose interest in a company’s share capital or voting rights passes a certain threshold to launch a public offer for all or part of the shares in the company. There is no obligation for a person required to declare his interest in the Company’s share capital or voting rights to declare its intentions for the coming months. Under a draft bill likely to be presented to the Dutch government before the end of 2005, any shareholder exceeding the 30% threshold of the share capital or voting rights will be required to submit a public offer.

However, the Articles of Association of the Company provide that any person that is required to give notice under the Disclosure Act (as described in paragraph 3.1.11 – Disclosure of holdings) of holding shares or voting rights in the Company exceeding a threshold of 25% (or, after the amendment of the Disclosure Act described in paragraph 3.1.11 – Disclosure of holdings, a threshold of 33 %) (a ‘Substantial Interest Holder’) will not be entitled to exercise his voting rights unless the Substantial Interest Holder has launched (or caused to be launched) an unconditional public offer to purchase, at a fair price, all issued and outstanding shares in the Company’s share capital, as well as all issued and outstanding financial instruments giving rights to shares in the Company’s capital or voting rights.
The public offer, described in the preceding paragraph, must comply with all requirements under applicable French statutory rules and regulations to ensure equal treatment of shareholders and holders of financial instruments.

Any shareholder who qualifies as a Substantial Interest Holder may, instead of launching a public offer as described above, request the Company to designate one or more persons who are unconditionally prepared to purchase from the Substantial Interest Holder the number of shares by which his holding exceeds the threshold of 25% (or 33%, if applicable) against a purchase price in cash to be determined by an independent expert designated jointly by the Company and the Substantial Interest Holder, or, if no agreement is reached, by the chairman of the Royal Institute of Registered Accountants (Koninklijk Nederlands Instituut van Registeraccountants). The Substantial Interest Holder may revoke his request at any time and/or refuse to sell the shares stated in the request sent to the Company. In each case, voting rights will remain suspended until the Substantial Interest Holder has made a public offer as described above. If the Company fails to comply with such a request within three months of receipt, the voting rights can once again be exercised by the Substantial Interest Holder. In this case, the shareholder will be deemed to have made a public offer for purposes of the Articles of Association.

The statutory obligations described above shall apply notably to shares held by subsidiaries (dochtermaatschappij) of or to any person acting in concert (in accordance with the Disclosure Act) with a Substantial Interest Holder. These obligations shall also apply to shares held by a central depository within the normal framework of its activities. The central depository is not entitled to exercise the voting rights attached to the shares to be taken into account in order to determine whether a person is a Substantial Interest Holder if the latter has not launched (or caused to be launched) the unconditional public offer under the conditions described above. The central depository may also, at the request of a Substantial Interest Holder, ask the Company to designate one or more persons to unconditionally acquire the number of shares held by the Substantial Interest Holder as mentioned above.

The obligations mentioned in the preceding paragraphs do not apply to the Company or to persons who have been made exempt from these obligations in accordance with the conditions and limitations determined by the Board of Directors, taking into account the interests of all shareholders and all other persons who, pursuant to the law or the Articles of Association, are associated with the Company. This exemption can only be granted if the Board of Directors determines that such exemption is required to facilitate an orderly disposal of shares causing the threshold of 25% (or 33%, if applicable) to be exceeded.

3.2 GENERAL INFORMATION ABOUT THE SHARE CAPITAL

3.2.1 Modifications to the share capital and rights attached to shares

The General Meeting of shareholders, on the recommendation of the Board of Directors, has the sole authority to issue shares. It may also authorize the Board of Directors, for a period of no more than five years, to issue shares and determine the terms of any such issuance, up to a maximum level. The General Meeting of shareholders may renew this authorization for a period of no more than five years on each renewal. Unless otherwise stated, each authorization is irrevocable.

On the issue of shares, unless otherwise stated in the law, each shareholder has a pre-emptive right proportional to the number of shares held, with the exception of shares issued against a non-cash contribution or shares issued in connection with employee offerings.

The General Meeting of shareholders may decide, on the recommendation of the Board of Directors, to limit or exclude pre-emptive rights for existing shareholders. The Board of Directors may also limit or exclude pre-emptive rights for shareholders, provided that it has been granted the authority to do so, for a defined period of no more than five years, and furthermore provided that the Board of Directors is also authorized to resolve upon the issue of shares. Unless stated otherwise, this authorization is irrevocable.

The decision of the General Meeting of shareholders to limit or exclude pre-emptive rights or to authorize the Board of Directors to do so requires the approval of at least two-thirds of the votes cast in a General Meeting of shareholders if less than one-half of the issued share capital is represented at the General Meeting of
3.2.2 Acquisition by the Company of its own shares

**Dutch law**

In accordance with Dutch law and Axalto’s Articles of Association, the Company may acquire, against payment, its own fully paid-up shares, as well as share certificates, if:

- the Company’s shareholders’ equity less the purchase price for these shares does not fall below the sum of the paid-up and issued share capital and any reserves which must be maintained pursuant to Dutch law;

- the aggregate par value of the shares that the Company acquires, holds or on which it holds a right of pledge, directly or via its subsidiaries, amounts to no more than one tenth of the aggregate par value of the issued share capital;

- the General Meeting of shareholders has authorized the Board of Directors to do so (this authorization is valid for a period of no more than 18 months and must state the maximum number of shares the Company may acquire, the methods of acquisition and the purchase price thresholds).

Notwithstanding the above stipulations, the Company may purchase its own shares and share certificates without the authorization of the General Meeting of shareholders for the purpose of transferring these shares to employees of the Company or of a group company (groepsmaatschappij) pursuant to an employee shareholding plan.

No voting rights are attached to shares held by the Company or by one of its subsidiaries or to shares in which the Company or one of its subsidiaries holds share certificates.

Subject to the provisions laid down by law and on the recommendation of the Board of Directors, the General Meeting of shareholders may decide to cancel shares or share certificates acquired by the Company.

**French regulations**

As its shares are admitted to trading on a regulated market in France, the Company is also subject to the regulations summarized below.

Pursuant to articles 241-1 et seq. of the General Regulations of the AMF, the purchase by a company of its own shares is subject, in principle, to the filing of a note d’information submitted to the AMF.

In accordance with articles 631-1 et seq. of the General Regulations of the AMF, a company may not purchase its own shares for the purposes of market manipulation. EC regulation No 2273/2003 of December 22, 2003 provides issuers with a safe harbor within the framework of share buy-back programs for the purpose of (i) reducing the issuer’s share capital by the cancellation of shares, (ii) covering securities exchangeable or convertible into shares or (iii) covering employee share option programs or other allocations of shares to employees of the issuer or of an associate company.

A company is required to inform the market of all transactions carried out within the framework of the share buy-back program no later than seven trading days after the execution date. This information is communicated on the Company’s website or the AMF website.

**Authorization of the Board of Directors to initiate a share buy-back program**

Pursuant a shareholders resolution dated March 18, 2004, the General Meeting of shareholders has authorized the Board of Directors to repurchase its own shares, on the stock market or otherwise, from the date of the start of trading of the Company’s shares on the Premier Marché of Euronext Paris (now Eurolist by Euronext Paris), up to the limit laid down by Dutch law, for a duration of 18 months, subject to the proportion and the dates determined in accordance with Dutch law and the Company’s Articles of Association for a price between the par value of the shares and a price equal to 110% of the average share price on Euronext Paris for the five trading days prior to the buy-back operation.
Initiation of a share buy-back program by the Board of Directors

In accordance with the shareholders resolution dated March 18, 2004, the Board of Directors decided on February 25, 2005 to initiate a share buy-back program.

A draft note d’information prepared by the Company and setting forth the elements required under Article 241-2-II of the General Regulations of the AMF is currently being reviewed by the AMF and will be published on the Company’s website and on the AMF website upon the AMF granting its visa.

At the record date of this annual report, the Company did not own any of its own shares.

3.2.3 Issued share capital

The Company’s issued and paid-up share capital amounts to €40,490,668 euros, consisting of 40,490,668 ordinary shares, all of the same category, fully paid-up, with a par value of €1 per share.

3.2.4 Form of shares

All of the shares are registered shares and no certificates representing shares may be issued.

Shares are either registered directly on the Company’s shareholder register or in an account via Euroclear France through an account holder or a financial intermediary. These shares are entered in the Company’s shareholder register in the name of Euroclear France.

3.2.5 Unissued authorized share capital

The Company’s authorized share capital at the date of this annual report is €150,000,000, consisting of 150,000,000 shares with a par value of €1 per share.

The Board of Directors is authorized to issue shares and all forms of securities to the Company’s share capital, subject to delegation by the General Meeting of shareholders.

Pursuant to a shareholders resolution of March 18, 2004, the Board of Directors has been authorized, for a period of five years from March 18, 2004 to March 18, 2009, to issue, in accordance with the conditions it shall decide and up to the maximum limit of share capital authorized, shares and share subscription rights in the Company (notably allowing the issuance of securities giving access to the share capital) and to limit or exclude pre-emptive rights.

3.2.6 Securities not representing share capital

None.

3.2.7 Other securities conferring the right to share capital

Other than those described in paragraph 6.3 – EMPLOYEE PROFIT-SHARING AND INCENTIVE PLANS, there are no other securities conferring the right to the Company’s share capital at the date of this annual report.

Authorization given to the Board of Directors to issue securities conferring the right to the Company’s share capital up to the authorized limit

The Board of Directors may issue other securities conferring the right to share capital provided that the number of new shares created on the exercise of the rights attached to these securities is within the limit set by the General Meeting of shareholders, as described in paragraph 3.2.5 – Unissued authorized capital.
3.2.8  Table of changes in the Company’s share capital from its foundation to the date of this annual report

The table below shows the main operations relating to the share capital since the Company was founded:

<table>
<thead>
<tr>
<th>Date</th>
<th>Operation</th>
<th>Number of shares issued</th>
<th>Par value per share (€)</th>
<th>Nominal value of capital increase/reduction (€)</th>
<th>Issue premium (€)</th>
<th>Authorized capital (€)</th>
<th>Cumul. capital (€)</th>
<th>Cumul. number of shares (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 10, 2002</td>
<td>Foundation of the Company</td>
<td>18,000</td>
<td>1</td>
<td>18,000</td>
<td>0</td>
<td>90,000</td>
<td>18,000</td>
<td>18,000</td>
</tr>
<tr>
<td>February 17, 2004</td>
<td>Capital increase in cash</td>
<td>27,000</td>
<td>1</td>
<td>27,000</td>
<td>0</td>
<td>225,000</td>
<td>45,000</td>
<td>45,000</td>
</tr>
<tr>
<td>March 5, 2004</td>
<td>Modification of authorized capital by modification of articles of association and capital increase in kind</td>
<td>40,000,000</td>
<td>1</td>
<td>40,000,000</td>
<td>310,000,000</td>
<td>150,000,000</td>
<td>40,045,000</td>
<td>40,045,000</td>
</tr>
<tr>
<td>June 11, 2004</td>
<td>Capital increase as part of offer reserved for employees</td>
<td>445,668</td>
<td>1</td>
<td>445,668</td>
<td>5,160,580</td>
<td>150,000,000</td>
<td>40,490,668</td>
<td>40,490,668</td>
</tr>
</tbody>
</table>

Pursuant to a resolution dated February 25, 2004, the General Meeting of shareholders decided to increase the amount of authorized capital from €225,000 to €150,000,000, effective as of March 5, 2004. The General Meeting of shareholders resolved to carry out the capital increase on March 5, 2004 through the issuance of 40,000,000 new shares in kind by Schlumberger B.V. as part of the reorganization preceding the Company’s IPO. The shares making up the share capital of Schlumberger Measurement & Systems India Ltd. and Schlumberger Distribucion SA de CV were transferred by Schlumberger B.V. to the Company on April 2, 2004 and the shares making up the capital of Axalto Inc. were transferred by Schlumberger B.V. to the Company effective as of May 1, 2004. These transfers were carried out through an increase in the share premium, without changing the number of shares issued by the Company.

The offer reserved for employees, carried out concomitantly with the Company’s IPO, in the form of a reserved capital increase, resulted in the creation of 445,668 new shares on June 11, 2004, bringing the number of shares making up the Company’s issued and paid-up share capital to 40,490,668.

In accordance with the provisions of Dutch law, a company’s issued capital may not be more than the authorized capital stated in the company’s articles of association or less than one-fifth of the authorized capital. A company’s authorized capital corresponds to the maximum number of shares that may be issued by the company in accordance with the articles of association.

There is no pledging of shares or pledging of other significant assets.

3.3  CURRENT BREAKDOWN OF SHARE CAPITAL AND VOTING RIGHTS

3.3.1  Shareholding structure

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Number of shares</th>
<th>% of share capital</th>
<th>% of voting rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directors and officers</td>
<td>73,500</td>
<td>0.18</td>
<td>0.18</td>
</tr>
<tr>
<td>Employees</td>
<td>445,668</td>
<td>1.10</td>
<td>1.10</td>
</tr>
<tr>
<td>Public</td>
<td>39,971,500</td>
<td>98.72</td>
<td>98.72</td>
</tr>
<tr>
<td>Treasury shares</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>40,490,668</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

All of the shares making up the Company’s issued and paid-up capital are listed on Eurolist by Euronext Paris.

To the Company’s knowledge at the date hereof, no shareholder owns more than 5% of the Company’s share capital.
3.3.2 Changes in the breakdown of share capital

Until May 17, 2004, Schlumberger B.V., a limited company under Dutch law (besloten vennootschap met beperkte aansprakelijkheid), whose registered office is in The Hague, owned all of the shares making up the Company’s share capital. Within the framework of the Company’s IPO, Schlumberger B.V. sold 87.0% of the Company’s share capital, consisting of 34,821,739 shares, to the public and French and international institutional investors on May 17, 2004.

In parallel with this operation, the Company carried out a capital increase reserved for the Company’s employees, resulting in the creation of 445,668 new shares, which were admitted to trading on June 11, 2004.

On June 21, 2004, the global coordinators of the Company’s IPO announced that they had exercised part of the greenshoe option granted by Schlumberger B.V., resulting in the disposal of an additional 166,250 shares by Schlumberger B.V.

Finally, on September 17, 2004, Schlumberger B.V. sold the remainder of its stake in the Company, consisting of 5,057,011 shares, to French and international institutional investors.

The Company has maintained relations with the Schlumberger group by virtue of the Master Separation Agreement (the ‘Separation Agreement’) between the Company and Schlumberger B.V. dated March 19, 2004. Under this contract, the two parties have organized their relations and responsibilities within the framework of the regrouping of the Cards and POS activities belonging to the Schlumberger group, their transferal to the Company and the withdrawal of Axalto from the Schlumberger group in connection with the admission to trading of the Company’s shares on the Premier Marché of Euronext Paris. The Separation Agreement will terminate 10 years from the closing date of the IPO, which occurred on May 20, 2004. For more details about the main stipulations of the Separation Agreement, see paragraph 4.1.1.2 - Reorganization. For information about the risks relating to the Separation Agreement with Schlumberger B.V., see paragraph 4.8.3 - Risks relating to the Reorganization and the Company’s operating as an independent entity.

3.3.3 Individuals or companies controlling the Company – Shareholders’ agreement

There are no shares held directly or by subsidiaries. Furthermore, there is no shareholders’ agreement.

At present, members of the Board of Directors hold 74,500 shares in the Company, representing around 0.18% of the Company’s issued share capital, which they acquired individually on the Paris stock market after Axalto’s IPO in May 2004.

3.3.4 Subsidiaries and participating interests

The Company’s main subsidiaries and participating interests at the date of this annual report are as follows:

<table>
<thead>
<tr>
<th>Country of incorporation</th>
<th>Name (1)</th>
<th>Direct or indirect ownership</th>
<th>Percentage held by the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia .................</td>
<td>Axalto Pty Ltd</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>Brazil ....................</td>
<td>Axalto do Brazil Cartoes e Terminais Ltda (1)</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>British Virgin Islands ...</td>
<td>Axalto Cards &amp; Terminals Ltd</td>
<td>Indirect</td>
<td>100</td>
</tr>
<tr>
<td>British Virgin Islands ...</td>
<td>Axalto Technology Ltd</td>
<td>Indirect</td>
<td>100</td>
</tr>
<tr>
<td>Canada ......................</td>
<td>Axalto Canada Ltd</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>China ......................</td>
<td>Axalto (Beijing) Smart Cards Technology Co Ltd</td>
<td>Indirect</td>
<td>100</td>
</tr>
<tr>
<td>China ......................</td>
<td>Hunan Telecommunications Equipment Co Ltd (3)</td>
<td>Indirect</td>
<td>51(3)</td>
</tr>
<tr>
<td>China ......................</td>
<td>Shanghai Axalto IC Cards Technology Co Ltd</td>
<td>Indirect</td>
<td>51</td>
</tr>
<tr>
<td>China ......................</td>
<td>Shanghai Solaic Smart Card Co Ltd (1)</td>
<td>Indirect</td>
<td>31</td>
</tr>
<tr>
<td>Czech Republic ............</td>
<td>Axalto SRO</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>Dutch Antilles ............</td>
<td>Cards &amp; Terminals N.V.</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>France .....................</td>
<td>CP8 Technologies S.A.</td>
<td>Indirect</td>
<td>100</td>
</tr>
<tr>
<td>France .....................</td>
<td>Electronics Transactions Integration Services S.A.</td>
<td>Indirect</td>
<td>100</td>
</tr>
<tr>
<td>France .....................</td>
<td>Axalto S.A.</td>
<td>Direct</td>
<td>100</td>
</tr>
<tr>
<td>France .....................</td>
<td>Axalto International S.A.S.</td>
<td>Direct</td>
<td>100</td>
</tr>
</tbody>
</table>
France................................. Trusted Logic S.A. Indirect 38
France................................. Xiring S.A. Indirect 22.69(2)
Germany............................. Axalto GmbH Direct 100
Hong Kong........................... CP8 Hong Kong Ltd Indirect 100
Hong Kong........................... Axalto Technologies Asia Ltd Indirect 100
Hungary............................. Axalto Hungary Commercial and Services Ltd Direct 100
India................................. Axalto Cards & Terminals India Ltd Direct 100
Indonesia............................ PT Axalto Indonesia Indirect 100
Italy.................................... Axalto SPA Direct 100
Japan.................................. Axalto KK Direct 100
Japan.................................. SPOM Japan KK Indirect 100
Malaysia............................. Axalto International Ltd Indirect 100
Malaysia............................. Axalto (M) Sdn Bhd Direct 100
Mexico............................... Distribucion S.A. de CV(1) Direct 100
Mexico............................... CP8 Mexico SA de CV Indirect 100
Mexico............................... Axalto Cards Mexico S.A. de CV(1) Indirect 100
Netherlands.......................... Axalto BV Direct 100
Panama............................... Axalto Eastern Holdings Inc Indirect 100
Philippines.......................... Axalto Philippines Inc Indirect 100
Singapore............................ Axalto Singapore Pte Ltd Direct 100
Spain................................. Axalto SP S.A. Indirect 100
Sweden............................... Axalto AB Indirect 100
Thailand.............................. Boolanakarn Holdings (Thailand) Ltd Indirect 100
Thailand.............................. Axalto Industries (Thailand) Ltd Indirect 100
Turkey............................... Axalto Cards & Terminals Ltd Sirketi Direct 100
UK..................................... Axalto Terminals Ltd Indirect 100
UK..................................... Axalto Cards Ltd Direct 100
UK..................................... Axalto UK Ltd Direct 100
USA.................................... Axalto CP8 Inc Indirect 100
USA.................................... Axalto Inc Direct 100

(1) The registration procedure for the new corporate name of certain subsidiaries was still in progress as of December 31, 2004.

(2) After shares in Xiring were acquired by new investors through a reserved capital increase on April 23, 2004, Axalto’s percentage stake in Xiring has been reduced to 22.69%.

(3) A framework agreement dated February 17, 2005 was signed by the parties, the terms of which include a mechanism for the full withdrawal by one of the parties from HSTE. In March 2005, the partner indicated its intention to sell its 49% stake. The parties have initiated the operation, as a result of which Axalto will own 100% of HSTE. Each transaction resulting from the operation is subject to approval by Chinese government authorities.

None of the companies listed above is listed on a regulated market in France or abroad.

3.4 MARKET FOR THE COMPANY’S SHARES

3.4.1 Listing market

The Company’s shares are admitted to trading on Eurolist by Euronext Paris.

3.4.2 Share name, business sector, codes

Share name: Axalto
ISIN code: NL 0000400653
Symbol: AXL
Euroclear/Clearstream common code: 019223973
3.4.3 Share registry services

The Company’s share register is kept by:
Netherlands Management Company B.V.
Parnassustoren, Locatellikade 1, 1076 AZ Amsterdam, The Netherlands

3.4.4 Historic share price data

<table>
<thead>
<tr>
<th>Year</th>
<th>High*</th>
<th>Low*</th>
<th>Trading volume</th>
<th>Value of transactions (€ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>May</td>
<td>16.30</td>
<td>14.00</td>
<td>10,558,521</td>
<td>155.49</td>
</tr>
<tr>
<td>June</td>
<td>16.25</td>
<td>14.96</td>
<td>6,240,932</td>
<td>97.72</td>
</tr>
<tr>
<td>July</td>
<td>16.60</td>
<td>14.87</td>
<td>4,762,515</td>
<td>76.05</td>
</tr>
<tr>
<td>August</td>
<td>16.39</td>
<td>15.20</td>
<td>2,063,480</td>
<td>32.63</td>
</tr>
<tr>
<td>September</td>
<td>17.49</td>
<td>16.00</td>
<td>11,899,454</td>
<td>198.55</td>
</tr>
<tr>
<td>October</td>
<td>18.50</td>
<td>17.10</td>
<td>4,837,272</td>
<td>85.71</td>
</tr>
<tr>
<td>November</td>
<td>18.63</td>
<td>17.60</td>
<td>2,386,848</td>
<td>43.19</td>
</tr>
<tr>
<td>December</td>
<td>19.15</td>
<td>17.90</td>
<td>2,740,450</td>
<td>50.24</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>High*</th>
<th>Low*</th>
<th>Trading volume</th>
<th>Value of transactions (€ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>22.30</td>
<td>18.87</td>
<td>5,912,063</td>
<td>119.64</td>
</tr>
<tr>
<td>February</td>
<td>22.85</td>
<td>21.18</td>
<td>4,317,460</td>
<td>94.34</td>
</tr>
</tbody>
</table>

*Based on closing prices
Source: Euronext

Between May 18, 2004 and February 28, 2005, the average daily trading volume was 271,800 shares, representing an average daily transaction value of €47 million.

Based on the definitive IPO price of €14.80 per share and the closing price on March 24, 2005 of €26.01 per share, the Company’s share price has risen by 75.7%.

3.5 DIVIDENDS

3.5.1 Dividend policy

The terms for the approval and distribution of dividends are described in paragraph 3.1.9 – Distribution of profits.

Rights relating to cash dividends or interim dividends distributed but which have not been collected within five years after they become due and payable shall revert to the Company.

When a dividend is paid in the form of shares, any shares in the Company that have not been claimed within a period determined by the Board of Directors shall be sold on the behalf of the persons entitled to the distribution who failed to claim the shares. The period and the terms of the sale shall be announced in a national daily newspaper in The Netherlands and a national daily newspaper in each country where the shares are admitted to trading on a regulated market. The net proceeds from the sale are made available to the above persons in proportion to their entitlement. Dividends that have not been claimed within five years after the date of the initial distribution in the form of shares shall revert to the Company.

Under its dividend policy, the amount of dividends to be paid by the Company to its shareholders shall be determined by taking into consideration the Company’s capital requirements, return on capital, current and future rates of return and market practices, notably in its business sector, as regards the distribution of dividends. The Company has indicated that it would not pay a dividend in 2005 in respect of the 2004 financial year.
3.5.2 Tax situation of shareholders residing in France

The following provisions give a general summary of the main tax implications that may apply to shareholders residing in France for tax purposes (the ‘Shareholders’) under the terms of the tax treaty signed between France and The Netherlands (the ‘Treaty’) on March 16, 1973 for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital. Their purpose is not to describe all the potential tax implications of investing in the Company’s shares. These provisions reflect Dutch tax law and the French laws currently in force but which may be subject to change, possibly with retroactive effect.

Investors should consult their own tax advisors about the tax requirements that apply to their particular case and notably in the case of the acquisition, ownership or transfer of shares.

3.5.2.1 Dutch tax law

**Withholding tax**

Dividends paid by the Company generally are subject to a withholding tax imposed by The Netherlands at a rate of 25%. The term ‘dividends paid’ as used herein includes, but is not limited to:

- Dividends in cash or in kind, deemed and constructive distributions;
- Liquidation proceeds, proceeds from the redemption of paid-up capital (gestort kapitaal) or, as a rule, consideration for the repurchase of shares by the Company in excess of the average paid-up capital recognized for Dutch dividend withholding tax purposes;
- The par value of shares issued to a shareholder or an increase of the par value of already issued shares, to the extent that it does not appear that a contribution, recognized for Dutch dividend withholding tax purposes, has been made or will be made;
- Partial repayment of paid-up capital (gestort kapitaal) which (i) is not recognized as such for Dutch dividend withholding tax purposes or (ii) is recognized as such for Dutch dividend withholding tax purposes, if and to the extent that there are net profits (zuivere winst) within the Company, unless the General Meeting of shareholders has resolved in advance to make such repayment and provided that the par value of the shares concerned has been reduced by an equal amount by way of an amendment to the Articles of Association.

Shareholders residing in a country other than The Netherlands may, if provided by an applicable tax treaty, be eligible for a full or partial exemption from, or refund of, Dutch dividend withholding tax.

Under the Treaty, dividends paid by the Company to a shareholder not residing in The Netherlands and resident in France can generally benefit from a reduction in the rate of Dutch dividend withholding tax from 25% to 15% or, in the case of certain qualifying shareholders owning at least 25% of the Company’s share capital, a reduction in the rate of Dutch dividend withholding tax to 5%, unless the shares held by the French resident are attributable to a business operating fully or partially through a permanent establishment or representative in The Netherlands.

According to an anti-dividend stripping provision, no exemption from or reduction or refund of Dutch dividend withholding tax will be granted if the recipient of a dividend is not considered to be the beneficial owner of such dividend under Dutch tax law.

**Taxes on income and capital gains**

No Dutch income tax (including that on capital gains) is payable by a Shareholder in respect of any income derived or gain made by him from the disposal of shares. Exceptions apply if the shareholder:

- is a Dutch resident (or deemed resident) for the purpose of the relevant Dutch tax law provisions, or
- is an individual who opts to be taxed as a Dutch resident, or
- is an individual who performs other activities in respect of shares in The Netherlands (including, without
limitation, activities which are beyond the scope of normal investment activities), or

- has an enterprise (or an interest in an enterprise) which is either (a) managed in The Netherlands or (b) in whole or in part, carried on through a permanent establishment or representative in The Netherlands to which the shares are attributable, or

- has a substantial interest (or a deemed substantial interest) (aanmerkelijk belang) in the Company and this interest does not belong to the assets of an enterprise.

**Gift or inheritance taxes**

No Dutch gift or inheritance tax is payable in respect of any gift by or the inheritance on the death of a shareholder. Exceptions may apply if:

- the shareholder is a Dutch resident (or deemed resident) for the purposes of the relevant Dutch tax law provisions, or

- at the time of the gift or his death, the shareholder has an enterprise (or an interest in an enterprise) which is either (a) managed in The Netherlands or (b) in whole or in part, carried on through permanent establishment or representative in The Netherlands to which the shares are attributable, or

- the shares are acquired by way of a gift from a shareholder who dies within 180 days after the gift and who was not at the time of the gift, but is at the time of his death, a Dutch (or deemed) resident.

For the purposes of Dutch gift or inheritance tax, an individual who holds Dutch citizenship is deemed to be a Dutch resident if he has been a Dutch resident at any time during the 10 years preceding the date of the gift or his death.

For the purposes of Dutch gift tax, an individual who does not hold Dutch citizenship is deemed to be a Dutch resident if he has been a Dutch resident at any time during the 12 months preceding the date of the gift.

**Turnover tax**

No Dutch turnover tax is payable by the Company in respect of financial rights attached to shares, or by a shareholder in consideration for the acquisition of shares (by way of an issue or transfer of shares).

**Other taxes and duties**

Save for capital registration duty payable by the Company, no Dutch stamp duty or registration of similar tax (other than court fees) is payable in connection with the issue or disposal of the Company’s shares, or on the fulfillment by the Company of its commitments to its shareholders or the implementation by shareholders of the rights attached to shares.

3.5.2.2 French tax law

**A Individuals holding shares as part of their private portfolio and not trading on the stock market on a regular basis**

(a) Dividends

The dividends paid by the Company are subject to income tax in France under the following conditions.

Shareholders may claim a tax credit on the total amount of French income tax, in accordance with article 24-B of the Treaty. The amount of this tax credit corresponds to the amount of Dutch withholding tax levied on these dividends, or 15/85ths of the net amount of the dividends.

Since January 1, 2005, the dividends paid by the Company no longer give entitlement to a tax credit: net dividends received, plus any tax credit attached to these dividends, are taken into account to calculate the taxpayer’s total income in the category of tax on income from investments in securities, after deduction of a tax
allowance equal to 50% of the amount of the dividends.

The amount calculated on this basis, minus a total annual tax allowance of €2,440 for married couples filing a joint tax return as well as for partners under a civil solidarity pact as defined in article 515-1 of the French Civil Code filing a joint tax return, and €1,220 for single persons, widowers, divorced persons or married couples who file separate tax returns, is subject to income tax calculated on a gradual scale.

Dividends are also subject, before taking any tax allowances into account, to:

- a general welfare tax (*contribution sociale généralisée*) of 8.2%, of which 5.8% is deductible from total taxable income;
- a social levy (*prélèvement social*) of 2%, which is not deductible from income tax;
- a tax for reducing social security debts (*contribution pour le remboursement de la dette sociale*) of 0.5%, which is not deductible from income tax;
- a special contribution of 0.3% in addition to the 2% social levy, pursuant to articles 11° 2° and 19-II 2° of French law n° 2004-626 of June 30, 2004 concerning support for the autonomy of the elderly and the handicapped, which is not deductible from income tax.

Taxpayers domiciled in France for tax purposes in the sense of article 4 B of the French General Tax Code ("Code général des impôts" or "CGI") may benefit from a tax credit in respect of these dividends equal to 50% of the total amount of dividends received. This tax credit is capped at an annual level of €230 for married couples filing a joint tax return and for partners under a civil solidarity pact as defined in article 515-1 of the French Civil Code filing a joint tax return and at €115 for single persons, widowers, divorced persons or married couples who file separate tax returns. The surplus tax credit not ascribed to income tax will be refunded.

(b) Capital gains

All capital gains are subject to income tax if the total amount of marketable securities sold during the calendar year exceeds €15,000 at the level of the tax household (*foyer fiscal*). Capital gains are subject to income tax at the rate of 16%, plus:

- a general welfare tax (*contribution sociale généralisée*) of 8.2%, which is not deductible from income tax;
- a social levy (*prélèvement social*) of 2%, which is not deductible from income tax;
- a tax for reducing social security debts (*contribution pour le remboursement de la dette sociale*) of 0.5%, which is not deductible from income tax;
- a special contribution of 0.3% in addition to the 2% social levy, which is not deductible from income tax.

Capital losses may be set off against capital gains of the same type realized during the same year, and possibly for the next 10 years, provided that the aforementioned disposal threshold has been exceeded during the year these capital losses were incurred.

In order to apply these provisions, capital gains of the same type include, in particular, net capital taxable gains taxable upon early closure of a share savings scheme (*plan d’épargne en actions* or ‘*PEA*’) before the end of the fifth year.

(c) PEA special share savings scheme

Shares issued by French companies and companies established in another member state of the European Union and which are subject to corporation tax or any similar tax are normally eligible to be held in a PEA, regulated by law n° 92-666 of July 16, 1992.

Subject to certain conditions, the dividends received and the capital gains realized are exempt from income tax but are still subject to the social levy, the general welfare tax, the tax for reducing social security debts and the
special contribution of 0.3%.

As of January 1, 2005, dividends paid in respect of shares held in a PEA benefit from a tax credit equal to 50% of their value, capped at €115 or at €230 (see above). These dividends must be declared in the tax return.

The tax credit is imputed against income tax due in respect of the year in which the income was generated (and no longer by payment on the PEA, as was the case with the former 'avoir fiscal' tax credit system). The tax credit is applied after the tax reductions mentioned in articles 199 quater B to 200 of the CGI, other tax credits and deductions not at source. If the amount of the tax credit is higher than the tax due, its value is returned if it is equal to or higher than €8.

The table below summarizes the different taxes applicable on the basis of the closing date of the PEA:

<table>
<thead>
<tr>
<th>Duration of the PEA</th>
<th>Social levy</th>
<th>C.S.G.</th>
<th>C.R.D.S.</th>
<th>Special contribution</th>
<th>Income</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 years..........</td>
<td>2.0%</td>
<td>8.2%</td>
<td>0.5%</td>
<td>0.3%</td>
<td>22.5%</td>
<td>33.5%</td>
</tr>
<tr>
<td>Between 2 and 5 years.....</td>
<td>2.0%</td>
<td>8.2%</td>
<td>0.5%</td>
<td>0.3%</td>
<td>16.0%</td>
<td>27.0%</td>
</tr>
<tr>
<td>More than 5 years..........</td>
<td>2.0%</td>
<td>8.2%</td>
<td>0.5%</td>
<td>0.3%</td>
<td>0.0%</td>
<td>11.0%</td>
</tr>
</tbody>
</table>

(1) Out of the full amount where the threshold has been exceeded.

(d) Wealth taxes

Shares in the Company held by individuals are included in their taxable assets, if applicable, for wealth tax purposes.

(e) Gift or inheritance taxes

Subject to the provisions of international treaties, shares in the Company acquired by way of an inheritance or gift are generally subject to inheritance or gift tax in France if the donor or the deceased is domiciled in France for tax purposes at the time of the gift or his death, or if the beneficiary or donee is domiciled in France for tax purposes at the date the shares are transferred or was for at least six of the 10 years preceding the year he receives the shares.

B Companies subject to corporation tax

(a) Dividends

Dividends paid by the Company are subject to corporation tax in France under the following conditions.

Pursuant to article 24-B of the treaty, the shareholder benefits from a tax credit imputed against the amount of French corporation tax. The amount of the conventional tax credit corresponds in principle to the amount of Dutch withholding tax levied on these dividends (as described above) and may not exceed the amount of French corporation tax relating to these dividends. No surplus tax credit can be imputed against French taxes due on other sources of revenues or cannot be repaid or deferred.

Dividends received, including the tax credit attached, are subject to French corporation tax at a rate of 33 1/3%, plus an additional contribution of 1.5% of the gross amount of corporation tax in 2005, which will be fully abolished for financial years ending on or after January 2006. A further social security contribution of 3.3% of the gross amount of corporation tax on amounts exceeding €763,000 per 12-month period is also applicable.

However, for companies with a turnover of less than €7,630,000 and if at least 75% of their share capital is fully paid up and has been continuously held by individuals or a company fulfilling all of these criteria, the rate of corporation tax is set at 15% for the first €38,120 of taxable profits per 12 month period. These companies are exempt from the aforementioned social security contribution of 3.3%.
Companies benefiting from the parent company-subsidiary tax regime

Companies which fulfill the conditions set out in articles 145 and 216 of the CGI may, upon election, exclude dividends received from their taxable income in application of the parent company-subsidiary tax regime. Article 216 I of the CGI provides for the inclusion in the taxable income of the recipient of the dividends of a share of its costs and expenses set at 5% of the amount of dividends received, including the conventional tax credit. However, this inclusion of costs may not exceed, for each fiscal year, the total amount of the costs and expenses of any kind paid by the recipient of the dividends during the same period.

In the context of this tax regime, the conventional tax credit attached to dividends received is not deductible from corporation tax.

(b) Capital gains

Capital gains on the disposal of shares in a portfolio are currently subject to income tax at the nominal rate of 33\(\frac{1}{3}\)% (or, if applicable, at the rate of 15% up to the limit of €38,120 per 12 month period for companies fulfilling the conditions described above), plus an additional contribution of 1.5% (but which will be fully abolished for financial years ending on or after January 1, 2006) and, if applicable, the aforementioned social security contribution of 3.3%.

However, in accordance with the provisions of article 219-I-ater of the CGI, net capital gains resulting from the disposal of participating interests which have been held for more than two years are subject to long-term capital gains tax.

Participating interests consist primarily of shares having such characteristics for accounting purposes and, provided that the charges have been made to a special reserve of capital gains, shares acquired through a public offer or exchange offer by the initiating company, as well as shares which are eligible for the parent company tax regime as mentioned in articles 145 and 216 of the CGI, or if their tax basis is at least equal to €22.8 million, those which fulfill the conditions for entitlement to this tax regime other than holding an interest of at least 5% in the share capital of the issuing company.

Capital gains on participating interests are subject to corporation tax at the reduced rate of 15% if they are realized during a financial year beginning on or after January 1, 2005, plus the additional contribution at the rate of 1.5% for financial years ended or the tax period ending in 2005 (abolished for financial years ending on or after January 1, 2006) and, if applicable, the aforementioned social security contribution of 3.3%.

Long-term capital losses resulting from the tax regime may be set off against capital gains of the same type realized during the same year or the following 10 years. These capital losses are generally not deductible from income taxable at the normal corporation tax rate. However, the French Amended Finance Law (Loi de finances rectificative) for 2004 includes specific provisions relating to carrying over remaining long-term capital gains existing at the start of the first financial year beginning on or after January 1, 2006.

Specific provisions applicable to financial years beginning on or after January 1, 2006

The French Amended Finance Law for 2004 provides for the gradual exemption of long-term capital gains on participating interests in accordance with the conditions described above. However, this exemption will not apply to participating interests in real estate companies.

- For financial years beginning on or after January 1, 2006, the net amount of long-term capital gains relating to participating interests will be taxed at a rate of 8% plus, if applicable, the aforementioned social security contribution of 3.3%. This rate will be set at 0% for financial years beginning on or after January 1, 2007.
- For financial years beginning on or after January 1, 2007, a share of costs and expenses equal to 5% of income net of capital gains on disposals shall be taken into account to calculate taxable income.
CHAPTER IV INFORMATION ABOUT THE COMPANY’S ACTIVITIES

4.1 COMPANY PROFILE

Axalto is the leading provider of microprocessor cards in the world in terms of units sold, with a global presence and expertise in all major areas of microprocessor card applications. It was the leading supplier of microprocessor cards in the world in 2003 with market share of 25.4%, compared with 21.9% for its nearest competitor. Thanks to its strong presence in countries with large populations experiencing rapid growth, Axalto is also the second-largest supplier of chip cards, which include both microprocessor and memory cards, controlling 22% of the global chip card market in 2003 (source: Gartner Dataquest 2004).

In 2004, Axalto generated revenue of around $960 million and net income of $59 million.

Axalto has sold over one billion microprocessor cards to date and is at the forefront of the development of new microprocessor card products and applications. The Company believes that the combination of its expertise in high-quality, high-volume, low-cost production, security, adaptability and product personalization, as well as its vast portfolio of products and patented technologies distributed under licenses is unrivalled in the industry. Its technological and manufacturing expertise covers the entire chip card value chain up to the highest value-added applications. Through strategic partnerships, acquisitions and alliances, Axalto has anticipated and shaped market trends and accelerated the acceptance of industry standards to facilitate new microprocessor card applications. Axalto also sells other types of secure plastic cards, in particular scratch cards, magnetic stripe cards and memory chip cards (including contactless cards). However, its main focus is on microprocessor cards (including contactless cards), which offer greater value-added and stronger growth potential. New outlets such as identity cards and electronic passports should help in the medium term to increase the proportion of microprocessor cards among all chip cards.

Axalto has two main business lines:

- Cards, which includes chip card products, software and services sold for the mobile communications, finance, Public Sector, Network Access and other applications and prepaid (memory chip) phone cards;
- Point-of-sale terminals.

Axalto is a leader in technology development and, during the past 25 years, has been at the forefront of most significant development in microprocessor card technology. The Company developed the first Java microprocessor card in 1996, which has now become the industry standard, and has sold more than 200 million Java Cards to date. According to Frost & Sullivan, Axalto is the world’s leading supplier of Java Cards. Other major technological developments include the introduction of the first public key cryptographic card in 1996, the first chip-based operating systems with memory capacity of 32KB in 2000 (which it was able to expand to 512KB within 24 months) and the first microprocessor card with a built-in USB interface in 2001. In 2002, Axalto launched the first multi-application card compatible with Microsoft’s .NET technology, which enables the creation of XML-based applications and processes. As of December 31, 2004, Axalto held approximately 2,150 patent rights (which include both patents granted and patent applications). The Company is also continuing to pursue the development of the new generation of microprocessor cards across existing and emerging applications, especially in what it considers to be future growth areas, such as mobile communications, finance and public sector and network access.

Axalto has a global presence with 11 production facilities (four in Asia, four in Europe and three in the Americas), nine technology centers and approximately 50 sales facilities around the world as of December 31, 2004. By standardizing its production processes globally around a ‘virtual factory’ concept, the Company is able to allocate its production across its facilities to optimize capacity utilization and reduce time to market for its customers. The Company has operations in 35 countries, and its workforce of approximately 4,500 employees as of December 31, 2004 is drawn from approximately 65 nationalities. In 2004, 87% of its revenues were generated outside France.
4.1.1 History and recent changes in the group’s structure

4.1.1.1 History

Axalto developed the first telephone chip cards for France Telecom and the Swedish telecommunications operator Telia in the early 1980s. As the pioneer in the development of chip card technology for telephone cards, the Company has been able to develop long-standing and close ties with telecommunications operators around the world and, as a result, has always been at the forefront of the development of microprocessor card technology for mobile communications. Axalto has played a key role in industry-wide efforts to develop new digital mobile communications standards, particularly the GSM transmission standard (Global System for Mobile Communications), and promoted the use of microprocessor card technology as the leading access and security solution for such standards. It designed its first SIM (Subscriber Identity Module) card in the early 1990s for the launch of GSM in Europe. Axalto currently serves over 300 wireless network operators around the world and has sold over one billion SIM cards since the early 1990s.

In the early 1980s, the French banking sector decided to migrate from the magnetic stripe card-based payment system to a more modern and secure microprocessor card-based system. Axalto received its first contract in June 1981 to provide GIE Cartes Bancaires, the French credit/debit card issuers’ association, with 5,000 microprocessor cards and 200 associated POS terminals. The microprocessor card payment system subsequently became standard in France in less than 10 years and has reduced financial card payment fraud in France to the lowest level in the world, according to banking industry publication The Banker. Axalto is currently a key participant in the global EMV initiative, set up by Europay, MasterCard and Visa to deploy highly secure microprocessor financial cards worldwide, principally by assisting the finance industry in developing the necessary technology, industry standards and local applications for EMV migration.

The high degree of flexibility provided by microprocessor cards, which were a key element of the success of GSM technology, has led to increasing use of microprocessor card technology in a broad range of industries and markets that require highly secure platforms and systems. Axalto has developed expertise in security and encryption, acquired mainly through the development of microprocessor chip cards in the French banking and Proton electronic purse systems, and has been and continues to be at the forefront of the development of enhanced security features for microprocessor cards.

Axalto has experienced strong internal growth since the launch of its chip card operations in the early 1980s, both in terms of revenue and product portfolio, as the markets for its products have expanded. During the 1980s, it grew significantly as the use of chip cards became more widespread in public telephone infrastructure. It continued to experience substantial growth in the 1990s with the rapid expansion of GSM-based mobile telecommunications. Since 2000, growth has been driven mainly by demand for increasingly sophisticated SIM and USIM cards (as part of the third-generation mobile communications network rollout) to provide value-added services through mobile communications networks, as well as the deployment of financial microprocessor cards outside France. In addition, the development of new applications, including identity, network access and security, has become increasingly important to the Company’s business.

Axalto has also grown in selected key markets as a result of strategic acquisitions and alliances. This acquisition strategy has been driven by the need to enter or expand in a particular geographic market, to obtain intellectual property rights or research and engineering capabilities, or to broaden its product offering. Since 1994, Axalto has acquired significant market share in key geographic markets through the acquisitions of Cowells (United Kingdom), Malco (United States), Printer (Mexico) and Cardtech (Brazil). The acquisition of Solaic in 1996 allowed the Company to strengthen its presence in the banking sector in France and China. The acquisition of Bull-CP8 from Bull in 2001 substantially increased its presence in the worldwide financial services market through, among other things, Bull-CP8’s participation in Proton, the e-purse system used widely in Belgium, Malaysia, Mexico, The Netherlands, Sweden and Switzerland. Bull-CP8 also held a significant portfolio of intellectual property rights, which has been extensively licensed by Axalto in order to encourage market growth and growth in new microprocessor card applications, and had advanced research and engineering capabilities with a particular focus on network security. Axalto has also created a number of joint ventures in China with local partners to establish its presence in the Chinese market since 1995.

Axalto has played a leading role in all of the major industry groups and in the development of industry standards designed to facilitate the acceptance, expansion and standardization of new chip card applications. For example, the Company is involved in the European Telecommunications Standards Institute (“ETSI”) project relating to
microprocessor card platforms and founded or co-founded the JavaCard Forum, the WLAN Smart Card Consortium and SIMalliance. Olivier Piou, Axalto’s chief executive officer, is currently the chairman of Eurosmart, which is the principal European and global industry organization to promote and standardize microprocessor card systems and related secure transaction solutions (see paragraph 4.5 – QUALITY, SECURITY AND STANDARDS).

4.1.1.2 Reorganization

Axalto was created by Schlumberger in order to consolidate into one company all of its card and POS terminal activities, which until then had been managed by several subsidiaries and joint ventures of the Schlumberger group. To create the company, Schlumberger had to reorganize the Cards and POS divisions’ activities so that they could be transferred to the parent company of the Axalto group and its subsidiaries (the “Reorganization”) prior to the admission of the Company’s shares to trading on the Premier Marché of Euronext Paris (the “IPO”).

The Reorganization involved operations in over 30 countries including, principally, Australia, Brazil, China, the Czech Republic, Colombia, Dubai, France, Germany, Great Britain, India, Italy, Japan, Malaysia, Mexico, The Netherlands, Panama, Russia, Singapore, Sweden, Turkey and the United States.

Within this framework and under the terms of the Separation Agreement, the Reorganization required a number of asset and share transfers. The main stages of the Reorganization were:

- Activities of companies which fell within the scope of Axalto’s business were separated from activities which fell outside the scope of its business. In certain cases, assets owned by a company belonging to the Schlumberger group which fell within the scope of Axalto’s business were transferred to Axalto or one of its subsidiaries. In other cases, assets owned by a company belonging to the Axalto group which did not fall within the scope Axalto’s business were transferred to the Schlumberger group.

- Once these measures to define the scope of Axalto’s business were complete, certain companies that only fell within the scope of Axalto’s business were transferred to Axalto or its subsidiaries by entities belonging to the Schlumberger group through share transfers. All of these share transfers were finalized in February 2004.

- Other companies falling within the scope of Axalto’s business were transferred prior to the IPO on May 17, 2004.

The main stipulations of the Separation Agreement are summarized below. For a more detailed description of the Separation Agreement, see paragraph 3.3.3 – Individuals or companies controlling the Company – Shareholders’ pact – Agreement with the selling shareholder of the Document de Base registered by the AMF on March 22, 2004, under number I. 04-037.

Remaining assets and liabilities

The commitments of Schlumberger and Axalto remain in effect so long as there are contracts, assets or liabilities falling within the scope of Axalto’s business that have not been transferred at the time of the Reorganization or that will remain with Axalto, even if they fall within the scope of the business of the Schlumberger group. The aim of the Reorganization is, where possible, to carry out the complete transfer of Axalto’s activities, excluding any Schlumberger activities. Until the date of transfer of such contracts, assets or liabilities to Axalto or to Schlumberger, as the case may be, or in the event that they cannot be transferred or shall not be transferred as agreed by both parties, Schlumberger and Axalto have agreed to cooperate and execute the contracts or manage the assets and liabilities in the name of and for the account of the other party, pursuant to the instructions of such party, who will receive all profits and bear all losses (including all taxes normally due, other than those due as a result of a tax reassessment, and which are covered by the tax indemnification mentioned below) resulting from these contracts, assets and liabilities, subject to certain limitations. The Separation Agreement also provides for the financial terms of the transfer of these residual assets and liabilities.
Non-solicitation and non-competition clauses

The Separation Agreement includes reciprocal agreements not to solicit employees of Axalto and Schlumberger for a period of one year, as well as an agreement not to compete with each other anywhere in the world for three years, limited to the respective activities of the two groups at the date of the IPO.

However, this non-competition agreement does not apply to any activities carried out by one of the parties in competition with the activities of the other representing less than 5% of Axalto’s consolidated annual revenue for the prior financial year. Furthermore, any company belonging to the Schlumberger group may acquire a maximum interest of 30% or form a partnership, create a joint venture or enter into a cooperation agreement giving it the equivalent of an interest of 30% in the share capital of a company in competition with Axalto. Schlumberger may also provide services related to microprocessor cards. In both cases, this exception will only be authorized in sectors related to the oil and gas industries and in sectors other than Axalto’s main business sectors (except up to the limit of 5% of Axalto’s annual revenue as stated above).

Indemnification

Under the Separation Agreement, Schlumberger has undertaken, until November 21, 2006 (a period of 18 months from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO), to indemnify Axalto for any direct loss and costs borne by Axalto or one of its subsidiaries as a result of the Reorganization, including the transfers of assets, shares and intellectual property rights made pursuant to the Reorganization. Schlumberger has not, however, provided Axalto with any warranties or guarantees in respect of the assets and liabilities that were formerly part of the Cards and POS businesses and were transferred as part of the Reorganization.

Schlumberger and Axalto have undertaken, until May 21, 2009 (five years from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO) to indemnify each other against any direct loss suffered by the other party relating to an activity that was transferred by such other party in the Reorganization.

In addition, Schlumberger has undertaken, as of May 21, 2004 (the settlement date of the Axalto shares sold by Schlumberger as part of the IPO), to indemnify the companies belonging to the Axalto group against all third party claims relating to products and services provided by one of the Axalto group’s companies prior to May 21, 2004. In order to benefit from this indemnity and to comply with Schlumberger’s relevant insurance policies, Schlumberger must have received notice of the claim before the settlement date or no later than the second anniversary of the settlement date. For all claims notified to Schlumberger by Axalto before May 21, 2004, Schlumberger is obligated to indemnify Axalto in full. For claims notified to Schlumberger after the settlement date but within a two-year period, Schlumberger is obligated to indemnify Axalto for 60% of the direct loss suffered by Axalto for such claim, up to a maximum total amount of $6.5 million.

Schlumberger and Axalto have also agreed, until November 21, 2006 (18 months from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO), to indemnify each other against any direct loss related to an employee claim based on such employee’s former participation in the business of the other party.

Pursuant to these aspects of the Separation Agreement, Axalto has sent several notifications to Schlumberger. Axalto and Schlumberger continue to collaborate in order to manage existing activities as best as possible.

Finally, Schlumberger and Axalto have agreed to certain reciprocal tax indemnities as described below.

Schlumberger’s indemnification obligations will terminate in the event of a change of control of Axalto, defined as the acquisition by a third party, or several parties acting in concert, of at least 50% of Axalto’s share capital or voting rights or the direct or indirect control over Axalto’s management. In such case, however, Axalto’s indemnification obligations to Schlumberger will not terminate.

Transitional services

Schlumberger and Axalto have agreed to share temporarily a limited number of support services, such as the sharing of certain offices and the provision of certain administrative services (such as payroll in certain countries, advisory in treasury and foreign exchange risk management, IT support and accounting).
The Separation Agreement sets out in detail all of the services provided in the aforementioned areas by Schlumberger to Axalto as well as those, which are more limited, provided by Axalto to Schlumberger. All of these services are billed at cost on a monthly basis under normal market terms.

The provision of these services is limited to 18 months from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO, or until November 21, 2006, for administrative services and to 12 months from the same date, or until May 21, 2005, for the sharing of administrative and marketing offices (with the exception of certain offices for which both parties have agreed to a longer duration, in particular Axalto’s offices located in Montrouge, France, for which the lease sharing period is set at is 23 months). Any transitional services provided by either party may be terminated upon three months’ notice.

In February 2005, Axalto sent a notification to Schlumberger concerning the failure to respect these aspects of the Separation Agreement. Axalto hopes to reach a rapid resolution with Schlumberger that will not jeopardize the services in question.

*Employees*

In general, Axalto’s employees will no longer be able to benefit from the advantages offered to employees of the Schlumberger group, in particular supplementary health insurance, or to benefit from Schlumberger’s employee savings and stock options plans.

*Tax matters*

In addition to the aforementioned commitment by Schlumberger to bear the transfer costs of the Reorganization, including related tax charges, the Separation Agreement sets out a number of commitments for one or other of the parties relating to the tax implications of the Reorganization and the IPO. The Separation Agreement also contains certain indemnification commitments by Schlumberger as regards tax matters.

The Separation Agreement also covers the tax implications of the exit of Axalto from any existing Schlumberger tax integration arrangements or tax groups. In particular, it provides that neither party will be liable towards the other for any indemnity in connection with Axalto’s exit from such arrangements or groups.

*Intellectual property rights*

Under the Separation Agreement, Schlumberger has committed to transfer to Axalto all intellectual property rights relating to the Cards and POS divisions and to indemnify Axalto for all costs relating to these transfers.

Schlumberger and Axalto have also agreed to enter into a reciprocal license for intellectual property (other than trademarks and internet domain names) that was developed by either of the parties. Axalto may use the reciprocal license only for activities relating to its Cards and POS divisions, while Schlumberger may use the reciprocal license for any activities not relating to any of Axalto’s business activities at the closing date of the IPO. The reciprocal license is irrevocable, non-exclusive, royalty-free, non-transferable with no right to sub-license and agreed with effect from the closing date of the IPO. The term and geographical scope of this reciprocal license is determined by the related intellectual property right. Neither party may sell to third parties any intellectual property rights which compete with the other’s intellectual property rights under the reciprocal license.

Axalto acknowledges that Schlumberger has already granted licenses prior to the Reorganization or may in the future grant sub-licenses to third parties relating to Axalto’s intellectual property in the context of a sale to these third parties of Schlumberger businesses. In both cases, Axalto has agreed to continue the existing licenses or to enter into new licenses with these third parties in its name, as well as to authorize Schlumberger, if necessary, to grant sub-licenses to third-party buyers, on the condition that Axalto’s intellectual property rights concerned by these sub-licenses are used within the framework of the transferred assets at settlement date of the Axalto shares sold by Schlumberger as part of the IPO.
Other commitments

Under the Separation Agreement, Axalto has agreed to provide Schlumberger with preferential contractual conditions in the context of potential future commercial agreements between the two groups, so that Schlumberger may benefit from the same terms and benefits (such as price and warranties) that are extended to third parties.

Termination of the Separation Agreement

The Separation Agreement will terminate 10 years from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO, on May 21, 2014.

Axalto’s analysis of the Reorganization and more specifically of the consequences of the Reorganization on all of the major contracts in which Axalto is involved leads to the conclusion that there is nothing to its knowledge to suggest that the Reorganization may have a significant impact on Axalto’s financial situation or production.

A presentation of the main companies belonging to the Axalto group following the Reorganization can be found in paragraph 3.3.4 – Subsidiaries and participating interests.

4.1.2 Competitive strengths

Axalto believes that its main competitive strengths are:

- its ability to identify, assess and pursue market opportunities for new chip card products and services;
- its balanced portfolio of products, including a strong presence in the mobile communications, financial services, public sector and network access markets;
- its presence in all of the world’s major areas of economic activity, allowing it to balance growth risks and seize opportunities as soon as they present themselves;
- its ability to provide high quality, individually customized products in high volumes and at reduced prices;
- its ability to produce and deliver rapidly on a local level thanks to its global presence, “virtual factory” production concept and production and logistics expertise;
- its ongoing commitment to research and development of secure microprocessor card applications, which is reflected by its long track record of successful innovation;
- its significant intellectual property portfolio, which is actively managed in order to encourage market growth and the use of microprocessor cards, which are developed continually;
- its experienced management team, which has ensured the growth of the business and developed defined, uniformly applied policies and processes to manage and develop its people. Axalto encourages internal promotion, international experience, gender and cultural diversity and anticipates market trends and developments through targeted recruiting;
- its culture of excellence, customer service, innovation, time to market and profitability, as well as its creed of conducting business according to high ethical standards.

4.1.3 Strategy

Axalto intends to leverage its leading market position and its portfolio of cutting-edge products and services to strengthen and develop its presence in all major microprocessor card markets, as well as to develop and exploit new markets and applications.
In order to achieve these objectives, Axalto intends to focus its efforts on the following:

- **Fully exploiting the potential of microprocessor card solutions for mobile communications and digital networks.** Axalto intends to strengthen its leading position further in microprocessor card solutions by providing cards to operators that permit them to better serve their subscribers and increase revenues per user. Axalto intends to capitalize on its global presence to benefit from the expansion of the mobile communications market in high growth areas such as Asia and the Americas and to seize opportunities provided by the increased penetration of new mobile standards, such as UMTS (WCDMA), HSPDA, WLAN and WiMAX, requiring card-based subscriber identification, to extend the card’s areas of application.

- **Capitalizing on its leading position in financial services.** Axalto offers its financial services clients solutions encompassing microprocessor cards and POS terminals for card-based transactions. The Company intends to leverage this product offering as well as its security expertise, interoperability skills, multi-application capabilities and extensive existing customer network to play a key role in EMV migration, which represents a major growth opportunity in Europe, Asia and Latin America. Axalto also intends to continue to promote actively the migration from magnetic stripe cards to microprocessor cards in the United States. The Company has successfully used its technology in the past to improve its market position and gain market share, and intends to continue doing so in the future.

- **Developing microprocessor card-based applications in the emerging public sector, access and transportation markets.** The expanding use of digital networks in public services relating to efforts to improve efficiency in administrative services and growing concerns about the security and reliability of online services makes this sector a major potential growth market. The events of September 11, 2001 have resulted in heightened security concerns, prompting governments around the world to explore new methods for the identification and authentication of people and to protect their computer networks and buildings. The microprocessor card is well suited for these applications as it provides simultaneously human-readable and machine-readable identity and requires a voluntary act for identification and authentication. The Company intends to promote and develop microprocessor card-based applications that provide higher security for identity documents, particularly passports, and facilitate the use of online government services, such as healthcare, while protecting the private lives of citizens. For large corporations, Axalto will use its expertise in security, public key cryptography and infrastructure deployment and contactless card technology to develop corporate physical access and private network security solutions. As municipalities and mass transit authorities renew and upgrade their transportation infrastructures, Axalto also offers contactless microprocessor cards for ticketing in urban and local transport services.

- **Focusing on higher value-added products and services.** Based on its leading technologies, Axalto intends to pursue actively the sales and marketing of value-added products and solutions. For example, it will offer cards with enhanced capabilities, open platform systems supporting multiple applications, contactless technology, as well as related software solutions. The Company will also capitalize on its close relationship with its customers to develop new services that complement its current product offering and allow its customers to anticipate and respond to the needs of their own clients. It will continue to focus on reallocating resources, including capital expenditure, personnel, research and engineering and manufacturing resources, from low-end to higher margin solutions. As standardization is essential to accelerate the creation of new markets and broaden microprocessor card applications, Axalto will continue to participate actively in the development of new standards for technologies and solutions that could use microprocessor cards, as well as to license its intellectual property with the aim of increasing the market penetration of these products.

- **Focusing on operating performance.** Efficiently managing its operations is a core component of Axalto’s corporate culture. The Company intends to maximize opportunities for revenue while closely monitoring expenses and pursuing its targets in terms of profitability.

- **Leveraging its worldwide presence.** Through its global business network, Axalto intends to benefit fully from the growth of local markets by identifying and assessing new opportunities and needs, leveraging its size and experience across different markets, offering customized proposals, optimizing time to market and logistics, and continuously deploying state-of-the-art products and services.
4.1.4 Overview of Axalto’s technology

Cards are used around the world daily in a wide range of applications and transactions, including mobile communications, payment transactions, loyalty programs, security badges and passes, network access, prepaid telephone calls, identity cards, health care, pay TV, authentication and access to information networks and mass transit, among others. There are two main types of cards used for secure applications: magnetic stripe cards and chip cards. Chip cards contain electronic components that store larger amounts of data than magnetic stripes and, unlike magnetic stripe technology, are able to process data like miniature computers. The increasing demand for security and flexibility has led to the growing use of chip cards in areas where magnetic stripe card systems were predominant, such as payment transactions, as well as in other more recent applications, including identity and health cards and authentication of users of computer networks and public services.

Chip card technology and applications have developed significantly since the late 1970s when chip cards were first introduced in France. Axalto began its chip card activities in February 1979, when it licensed and marketed certain chip card technologies developed and patented by Roland Moreno, who is generally acknowledged as the inventor of the chip card. Since then, Axalto has played and continues to play an important role in the evolution of chip cards, related devices and applications and POS terminals (see paragraph 4.1.1.1 - History).

4.1.4.1 Chip cards

Chip cards are used to store securely the card user’s profile and other personal information that is relevant to the service for which the card is being used. In addition, certain types of chip cards have embedded software that enables complex transaction processing. Data residing in the chip can be protected against attempts at unwanted external inspection or alteration through physical and software protection systems.

There are two major types of chip cards:

- Memory cards, which securely store data that can be modified at a special reading terminal. Memory cards are generally used for single applications that do not require data processing functions. Prepaid phone cards, loyalty cards and e-tickets for transportation are generally memory cards.

- Microprocessor cards, which store and process data and transfer processed data to a network reader. Each microprocessor card has an embedded operating system that manages the various core functions of the card, such as memory, security features, communication interfaces and crypto-engines, and which enables software programs to run on the card. The exchange of data between the card reader and the microprocessor card is controlled by the microprocessor chip operating system, which enhances the security of the system. For example, SIM cards used in mobile communications are microprocessor cards able to carry out complex cryptographic operations.

Most chip cards are used by placing the chip card in a reader integrated into a device such as a wireless handset, POS terminal, personal computer or payphone. The chip card has a set of electrical contacts embedded in the surface of the plastic that connect to the electrical contacts in the card reader. Through the reader and using a security process between the card and the reader, the network operator or card issuer can authenticate the card user by verifying the legitimacy of the card and by identifying the end user before authorizing a transaction. Once the card user has been authenticated, the reader can access and modify the data stored on the card and, in the case of microprocessor cards, transfer information from and to the card and allow miniature software programs or “applets” stored on the card to interact with software applications that run on the network operator’s server.

The most important features that make chip cards highly attractive to network operators, financial institutions and end users are:

- Security. Chip cards can store complex algorithms and keys that can be used to encrypt information exchanged between a card and a network and to identify a user, a card or a network. A chip card user needs both a card and an access code, such as a personal identification number (“PIN”), to use a card. Security is therefore ensured as long as the card and the PIN do not fall into the possession of a third party. As a result, chip cards may significantly reduce the incidence of fraud, including for mobile communications networks and payment transactions. Microprocessor chips also contain sophisticated technology that prevents unauthorized parties from tampering with the card and from accessing and manipulating the user’s personal
information stored on the card. This feature is particularly important in segments where privacy is a key concern, such as in health care, identity and other public sector applications.

- **Portability.** As the card chip contains all of the data, the cardholder can use his personal data by simply transferring the card from one device to another. For example, a user can purchase a new wireless handset without changing his subscription, as his personal information and service subscription are kept in the operator’s SIM card, which is easier for the user and reduces customer churn for operators. Chip cards can also be designed to work in different types of devices, enabling users to rely on a single card for a number of applications. For example, an employee may use a single chip card as a corporate identity badge to enter the workplace, and as a network access card to access the corporate network from any computer equipped with a chip card reader, potentially even remotely.

- **Privacy.** As information is stored on the card itself rather than on a remote database, chip cards provide greater protection of the personal data they contain. Safeguarding privacy is becoming particularly important as the number of card applications expands, particularly in areas that rely on the secure communication and use of sensitive information such as health care and public records.

- **Flexibility.** Chip cards are capable of running multiple software programs or applets that enable card issuers and mobile communications operators to offer a range of services through a single card. In addition, these software programs can be downloaded and updated remotely, which allows card issuers to add services and tailor cards to changes in customer demands without having to issue new cards or replace the existing cards.

**Key developments in chip card technology**

The most important developments in chip card technology are:

- The development of open-platform operating systems for microprocessor cards, which contain an application programming interface and an interpreter to execute applets. This allows software programmers to create applications based on a standard protocol that can run on any microprocessor card, irrespective of the card manufacturer. Because software programmers are no longer required to customize or adapt each application to the specifications of each card manufacturer’s proprietary operating systems, card issuers and network operators are able to offer new services to their customers in a relatively short space of time, based on off-the-shelf applications or by developing new applications using the standard protocol. Axalto developed the first microprocessor card using Java technology in 1996, which is now the most widely used open standard and was recently included in the specifications for the GSM and UMTS (Universal Mobile Telecommunications System) standards.

- The continuous increase in the memory capacity of microprocessor chips, which permits card issuers to offer new services thanks to the growing memory capacity of cards, load a higher number of applets and conduct increasingly sophisticated operations. Since their introduction in the early 1980s, the memory capacity of microprocessor chips has evolved significantly from less than one kilobyte (“KB”) of data storage to 8-16 KB in the mid-1990s and 16-32 KB in the late 1990s. The current generation of microprocessor chips is capable of storing and processing up to 256 KB of user data. Chip manufacturers recently developed new silicon-based ‘flash’ technology that enables microprocessor chips to store even more data than the current generation of chips and will give card manufacturers increased flexibility to modify the chip operating system and reprogram the chip for other functionalities more quickly. Axalto launched the first microprocessor cards with 512 KB of data storage capacity using flash technology in February 2003. In 2004, the majority of SIM cards sold had storage capacity of 32 KB. Despite the high sales volume of SIM cards with 16 KB of storage capacity, the proportion of cards with higher storage capacity of 64 KB, 128 KB or 256 KB is rising continually.

- The development of microprocessor architecture allows for increased processing power and faster data transmission. A standard ISO interface transmits data at speeds of 9.6 kilobits per second. In certain circumstances, this can be improved to up to 110 kilobits per second. The use of USB technology has further increased data transmission speeds from 1.5 megabits to up to 12 megabits a second. The increased processing power and data transmission speed has been enabled by the integration of increasingly complex functions on single chips.
• The development of microprocessor cards using the most sophisticated security technologies, such as public key infrastructure (PKI) systems. PKI technology enables secure access, communications and transactions over internal or open networks using digital certificates to identify users and keys or algorithms to encrypt information transmitted over the network. Microprocessor cards enable card issuers to enhance the security and flexibility of PKI-based systems by storing the digital certificates and keys on the cards, with the possibility of revoking certificates and changing authorization levels remotely without issuing new cards. Cards using PKI technology are offered to customers requiring the highest level of security, such as public authorities and corporations implementing online network access services, wireless network operators and financial institutions implementing e-commerce systems, and are capable of enabling new types of secure transactions using digital signatures. Microprocessor cards have obtained the highest levels of certification relating to analysis of the card’s ability to handle attacks and prevent covert channels.

• The development of sophisticated card management software that enables customers to manage their cards remotely, in particular through an Over-the-Air wireless transmission platform (“OTA”) that uses radio-frequency channels. OTA allows card issuers to provide remote card management, such as subscription activation, user preference updates and network management, and to download and install new information or applets as they become available without replacing the card. These new capabilities have also led to a demand for system design, integration and management services.

• The development of microprocessor cards with built-in USB ports, which can also be used in personal computer peripherals through a USB protocol without requiring the user to install a special card reader. Until recently, the need to connect a specific reader to a PC in order to use a chip card constituted a major obstacle to the widespread use of microprocessor cards in PC-based applications, particularly for secure e-business and home banking transactions. Most PC operating systems manufactured today contain embedded software which allows for interaction with microprocessor cards through a USB port.

• The development of contactless chip technology, which allows the chip card to receive and transmit data and interact remotely with the reader from a specified distance through an embedded antenna using a radio frequency, without being physically inserted in the reader. Chip cards can also combine contact and contactless functionalities on a single card which are compatible with existing card infrastructures in order to increase the card’s versatility and increase the number of areas in which the chip card can be used.

**Chip card production**

The chip card production cycle consists of four main stages: chip design, micromodule manufacturing, embedding and personalization.

**Chip design**

The most important features of a chip relate to its memory and data processing capacity, as well as its performance. Chips are designed and manufactured by semiconductor makers such as Philips, Samsung, Infineon, STMicroelectronics and Renesas, on the basis of the needs of the various chip card manufacturers. As a result, chip card manufacturers dedicate a large part of their research efforts to the specification of new chip designs, including chip speed, circuit and architecture, in order to optimize the chip’s performance and meet customers’ requirements. The chip’s security and performance depend on the chip itself and the specifications of the chip operating system, which is supplied by the chip card manufacturer. Chip card manufacturers therefore dedicate a large part of their research efforts to the design and development of new chip operating systems in order to maximize security and ensure efficient use of the chip’s features. As part of this effort, chip card manufacturers generally have teams of software programmers dedicated to the development of new operating systems and new applications that are loaded onto the chip to enhance the functionalities of each specific type of chip card.

**Micromodule manufacturing**

The chips used in chip cards are supplied by silicon chip manufacturers in the form of wafers that contain a large number of chips. To be used in chip cards, the wafers need to be cut and the chips need to be separated from the wafers and assembled into ‘micromodules’, which consist of a chip connected to a printed circuit board, using microelectronic technologies. Because this process requires a high level of expertise and technology, many small to mid-sized chip card companies do not have the capabilities to produce micromodules and depend on silicon
chip suppliers or larger chip card manufacturers, such as Axalto, to supply them with micromodules.

The micromodule manufacturing stage is conducted in a ‘clean room’ which benefits from a tightly controlled environment in terms of air filtering, temperature and humidity. Chips are delivered by silicon chip manufacturers in wafer form with approximately 1,000 to 10,000 chips per wafer, depending on their memory capacity, size and technology. The following diagram illustrates the main stages of micromodule manufacturing:

Micromodule manufacturing

The wafers are sawed into individual chips, which are then ‘picked’ from the wafer one by one and ‘placed’ on flexible printed circuit boards using a specialized adhesive. The chip is then connected to the printed circuit board using wire which is generally gold. A thin layer of resin is then applied to cover and protect the assembled chip and circuit board.

Embedding

The embedding stage consists of the production and preparation of the card body and the placing of the micromodule in the card body. Because chip cards can be lost, stolen, damaged or even subject to heat, cold, pressure and other types of physical stress, the card body and the micromodule must be highly resistant to physical damage and repeated use. The following diagram illustrates the principal stages of card body manufacturing and micromodule embedding:

Card body manufacturing and micromodule embedding

The manufacture of card bodies includes printing, collation and lamination, card punching, hologram and signature panel hot stamping.

During the printing process, using offset printing and/or silkscreen printing presses, between one and twelve coats of ink are applied to blank sheets of white plastic. The printed plastic sheets are then covered with transparent plastic overlays that may include magnetic stripes (particularly for financial cards). The printed and laminated plastic sheets are then punched into individual cards and, if necessary, hot stamped with holograms and signature panels. Because card issuers’ brand image is linked to the quality of their card presentation, card issuers demand that card manufacturers have a high standard of expertise in printing processes to ensure that the final card product meets their customers’ quality expectations. The security features of the printed card body are also important in certain segments, such as national identity cards. In these cases, card issuers require card manufacturers to have expertise similar to that required of currency printing companies in order to include anti-counterfeiting and tamper-proof features on the card body, using special inks.

The micromodule is embedded into the card body in an environment where temperature, dust and humidity are controlled. Before this can take place, the card body needs to be prepared by milling a cavity on the card body corresponding to the size and shape of the micromodule. The micromodule is then attached to the card body using high performance gluing techniques.
The production and preparation of contactless chip cards require different techniques depending on whether the card is purely contactless or dual interface. In a pure contactless card, the chip is contained in the card and is not visible to the eye. The manufacture of this card starts from the inside out, as the card body is built up around a thin plastic sheet that contains an antenna embedded in its perimeter, a thin conductive module and a contactless chip. The contactless chip is bonded to the module which is connected to the antenna. This center layer is placed between layers of plastic, which are in turn assembled with the printed card exteriors. The card then undergoes the same remaining stages of the manufacturing process, including lamination and card punching. A dual interface card, which has both contact and contactless functionalities, is first of all manufactured in the same manner as a contactless card, but, instead of containing the contactless chip in its center layer, a micromodule is embedded onto the card surface and conductive glue connects the chip to the antenna.

**Testing**

During each stage of production, Axalto’s fully automated and robotized production lines monitor and record the main product parameters. Most machines are equipped with on-line vision systems and permanent statistic process control tools to optimize production conditions. Automated tests are completed according to specific sampling procedures to verify that each production batch complies with the customer’s specifications.

**Personalization**

Card personalization, which is particularly important in financial cards, consists of electrical and graphic processes. The method used varies depending on specific needs of each customer. The different stages of personalization can include data processing (such as PIN code or digital key generation), chip loading (personal data and applets), card body embossing, magnetic stripe encoding, laser or inkjet printing and packaging. At the personalization stage, it is imperative to take extremely rigorous security measures in order to ensure the confidentiality of the information transmitted by the customer. Manufacturers’ facilities must meet stringent security requirements and are routinely subject to inspections and certification by industry organizations and customers.

4.1.4.2 **Point-of-sale terminals**

A point-of-sale terminal is a complex computerized device that securely receives and processes electronic payments made through magnetic stripe or microprocessor cards. These terminals are widely used, mainly in retail stores, restaurants, cinemas, gas stations, public transit systems and museums. The point-of-sale terminal system can process credit and debit card payments, connect securely to a network and run specific additional applications, such as loyalty schemes.

A point-of-sale terminal has its own embedded microprocessor, which allows it to run specific applications for the particular environment in which it will serve. The terminal is programmed to read the data on the magnetic stripe or microprocessor card used for payment and to allow for specific transaction data to be entered using a keyboard or touch-based screen. It then transmits the data electronically over the telecommunications network to a payment center and receives and displays the center’s response or, in the case of microprocessor cards, it authorizes the transaction off-line. The card is first authenticated and then transmits a transaction limit to the terminal, without requiring authorization from an authorization center. Point-of-sale terminals meet the various standards set by the main financial industry organizations, notably Europay-MasterCard-Visa (EMV), and have to be adapted to customer- or country-specific requirements for local card payments.

Point-of-sale terminals come in five basic forms: desktop, portable, semi-portable, mobile and multilane. Desktop terminals are used primarily at retail sales counters and cannot be moved. They may be used outside, for example at gas pumps or car park pay points. Portable terminals are used to process payments at a limited range from the sales counter (such as in restaurants). Semi-portable terminals are comprised of a moveable handset which is placed on a base station to transmit and verify transaction data and print a receipt. Mobile terminals use wireless technology and can either be connected to a network or off-line. They can be used to transmit payment data from mobile or remote locations (such as taxis, delivery trucks or motorcycles). Multilane terminals are used in networks of cash registers and other payment points, for example in supermarkets.
4.1.5 Presentation of the market for cards and point-of-sale terminals

Cards are used on a daily basis for a wide range of purposes such as to make payments, to identify people and grant them access to places or services and to store information. As a result, the market for card products and services encompasses a large number of sectors and applications where cards are used mainly for data storage, data retrieval and secure data transmission within secure and flexible systems or platforms. Although the cards used in different sectors and applications vary greatly in terms of sophistication and capabilities, a card typically consists of a standard-sized plastic body that is 'personalized' or customized for each function or user through various techniques, such as embossing, ink markings or laser engravings. In most cases, the data stored on the body of the card is limited to visual identification information that is used to access centrally stored databases. However, cards that contain magnetic stripes, memory chips or microprocessor chips are able to store additional data, such as bank account or telephone subscription details, and provide higher levels of security to protect the data stored in the card. Despite their advantages, in each sector these cards are in competition with a number of alternative technologies, such as hardware-based authentication solutions for access to wireless networks, magnetic tickets for public transportation, identity papers or software-based solutions for access to computer networks or encrypted media broadcast content.

Within the global market for card products and services, demand for chip cards, which include microprocessor and memory cards, has grown steadily and rapidly, both geographically and by sectors of activity, since the development of the first chip card over twenty five years ago. Chip cards are used extensively in Europe and Asia, where they have several hundreds of millions of users. Their use is growing worldwide, particularly in China and the Americas. According to Frost & Sullivan Datamonitor, 2.02 billion chip cards were sold worldwide in 2003 and worldwide chip sales could reach 2.56 billion cards in 2006. Gartner estimates that Axalto is the world’s second-largest chip card supplier, with 22% of units shipped globally in 2003.

The microprocessor card market has grown substantially since the first card appeared in 1983, with global annual sales rising from 398 million cards in 1999 to 899 million cards in 2003, according to Eurosmart. In 2003, according to Eurosmart, 514 million microprocessor cards were sold in Europe, the Middle East and Africa (EMEA), 271 million in Asia and 114 million in the Americas, and sales of microprocessor cards are expected to see a compound annual growth rate between 2003 to 2006 of 13.5% in EMEA, 16.9% in Asia and 20.2% in the Americas. One of the key drivers of this growth has been significant demand for SIM cards, which were included in the specifications of the GSM standard in the late 1980s. GSM is the dominant mobile communications standard in Europe and the most widely used in the world. Demand for microprocessor cards should continue to grow in the near future with the development of operators working in countries with very large populations. Mobile communications operators are also expanding their related services offerings using increasingly sophisticated cards that provide new features and better capabilities. Growth is also sustained by the worldwide rollout of new “third generation” (3G or UMTS) mobile communications networks using microprocessor cards. Axalto also believes that other sectors of the global card market offer significant potential. The migration of financial card systems to the EMV standard, which is microprocessor card-based, is expected to create significant demand for financial microprocessor cards in countries that currently rely on magnetic stripe card payment systems. The new EMV standard is the first truly international standard that requires interoperability between the cards and point-of-sale terminals. Previously, there was only a variety of local standards, each based on different specifications. The migration to chip card-based payment systems should also have a positive impact on the market for POS terminals as it is one of the factors favoring the replacement of previous generations of equipment and should also help expand the market geographically. Furthermore, the increasing need for security and the expansion of on-line government services are likely to make the network security and the government, health and identity markets significant growth areas. Frost & Sullivan expects global microprocessor card sales to grow to 1.6 billion units in 2006.

4.1.5.1 Cards

Mobile communications market

Historically, mobile communications has been the largest market for microprocessor cards. In a recent study of July 2004 on the mobile communications market, Frost & Sullivan estimates that 724 million SIM cards were sold worldwide in 2003 and expects sales to increase to 1,053 million cards in 2006. Eurosmart estimates that SIM cards will represent approximately 65% of total microprocessor cards sold worldwide in 2003.
Microprocessor cards have been a key component of mobile communications systems that use the GSM standard since their launch in 1990. SIM cards are placed inside the wireless handset and are used by mobile communications operators for user authentication to give access to the network without compromising the security of the network. The authentication software loaded on SIM cards has also enabled operators to manage network subscription, including type of subscription and network access, billing and roaming preferences. SIM also allow subscribers to store their telephone numbers and personal information, such as a personal phonebook, on a removable card that could be inserted in any GSM mobile phone, enabling subscribers to change handsets without changing subscription or losing personal information.

Historically, the key driver of SIM card sales has been subscriber growth in parallel with the construction and rollout of digital wireless networks, particularly in Europe. More recently, as mobile communications penetration rates have increased and subscriber growth has slowed down in Europe, sales of microprocessor card products in this market have benefited from subscriber turnover or ‘churn’, new value-added services and international roaming between different mobile communications networks. Finally, this market should also benefit from the migration to new mobile communications standards that require sophisticated microprocessor cards, in particular third-generation networks.

**Subscriber growth**

Growth in the SIM card market was historically driven by the increasing use of mobile phones. This continues to be the case in countries and regions that still have relatively low mobile phone penetration rates, such as China, India, Indonesia, Nigeria and South America. In these markets, SIM cards are sold to network operators as they build up their primary networks and add new subscribers. The mobile communications market in high-population countries, currently the largest market for SIM cards in the world (China currently represents around one-third of the global SIM card market, according to Frost & Sullivan), is characterized by both a relatively low penetration rate (mostly due to the very large population) and by intense competition between operators for subscribers. Consequently, operators are divided between the use of basic SIM cards for subscriber identification for voice and short message services, in order to win customers at lower cost, and the need to retain these customers by offering them a growing range of services, principally through high-end SIM cards with greater memory capacity and processing power.

**Subscriber churn**

Growth in the European mobile communications market has recently slowed as, among other things, the market for voice transmission services has matured. In this mature market, intense competition between operators has resulted in a very high level of customer turnover or ‘churn’. The desire to upgrade handsets coupled with the availability of number portability, the ability of a customer to switch operators without being forced to switch their existing phone number, have led to significant increases in churn rates. The churn rate in China is particularly pronounced due to the high number of prepay users, who generally have little attachment to their supplier and have no qualms about changing operator when their contract expires. The growing proportion of prepay subscribers has resulted in more and more users switching networks. Customer churn leads to greater demand for SIM cards and notably for more sophisticated SIM cards in order to attract subscribers with innovative services.

**Value-added services**

Meanwhile, because of the slowdown in the voice transmission services market, operators have seen a sharp decline in average revenues per user and are seeking to enhance their offering of value-added services by increasingly using the new possibilities offered by mobile communications in terms of data transmission capabilities. Growing demand for new services, including the very popular short message services (“SMS”) and to a lesser extent multimedia message services (“MMS”), information-on-demand services and email access through wireless devices, has led mobile operators to use more sophisticated SIM cards. Growth opportunities in the mobile data transmission market have also led mobile communications operators to invest in new technologies and networks and to upgrade existing infrastructures. In order to be able to offer these advanced services, operators are often willing to pay higher prices for multi-application SIM cards with much more powerful processing capabilities, memory capacity and security features, which creates new market opportunities.
Multi-standard interoperability

In addition to GSM, the two other main mobile communications standards used around the world are Code Division Multiple Access (“CDMA”), used primarily in the United States, South Korea and China, and Time Division Multiple Access (“TDMA”), used mostly in North, Central and South America. These standards do not provide for the systematic use of removable identification modules such as SIM cards as part of their mandatory technical specifications. However, numerous wireless networks based on CDMA and TDMA standards have recently been implementing chip cards in their infrastructure to facilitate interoperability between networks that use different standards. SIM cards and removable universal identity module (“R-UIM”) cards (the CDMA equivalent of the SIM card) with a roaming feature allow mobile phones to use the infrastructure of other mobile transmission standards. This technology is well-suited to the North American and Chinese markets, which have fragmented networks providing uneven coverage using various standards, including CDMA and GSM. In 2001, for example, China Unicom commenced a significant rollout of R-UIM cards (partly supplied by Axalto) for its CDMA subscribers and, in the United States, AT&T Wireless and Cingular Wireless rolled out cards incorporating the GSM/ANSI-136 Interoperable Team, or GAIT, standard (including GAIT cards supplied by Axalto) which enable interoperability between TDMA and GSM coverage areas.

Migration from standards that require microprocessor cards

In certain regions, the migration to standards that use microprocessor cards has also contributed to growth in this market. This is notably the case in the United States and South America (where operators are moving from the TDMA standard towards the GSM standard), in Japan (where operators are moving from the second generation PDC standard (Personal Digital Cellular) to the Wideband CDMA (“WCDMA”) standard) and in Korea (where operators are moving from the CDMA standard towards the WCDMA standard).

New wireless standards

The mobile communications industry has started deploying new wireless standards that are expected to provide greater data transmission capacity to allow operators continuously to provide new services to their customers. The new standards, which are commonly referred to as third-generation standards because they represent the third generation of technology used for mobile communications, are collectively known as Universal Mobile Telecommunications Systems (“UMTS”) standards. All of the third generation standards include identification module technology similar to SIM cards, but with significantly greater memory and processing capacity and enhanced security features. The mobile communications industry has adopted the technical specifications for these standards and is currently deploying two new versions of UMTS standards, WCDMA, which is expected to be predominant in Europe and Asia, and CDMA2000, which is expected to be used mainly in the United States and some parts of Asia.

The WCDMA standard, like the GSM standard, incorporates an identification module in a removable card, which is referred to as a Universal SIM, or USIM, card. In the CDMA2000 standard, the identification module technology can be incorporated in either a removable card, which is referred to as a Universal Identification Module, or UIM, card, or in the telephone handset.

Because it will take several years for mobile operators to deploy fully and take advantage of new third generation networks, the mobile communications industry has developed interim standards that support higher transmission capacity based on existing second generation technology. The main interim standards, which are known as 2.5G standards, are General Packet Radio Service (“GPRS”) and Enhanced Data rates for GSM Evolution (“EDGE”) both of which use GSM technology, and CDMA-One, which uses CDMA technology. All of these standards incorporate identification module technology, which can be included in a removable card or, in the case of CDMA-One, in the telephone handset. The 2.5G standard adopted in Europe and China uses removable card identification module technology, while in the United States the decision is made by each individual operator.

In addition to 2.5G and third-generation standards, wireless local area networks using Wireless Fidelity (“Wi-Fi“) standards may present new opportunities for chip card manufacturers (see paragraph 4.1.5.2 - Emerging Applications Markets, for a brief overview of the market for Wi-Fi products and services).
**Competition / Recent market developments**

Mobile communications operators generally award one-year SIM card supply contracts to one or more card manufacturers through annual public tenders in which many card manufacturers participate, which results in a high level of competition for SIM card orders. Moreover, because there are approximately 30 SIM card suppliers worldwide, of which approximately 10 have a global presence, there is intense competition among global, regional and local players for each contract. For example, the size of the Chinese market has recently given rise to local SIM card manufacturers which compete for card orders from Chinese mobile operators. These producers are expected to continue to build on their domestic market share and make the most of both their low production costs and large domestic market to expand internationally and gradually compete with global players in the region. Despite this intense competition, operators tend to develop long-term relationships with three or four major manufacturers based on product quality, services offered and the common development of dedicated software and other applications, although these relationships may not necessarily lead to contract awards or orders each year.

In 2001 and 2002, this market experienced an overall decline, which has led to a fall in the average sales price of SIM cards, particularly low-end SIM cards, due to increased competition between local suppliers. This decline was exacerbated by the slowdown in the mobile communications industry that led operators to cut costs, particularly SIM card supply costs. Axalto believes that this period of slowdown is now almost over and its customers have recently begun to focus on providing a higher value-added range of products and services to their subscribers, while also still pursuing cost reduction objectives. Axalto has also noted that the size of this market is regularly undervalued by experts who underestimate sales generated in high-population countries, which represent an increasingly large proportion of the market. Axalto believes that SIM card sales exceeded one billion units in 2004. However, pressure on average sales prices in this market is likely to continue, although at a significantly slower rate due to improving sector conditions and the continuous new product launches.

**Financial services market**

According to Frost & Sullivan, approximately 235 million chip cards were sold in the financial services industry in 2003, and it estimates that 504 million chip cards will be sold in 2006.

There are currently three main applications for microprocessor cards in the financial market:

- the credit and/or debit card, which allows users to make cash withdrawals and purchase goods and services using their bank accounts or credit lines without requiring on-line authorization from the card issuer for each transaction. France was the first country to implement these card systems in a widespread fashion, resulting in an estimated 45 million cards in circulation in 2002 according to Datamonitor. Microprocessor credit and/or debit cards are already widely used for payments in Germany, Belgium, Malaysia and The Netherlands, while Italy, Turkey and the United Kingdom are currently in various stages of migration from magnetic stripe cards to microprocessor cards. Financial institutions in other countries, such as Switzerland, Canada, Brazil, Mexico, Japan, Taiwan, Spain, and several Eastern European countries have also begun migrating to microprocessor card technology;

- the ‘e-purse’ or ‘electronic purse’, which allows users to download cash in electronic form and debit an appropriate amount at each transaction. E-purse systems, such as the Moneo, GeldKarte and Proton systems, are currently used in Germany, Belgium, The Netherlands, Luxembourg, Mexico and Malaysia;

- multi-application cards based on open-platform technology, which permit card issuers to deploy a number of applications, such as credit and debit payments, e-purse, loyalty programs and other value-added services, on a single card and to update and add other services after cards have been issued in order to tailor services offerings to customer demand.

In countries that have adopted chip card-based payment systems, financial institutions, banks and retailers that offer consumer credit periodically award contracts that generally last one year to card manufacturers for the initial issuance or replacement issuances of cards intended for targeted groups of customers. To obtain these contracts, card manufacturers must meet stringent quality and security criteria both in respect of the cards as well as the production process (see paragraphs 4.1.4.1 – Chip cards – Chip card production, and 4.1.8 – Production). The main feature of these markets is the regular need to replace cards in circulation. Financial cards are issued to cardholders for a pre-determined period of time, which typically ranges from two to three years. When the card
expires, the cardholder requests and generally receives a new card for another similar period. Card issuers are also required to issue new cards to their customers at short notice when they enroll new card users or when the original cards are lost, stolen or damaged. As a result, chip card manufacturers that are selected for a financial card project must have the capability to respond at any time to orders for new cards in large or small batches to replace those that expire or are lost, stolen or damaged. Personalization capabilities are a key element of a chip card manufacturer’s ability to respond quickly to large or small orders for replacement cards, as each card requires a high level of personalization, including graphical personalization such as images of the cardholder’s photograph, and electrical personalization as regards whether or not all confidential data is downloaded into the microprocessor. This personalization service can also includes the secure separate mailing of the card and the PIN.

In countries that continue to rely on magnetic stripe card-based payment systems, the migration to microprocessor card-based systems is being driven mainly by the desire to reduce the levels of fraud associated with magnetic stripe cards. Financial cards with microprocessor chips store a specific cardholder profile, as well as security software that allows the POS terminals to carry out a transaction without on-line authorization. The cardholder enters his PIN code into the POS terminal instead of signing a printed card receipt, which reduces fraud. Microprocessor chips also contain sophisticated cryptographic algorithms that prevent access to and duplication of data stored in the microprocessor card. Furthermore, microprocessor cards enable financial institutions to offer multiple applications through a single card platform, such as the combination of credit and debit applications with loyalty programs, as well as to run sophisticated customer relationship management programs.

Most large financial card networks have standardized their payment systems in order to enhance interoperability and security. Europay, MasterCard and Visa have adopted a common specification for credit and debit cards, known as the EMV standard, which is based on microprocessor cards. MasterCard and Visa have announced that they will no longer guarantee repayments in the event of fraudulent card use in Europe after January 1, 2005, unless the fraud takes place within EMV-certified microprocessor card-based payment systems. They have set EMV migration deadlines for shift of responsibility worldwide, including Africa and the Middle East (January 2006) Asia (January 2006), Latin America (January 2008) and Canada (January 2008). No deadline has been set with respect to migration in the United States, however, and magnetic stripe-based credit cards continue to be widely used in the U.S. market. The United Kingdom, France, Belgium, Turkey, Sweden, Italy and Brazil have already implemented EMV platforms while other countries are currently running pilot migration programs. However, financial institutions in several European countries, such as Spain, have recently announced that they are experiencing delays in the migration to EMV-compliant systems and do not expect to meet the 2005 deadline set by Visa and MasterCard.

E-purse schemes are typically implemented by financial institutions and banks, according to national markets. These include Visa Cash (Visa), Mondex (MasterCard), the Common Electric Purse Standard (CEPS), Proton (through the Proton World International card operators association), Visa Sermepa (the Spanish Visa Cash operator), Chip Knip (the Dutch card), GeldKarte (the German card) and Moneo (the French card). Loyalty card programs are implemented by businesses and retailers, particularly supermarkets and hypermarkets, and when in a multi-application setting, these cards are often implemented in collaboration with financial institutions.

In terms of geographic regions, Europe (including Eastern Europe and Russia) and Latin America are experiencing significant growth in the market for microprocessor financial cards. In Asia, according to Frost & Sullivan, several Japanese credit card issuers began in 2001 the process of converting their magnetic stripe card bases into microprocessor cards, and JCB, a major Japanese card issuer, has started to deploy several microprocessor card initiatives to promote chip-based credit/debit cards, targeted in particular at certain categories of customers, including international travelers. In South Korea, according to Frost & Sullivan, over 1.1 million EMV-compliant cards have been issued and Visa and SK Telecom have, in conjunction with Visa member banks, incorporated chip-based debit card payment technology into mobile handsets. American Express launched its first chip-based credit card in the United States in 1999, Australia in 2001 and the United Kingdom in 2002.

Some financial institutions are conducting pilot programs using contactless technology with credit cards offering the advantages of speed and security, such as MasterCard’s PayPass in Florida. According to Frost & Sullivan, these contactless cards should offer growth opportunities in small payments, primarily in the United States.
Public Sector, Network Access and Other Products markets

The security, portability, privacy and privacy features of chip cards make them well suited to respond to customer and consumer demands in a diverse range of markets, including the public sector (comprised of government, healthcare, transportation and national identity cards and passports), network security and access, and pay-TV markets.

Public sector

Government, healthcare and identity

Chip cards are generally intended to replace paper documents that are currently used by public institutions and to provide a broad range of services to citizens, such as social security cards, identity cards, passports, drivers’ licenses and health cards. Datamonitor estimates that approximately 54 million chip cards were sold globally in these markets in 2003 and believes that global sales of these cards in these markets will reach 111 million cards in 2006. The adoption of chip cards in this area should be driven principally by the need to improve efficiency in government services, the need to reduce fraud and forgery and growing security and privacy concerns, particularly in the area of healthcare and identity. Chip cards provide a higher level of security than other technologies in this domain, particularly due to the cryptographic and tamper-resistant nature of the chip card as well as the ability to include other security features such as holograms, optical variable imaging, microprinting and biometrics (for example, retina scans, digital fingerprinting or voice verification). Chip cards present additional advantages over other security alternatives as they provide both physical security (physical presentation of the card on demand, difficulty of reproducing the card, the chip and the data at the same time) and network access security (confidential code, verification of the legitimate holder’s biometric data, cryptographic authentication of remote systems etc.). Furthermore, chip cards address consumer privacy concerns by allowing card users to control access to sensitive information by storing it in their cards, which they keep with them and which are only presented when necessary.

For these reasons, numerous governments and public authorities have commenced implementing chip card-based systems in a wide range of areas. Since the events of September 11, 2001, security concerns have increased interest in proper and secure identification and consequently in secure identity applications. Governments, particularly the United States, have taken initiatives to analyze the implementation of microprocessor card-based systems for secure identification, including the use of biometrics, notably in passports and other national identity documents. Because microprocessor cards are capable of storing the physical traits used for biometric identification, such as fingerprints, hand geometry and retina scans, the use of these cards enhances the security of biometrics-based access networks by requiring each user to present both the card and the relevant physical trait at designated access points. According to Frost & Sullivan, 18 U.S. federal government agencies have launched 62 chip card projects for identity and physical and network access control. In addition, in 2001 the U.S. Department of Defense awarded a contract to a consortium including Axalto to develop and install a microprocessor card-based security network for all current and retired military personnel and their families, the Common Access Card project (CAC). According to Frost & Sullivan, it is currently looking into the use of contactless chip cards and biometrics in this project.

In Asia, Taiwan and Singapore deployed a chip-based national identity card in 2001. Hong Kong launched a multi-application identity microprocessor card with digital fingerprinting in 2003. Japan has launched a pilot program for a national microprocessor-based identity card. Other significant projects proposed or underway include the adoption of a microprocessor card-based system for drivers’ licenses in India and the first European rollout of microprocessor-based identity cards in Belgium. The International Civil Aviation Organization (“ICAO”) is currently looking into the incorporation of biometrics and recommends contactless chip card technology in the standards for the new generation passports to be adopted by all countries. This electronic passport will be in paper format, integrating a contactless microprocessor chip which stores biometric information and high-definition ID photographs. The United States has announced its intention to commence issuing passports that meet these ICAO specifications by October 2005.

In healthcare applications, France, Germany, Belgium and Italy have already developed chip card-based systems to improve service to patients and the information available to medical professionals, as well as to cut costs. France has issued more than 75 million health cards since 1998 as part of the Sesame Vitale and CPS projects. Germany, which has been using memory cards for many years to simplify the administrative duties of healthcare professionals, also recently launched a targeted initiative for the deployment of microprocessor-based health
Contracts for the implementation of projects for government administration products and services are typically long term and are offered through public tender and procurement procedures. These tender procedures often set out tailored specifications based on highly specific requirements. Because chip cards are usually only one of several components of a project, chip card manufacturers compete in these tenders in association with major system integrators and local partners to provide the cards and services required for these systems. Although a number of systems have been implemented and pilot programs launched around the world, the market for government, healthcare and identity chip card products and services is still in its development stage and the widespread deployment of chip cards in this area will depend primarily on governmental bodies taking the requisite political decisions and supporting the rollout of the required infrastructure.

Transportation

Chip cards used in mass transportation mainly consist of contactless cards, which provide an easy-to-use and cost-effective basis for high speed transactions. There is a small but growing market in this industry for high-end contactless microprocessor cards. Datamonitor estimates that 38 million chip cards were sold globally in the transportation market in 2002 and believes that global sales will reach 70 million units in 2006. The transportation market is highly fragmented, generally with one project per city, but growth in recent years has been high, due largely to the standardization and cost-effectiveness of contactless technology solutions and the increased focus on upgrading existing transportation infrastructures. In addition, contactless card solutions have lower maintenance requirements than paper-based ticketing systems in mass transportation. Recent opportunities in this market have included projects using contactless card technology such as the Oyster card in London, the Navigo card in Paris and the Octopus card in Hong Kong, as well as similar projects in other major Chinese cities, Japan and Brazil. The deployment of chip card solutions depends primarily on the full implementation of a new contactless ticketing system and related infrastructure and, as a result, the period between project decision and rollout is approximately two to five years on average. Once such systems are developed and thanks to their multi-application features, microprocessor cards may also allow for other contactless card applications in close proximity to the transportation centers, such as payment functions for retail purchases in train stations.

Network Access

Microprocessor card technology also allows users to access corporate and external networks, in order to identify themselves, send confidential encrypted messages and digitally sign transactions and documents. The principal drivers in the development of this market are heightened awareness of the risks relating to computer network integrity, as well as the need to protect information against theft or corruption, the need for an increasingly mobile workforce to transmit and consult data remotely and securely, the growing interconnection between computing systems and the need to safeguard against fraud. Datamonitor estimates that 14 million chip cards were sold globally in this market in 2002 and believes that global sales will reach 36 million cards in 2006. The latest generation of microprocessor cards has been designed to work with the most sophisticated security technologies, such as PKI systems, which are used to facilitate secure data transmissions and transactions. Microprocessor cards can store digital certificates that identify the different parties to secure transactions, as well as keys or complex algorithms that are used to encrypt information transmitted over the internet or network and to authenticate transactions. The need to be able physically to present a microprocessor card and to activate it with a confidential access code, as well as the tamper-resistant nature of microprocessor cards, enhances the security of microprocessor card-based systems compared to other software or key-based systems. In addition, because the digital certificate is stored on the microprocessor card and not on the computer, access to the network and certification or authentication does not require the user to be physically located at a particular computer terminal. Large corporations such as Merck and Schlumberger and governmental agencies such as the U.S. Department of Defense and the French Ministry of Finance currently use microprocessor cards for network security and access purposes.

Pay-TV

Microprocessor cards are used for pay-TV as an essential security tool to control subscribers’ access to pay-TV services, which are accessible only through set-top boxes or decoders. The microprocessor card enables the set-top box to perform several critical functions, such as decryption and the recording of subscriber information received from the head-end of a satellite, cable, digital terrestrial or other broadband-based network.
Additionally, the microprocessor cards record information about pay-per-view movies and events that the viewer has decided to purchase. At predetermined points, the information about these purchases is transmitted through a return path such as a cable or phone line to the broadcast database to allow for billing. Frost & Sullivan estimates that 30 million chip cards were sold globally in this market in 2003 and believes that global sales will reach 46.5 million cards in 2006.

The growth of encrypted television channels, satellite and cable packages, pay-per-view television, interactive television and television over the Internet is likely to increase demand for microprocessor cards in this market. In addition to subscriber growth, card renewal frequency is a significant factor in the growth of microprocessor cards in this market. Operators tend to enforce card renewals on average every two to three years to minimize the risk of card fraud.

**Prepaid phone cards**

The phone card market is the oldest segment of the chip card market and continues to be the largest segment in terms of volumes. Phone cards, which reduce fraud and vandalism and the costs of supply and maintenance of public telephony equipment, are mainly used in Europe, Latin America and China. The United States constitutes a small portion of the phone card market, as operators continue to rely on magnetic stripe cards and other types of prepaid phone cards.

Despite the large volumes of phone cards shipped every year, the relative lack of sophistication of these cards results in lower unit prices compared with microprocessor cards. In addition, this segment has declined significantly from more than one billion units in 2001 to 980 million units in 2002 and 961 million units in 2003, as consumers rely increasingly on mobile phones and calling cards to place calls when they are on the move. Datamonitor anticipates a further decline in this market and believes global shipments of prepaid phone cards will reach 895 million in 2006.

### 4.1.5.2 Emerging applications markets

There are currently a number of emerging applications for microprocessor cards. One of these is in the area of public wireless local area networks ("PWLANs") using the Wireless Fidelity standard. The Wi-Fi market is developing around three principal applications: ‘hot spots’ or PWLANs in public spaces such as airport waiting rooms, malls, coffee shops and hotels, corporate networks and internet access by individuals. Hot spots or PWLAN services in public spaces are offered mainly by mobile phone operators as an addition to their GPRS or 3G services. They present many of the same identification, subscriber and tariff management, authentication and security concerns that are addressed by SIM card technology. Mobile operators need to restrict access and use of the PWLAN to subscribers and, as the subscriber base grows, may wish to implement sophisticated subscriber management tools and roaming with other wireless networks and offer associated services. Because these concerns have already been successfully addressed through SIM card technology in mobile communications, many operators have already started to implement identification module-type technology for PWLAN services. More recently, several mobile communications operators have launched pilot PWLAN-SIM projects and, while few microprocessor cards have been deployed in this area, there have been tenders for microprocessor card supply contracts in the United States, France and Italy. The Wireless Local Area Network (WLAN) Smart Card Consortium, an industry consortium established to define specifications for worldwide access to wireless LAN networks with smart card security and related capabilities, has developed the WLAN-SIM specification, which details how microprocessor card technology can be used in a WLAN network.

Corporate WLANs, on the other hand, present many of the same security issues encountered in the network security and access segment. As corporations take advantage of WLAN technology to enhance flexibility in the working environment, the vulnerability of corporate networks to unauthorized access and use of confidential information increases. Microprocessor cards provide an appropriate solution to these problems by authenticating users and enabling secure data transmissions over the PWLAN through their encryption capabilities. Finally, the implementation of PWLAN technology by Internet service providers, or ISPs, also raises access and security concerns, as ISPs seek to restrict use of their broadband infrastructure, and by extension the PWLAN networks, to their subscribers, particularly in environments with large number of potential users, such as schools and university campuses. These concerns may also be addressed through microprocessor cards that provide the same functionalities as SIM cards. ISPs are not only a potential market for PWLAN, but also more generally for chip card manufacturers, as ISPs will require secure access to networks and m-commerce transactions. Microprocessor card technology is expected to play an important role in the development of each these new...
markets, which should in turn create new growth opportunities for chip card manufacturers.

Other areas of emerging applications include contactless technology and the protection of copyrighted digital material. There are a number of projects underway either to incorporate a contactless microprocessor chip into a mobile telephone cover or to create a contactless SIM card, thereby enabling a phone to act as an access badge or a public transportation ticket. Digital rights management using microprocessor cards is also currently being investigated. One approach would involve selling digital copyrighted information in encrypted form, for example to download news, digital music or video clips, with a unique microprocessor-based key for decrypting it, which could be used in a mobile device, an MP3 player or a stereo system.

4.1.5.3 Point-of-sale terminals

The market for POS terminals is large and growing, as virtually every card-based payment system, including magnetic stripe cards and chip cards, requires specialized readers to interact with the cards at points of sale. As a result, the POS market has traditionally benefited from the increasing use of cards to purchase goods and services and make payments around the world, particularly in countries such as the United States where a single person typically has more than one payment card. According to Frost & Sullivan, approximately 7.0 million POS terminals were sold worldwide in 2003, compared with approximately 6.4 million in 2002 and 5.9 million in 2001. In addition, the POS market is expected to grow significantly as existing magnetic stripe card payment systems migrate to EMV-compliant systems. This migration will require the deployment of EMV-compliant POS terminals to replace the existing base of non-compliant POS terminals, particularly in countries with high magnetic-stripe card penetration and in countries with legacy non-EMV payment systems such as France or Spain. However, the large product orders resulting from this migration are likely to put significant pressure on prices as international suppliers will compete to win contracts from large financial institutions.

This growth should occur as POS terminals become more sophisticated. Most POS terminals are already equipped with microprocessors that can perform electronic payment, inventory management, fraud prevention and marketing applications. Increasingly, POS terminals are used for client relationship management, or CRM, acting as gateways to client behavior, including purchasing behavior. Frost & Sullivan anticipates that POS terminal sales will increase to approximately 11.0 million in 2006.

4.1.6 Description of Axalto’s business lines

According to Gartner, Axalto was the leading provider of microprocessor cards in the world in terms of units sold in 2003. Its business lines and expertise cover the main areas in which chip cards are used.

Axalto has two main business lines:

- Cards, which includes chip cards, magnetic stripe cards, scratch cards, software and associated services for mobile communications, finance, public sector, network access and other products (which includes revenue from the licensing and intellectual property) and prepaid phone cards;

- Point-of-sale terminals.

The following table presents the breakdown of Axalto’s revenue by business line in 2002, 2003 and 2004.
(1) Includes revenue from the licensing of intellectual property.

The following table presents the breakdown of Axalto’s revenue by region in 2002, 2003 and 2004.

<table>
<thead>
<tr>
<th>Region</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(millions of US dollars)</td>
<td>(% of total revenue)</td>
<td>(millions of US dollars)</td>
</tr>
<tr>
<td>Europe, Middle East and Africa</td>
<td>387</td>
<td>53 %</td>
<td>403</td>
</tr>
<tr>
<td>Asia</td>
<td>216</td>
<td>30 %</td>
<td>220</td>
</tr>
<tr>
<td>North, Central and South America</td>
<td>127</td>
<td>17 %</td>
<td>145</td>
</tr>
<tr>
<td>Total</td>
<td>730</td>
<td>100 %</td>
<td>768</td>
</tr>
</tbody>
</table>

4.1.6.1 Cards

Mobile communications

According to Frost & Sullivan, Axalto is the largest provider of SIM cards for mobile communications operators in terms of the number of units sold in 2002 with a global market share of 28%. In 2004, Axalto sold 257 million SIM cards worldwide. The Company offers a complete range of products, including SIM cards, software and servers, as well as associated services including consulting, training and systems design and installation. Mobile communications operators use SIM technology to provide secure voice and data communications over mobile communications networks to their subscribers. Axalto also sells complete platforms integrating its microprocessor cards, software and servers.

To maintain its leading position in this market, Axalto constantly upgrades the capabilities of its SIM products and continuously develops new more sophisticated and powerful SIM products that enable mobile communications operators to enhance their value-added service offerings to their customers. In particular, Axalto’s newest SIM cards provide greater memory and processing capacity that permits more complex applications, security programs that can be downloaded and other additional features.

Axalto’s main SIM products incorporate the Java Card operating system, which is the most widely accepted open platform to run SIM-based services and has become the industry standard. Java’s open technology model offers many advantages to its customers, including interoperability and flexibility in working with application service providers permitting decreased time to market for new applications.

According to Datamonitor, global shipments for Java-based SIM cards are expected to grow at an annual rate of 25% from 2002 to 2006. Axalto has sold over 300 million Java-based SIM cards to date and has developed over 300 Java applications.

According to Frost & Sullivan, Axalto is the market leader for Java SIM cards.

Since the adoption of GSM in 1990, Axalto has provided increasingly sophisticated SIM cards for secure voice transmission to mobile communications operators around the world. The Company offers Over The Air Customizable (“OTAC”) SIM cards to mobile operators looking to provide basic voice services to their customers. Its OTAC cards are based on an OTA platform, which allows operators to install and manage applications on SIM cards remotely through a server. OTAC SIM cards connect with Axalto’s Aremis server or similar OTAC servers installed by the operators. They provide 16-32KB of storage capacity and allow operators to authenticate network users and to offer prepaid services, dual subscription and remote management and customization of the SIM card, including subscription activation, churn and network management and user parameter assistance and verification.

As the market for mobile voice transmission services matures, mobile communications operators are increasingly seeking to enhance their service offerings with new premium value-added services. These include, for example, SMS and MMS, which allow users to send text and image messages through mobile phones, email network access services or information on demand, such as weather reports, ring tones and stock quotes. Axalto’s current main SIM products, the Simera line of Java-based SIM cards, enable mobile communications
operators to respond to growing demand for these mobile data services and has been designed to include the SIM ToolKit standard, which facilitates the development and installation of new Java-based applications on SIM cards and allows the card to send orders to the telephone, for example to send a message or display a menu.

The main Simera product, the Simera Classic, which integrates remote management functions using an OTA platform and can also be connected to the Aremis server, provides 16-256KB of data storage capacity intended primarily to safeguard the user’s personal data, such as the address book. This solution can also be used for value-added applications, remote card and applet management, managing user subscription parameters and downloading and installing applets on the SIM card for access to new premium services.

Within the Simera card range, Axalto also offers several SIM cards with a high level of data storage capacity and processing power that enable mobile communications operators to take full advantage of the increased capabilities of 2.5G networks, the precursor to UMTS or 3G networks. For example, its Simera N@vigate and Simera WIB products incorporate browsing capabilities using S@T and WIG technologies respectively, enabling access from a mobile phone or other mobile device to a wide range of internet content. The Simera e-motion card incorporates the internet browsing capabilities of the Simera N@vigate product together with enhanced security features to enable secure mobile commerce transactions.

Axalto has also developed SIM-based solutions to address the difficulties encountered by mobile communications operators in allowing users to roam between networks with different technologies and minimize their operating costs by using a single platform that is independent of the network technology. The Simera Airflex solution, which consists of a high-end Java-based R-UIM and SIM card, enables users to roam between GSM and CDMA networks, while the Simera GAIT solution, which is a high-end Java-based GAIT and SIM card, allows TDMA networks users to roam between GSM and TDMA networks. In 2001, Axalto was awarded an Advanced Card Award for Best Communications Implementation by a panel of experts at the Smart Card London international chip card fair for its Simera Airflex solution produced for Korea Telecom Freetel, making it the first mobile operator able to offer its subscribers interoperability between CDMA and GSM networks.

In anticipation of the expected rollout of third-generation networks around the world, Axalto has developed a new line of cards with enhanced memory capacity and processing power for a broad range of sophisticated applications. The Usimera line of cards includes UIM cards for use in CDMA2000 networks and USIM cards for use in WCDMA networks. The Company launched its first Usimera USIM card in 2000, which has been used in the majority of UMTS pilot programs. Axalto is currently supplying Usimera USIM cards to several major mobile communications operators that are launching UMTS networks, including Hutchinson 3, J-Phone and KDDI in Japan. Its Usimera cards have also been tested and selected by more than 15 mobile operators in connection with their UMTS projects.

Axalto also provides a range of software tools to support operators and service providers in delivering state-of-the-art voice and data transmission services. Axalto’s leading position in Java technology allows it to offer full compliance with the latest standards for over-the-air downloading, source code development and interoperable applet loading and processing. Axalto’s main software development product for customers wishing to create SIM card applications is the Visual Integrated Environment for Wireless Smart cards (“VIEWS”), which is a PC-based suite of tools that provides a range of development and testing capabilities. The VIEWS software is designed to work with SIM, USIM and UIM cards, as well as with roaming cards from any manufacturer and gives operators the flexibility to choose between individual components or a pre-integrated set of tools.

Axalto’s customer software development department of approximately 100 engineers is dedicated to developing specific applications. These developers work principally in the mobile communications business but may also design applications for other business lines. They are located, as much as possible, near customers in order to simplify interactions and shorten time to market.

Axalto intends to continue to develop its extensive product portfolio in order to anticipate and address the evolving needs of mobile operators with high quality technologies and a common software platform across the product range, which should save it significant research and engineering expenses. Axalto is currently developing a set of associated software to complement its SIM card product offering in order to facilitate the integration of SIM-based solutions into the operator network. It is also developing the Extensive Authentication Protocol using a Subscriber Identification Module (EAP-SIM) product line, which enables operators to provide their customers with secure access to Wi-Fi networks or PWLANs, joint billing of GSM and PWLAN services and the possibility of combined voice and data services via the GSM network and data services using the Wi-Fi
network. The EAP-SIM microprocessor card enables end-user authentication, secure access, interoperability and single billing, and is compatible with the Simera and Usimera product ranges. Finally, the Company is also developing a Usimera Hybrid card, which incorporates USIM technology in a contactless radio frequency chip (which will work without a battery) giving users the ability to benefit from a single, highly secure card providing access to remote services including e-payment, public transport and office access.

Axalto’s other mobile communications products are scratch cards, which are sold to mobile communications operators that desire a single supplier for all of their card needs. Scratch cards are laminated plastic cards with a scratch-off panel that covers numbers or codes necessary to activate a wireless subscription or to top up a prepaid subscription. To use the card to make a phone call, the user would scratch off the panel, dial a toll-free number indicated on the card and type in the code revealed to increase the value of the prepaid account. Axalto does not consider scratch cards to be a strategic area of its business but offers them as part of a global solution to mobile operators.

Financial cards

According to Frost & Sullivan, Axalto is the world’s leading provider of financial chip cards in terms of the number of units sold with a global market share of 28% in 2003. It further strengthened its leadership with the acquisition in 2001 of Bull subsidiary Bull-CP8, a forerunner in the area of financial chip cards.

Axalto’s products are designed to comply with the principal industry standards for financial cards, such as the EMV standard for credit and debit cards. In addition, the Company’s microprocessor cards have been certified by major financial institutions and industry organizations, including APACS (United Kingdom), Banksys (Belgium), GIE Cartes Bancaires (France), Malaysian Electronic Payment System (MEPS) (Malaysia), MasterCard, People’s Bank of China (China) and Visa. Its e-purse cards have been certified by BMS (France) MasterCard-Mondex, Proton and Visa. One of Axalto’s main competitive advantages in this market is that a substantial proportion of its products comply with the various standards used by previous generations of payment systems, which are known as legacy standards, as well as EMV. This flexibility enables its customers to issue more versatile cards that can be used in a broad range of different payment systems around the world, as well as to ensure a smooth transition to the new EMV standard.

Axalto’s offering to financial institutions includes cards that incorporate an open platform system, such as Java Card or Multos (whose specifications are determined by Maaesco, an industry-wide financial consortium). This platform allows the card issuer principally to load new applications onto the card after it has been issued, which enables issuers to offer new services or features to their clients rapidly and without having to incur the cost of supplying replacement cards.

Axalto’s product offering of financial cards is divided into three main categories:

- credit and debit cards;
- e-purse cards;
- multi-application cards.

Services offered by Axalto include card personalization, which is important for establishing close relations with customers in the financial card market, and other ancillary services, such as consulting and professional services related to financial card systems, including migration to EMV.

Credit and debit cards

Axalto’s broad range of credit and debit cards are both EMV-certified and designed to accommodate national payment systems. Its principal state-of-the-art EMV-certified product is the e-Galleon range of cards. These cards can implement the two most widely-used EMV applications, VIS from Visa and M/Chip from MasterCard, and have been adapted to a number of national payment systems, a feature which is particularly important during the various transition periods that accompany EMV migration. Axalto markets its e-Galleon products principally in the United Kingdom, Italy, Brazil, Spain and Eastern Europe.
The Multima line of financial cards is designed for the French banking market. These cards are EMV-compliant, are certified by GIE Cartes Bancaires and have received the Common Criteria EAL4+ security certification, which is currently a high security rating based on an international security measurement system used in Europe, Canada, Japan and the United States. Multima cards also integrate the Moneo e-purse application used in France.

The Qianflex card is a credit and debit card for the Chinese market that may be customized to permit other functions, such as e-purse and storage of personal data. In addition to banking, it is used in a number of industries in China, including retail, health insurance and other government services such as payment of traffic fines. Qianflex is compliant with Chinese standards, including the specifications of the People’s Bank of China.

Axalto also sells magnetic stripe cards, principally in North and South America, as a complement to its microprocessor financial cards, the market for which is in its infancy in these regions. Axalto decided several years ago to prioritize its microprocessor card products in the financial services market and has redeployed part of its capacity for magnetic stripe cards towards the production and sale of microprocessor cards to improve the margins typically generated in this business.

E-purse systems

Axalto is developing and marketing a full range of e-purse cards that store cash values and can be used for payments. Its main range of cards, the Prismera line of cards, complies with the Proton standard and provides a flexible platform for the entire spectrum of e-payment applications, including withdrawal, credit and e-purse applications, as well as PKI-based authentication functions, for example, for secure payments made over the internet. The Company has also developed an e-purse product called CashCard which is fully compliant with NETS standards, the most commonly accepted cashless payment method in Singapore, and an e-purse product with payment, identity and loyalty functions called Payflex, which is used principally as a loyalty card by large retailers and as an e-purse card at casinos.

Multi-application cards

The Palmera range of multi-application cards is based on the Java open platform and can be used for a range of functions, including credit and debit, e-purse, loyalty schemes, personal data storage and PKI-based applications for remote banking. The Palmera open platform architecture allows customers to add, upgrade or delete applications through a simple, secure downloading process without needing to reissue the card. Axalto is currently providing multi-application financial cards for the Yoido financial district of Seoul, South Korea, as part of a Visa program to migrate from magnetic stripe to smart card technology. Six Visa card members, which account for 90% of Korea’s domestic financial card market, are participating in the pilot program. Depending on the issuer, the cards will feature options such as credit/debit, loyalty applications and chip card-based e-commerce.

Personalization and other services

Axalto provides card personalization services to its customers in the world’s major financial centers, including France, the United Kingdom, Spain, Hong Kong, the United States, Mexico and Brazil. Axalto has the capacity to process large (regular replacement cards) or small (new and lost cards) orders in secure personalization centers located close to its customers in order to diminish delivery time. Through these personalization centers, the Company provides customers with a wide range of electrical and graphical personalization services, including embossing, secure laser printing, signature panels and photos, secure key generation, data loading and magnetic stripe encoding. Axalto also provides a secure PIN mailing service. Finally, it sells personalization software and equipment to financial card issuers that wish to perform their own card personalization.

In addition, Axalto provides a wide range of consulting services, including design of technical specifications for cards, personalization solutions, project management and application development. It also provides consulting services in connection with customers’ migration to EMV standards.

New financial applications

The Company dedicates a proportion of its research and engineering resources to developing new applications for financial cards. Axalto combines its expertise in financial cards and mobile communications (to enable, for example, mobile banking and commerce) as well as security and access. One of the newest applications includes
the use of e-gate technology, which enables financial cards to interact with personal computers through a built-in USB interface for home banking and e-commerce with a higher level of security (see Public Sector, Network Access and Other Products). In addition, Axalto recently developed a dual-interface (contact and contactless) microprocessor card for the new contactless payment and ticketing systems of Visa and MasterCard Paypass.

Public sector, network access and other products

Axalto designs and develops identity, security, access and privacy solutions based on chip card technology for a wide range of governmental, public sector and corporate applications, including controlled access to facilities, networks and public services and the secure exchange of information. Its products have been certified by a number of major bodies and industry organizations, which allows it to meet the most stringent criteria imposed by governments, public authorities and corporations in selecting suppliers (see paragraph 4.5 - QUALITY, SECURITY AND STANDARDS).

Public sector

Government, healthcare and identity

Axalto designs and develop microprocessor card systems for a wide range of governmental and public sector applications, including drivers’ licenses, passports and other identity documents, as well as public healthcare and social security. The public sector is a promising market for microprocessor card applications as governments seek to implement an ever widening range of online services requiring a highly secure platform that protects their citizens’ privacy and as governments find chip cards a simpler way of streamlining the administrative process of and costs involved in, for example, the distribution of social security benefits. Applications being developed in the on-line government market include electronic identity cards, social security cards, drivers’ licenses, passports, visas, certified digital signatures, entitlement cards for public service beneficiaries and microprocessor cards for public service employees.

The ICitizen card, which is a highly secure and easy-to-use identification card that provides access to e-government applications, consists of a customized microprocessor card that combines a secure card body with a range of security features (including PKI-based authentication), a large memory capacity, and an interoperable open Java operating system that enables the deployment of additional applications, whether or not developed by Axalto, after the card is issued.

It also provides a variety of access mechanism options, ranging from a PIN code to sophisticated biometric systems such as digital fingerprints or retina scans. The Malaysian government recently selected Axalto to supply the operating system for its multi-application citizen card, which includes identification applications, such as drivers’ licenses, passports and health information, a PKI-based digital signature application and an e-purse. To date, more than two million cards have been sold under this project. Axalto also provided the operating system for the Belgian national identification card (“Bel PIC”), the first major European rollout of personal identification microprocessor cards. The Company has also been selected to supply microprocessor cards in the initial stage of deployment of microprocessor card-based driver’s licenses in India, which is expected to occur in 2005. In addition, Axalto also designed the operating system for the European digital tachograph project that will replace existing paper-based driving time and speed records with microprocessor cards.

According to the Nilson Report, Axalto was the leading provider of healthcare microprocessor cards worldwide in 2002 with 6.9 million units sold. These cards allow healthcare and health insurance providers to securely access and manage medical and insurance information, while at the same time ensuring the security and confidentiality of medical records. Health cards also help governments to understand and control healthcare expenses through better information management and reduced paperwork. The security features of these cards also help healthcare providers reduce medical fraud. Axalto was chosen to supply microprocessor cards for the French health system in 1988, which was the first tender for a microprocessor card-based nationwide health management system in the world. Since 1988, it has been a key player in the development of the microprocessor card-based French health system, including the creation of the GIE Sesame Vitale card (patient card) and GIP CPS card (health professional card) in 1998, which permits patients and doctors to submit insurance claims and related healthcare administrative documents securely online. As of December 31, 2003, the Company had sold 33 million out of a total of approximately 75 million healthcare microprocessor cards issued under the Sesame Vitale and CPS projects. On November 2, 2004, Axalto announced that it had been selected to supply all two million for the Puerto Rico Department of Health’s new healthcare microprocessor card (“Tarjeta Inteligente De
Salud”) program. The project covers the entire Commonwealth of Puerto Rico and is the largest rollout of healthcare smart cards in North America to date.

Axalto is also involved in the design and realization of security systems using biometrics and has developed an entire range of microprocessor cards integrating biometric technology. It is also involved in setting future standards for biometrics, working closely with the key players in this field.

On October 14, 2004, Axalto announced that it had been pre-selected as one of a limited number of potential suppliers by the United States Government Printing Office (GPO) to provide technology for electronic passports. The electronic passport technology developed by Axalto includes certified operating software with biometric capabilities that meet the highest security standards, running in a large capacity contactless electronic chip embedded in a module that is highly resistant to damage, which is integrated in the passport cover.

Transportation

Axalto has been a pioneer in the use of contactless chip cards and related technologies in mass transportation since 1997. The Company currently offers a range of products from contactless cards to dual-interface (contact and contactless) multi-application cards.

The Easyflow line of contactless memory cards addresses the market for mass transportation applications, which is characterized by high customer volumes and the need for high transaction speed. Axalto is currently supplying Easyflow cards for London Transport’s Prestige project, which is one of the largest projects currently underway in Europe. It has sold approximately 2.5 million cards for this project to date.

Axalto participated in the development of the first dual-interface microprocessor card in 1997, which was subsequently deployed worldwide as the Easyflex product line. The Company is currently one of the providers of contactless microprocessor cards to the RATP, which operates the Paris region metro and bus network, and the SNCF, the French national rail company, and its Easyflex products have been deployed in a number of public transportation projects around the world, such as in Kuala Lumpur (Malaysia), Aberdeen (United Kingdom), Curitiba (Brazil) and Matkahuolto (Finland). The Easyflex line of cards also includes multi-application cards that allow transport operators to provide a range of additional services to passengers, such as parking and municipal services (for example, library or swimming pool access), and to remotely update the information and applets on the card. Axalto intends to focus increasingly on the small but growing market for high-end contactless microprocessor cards, which are of greater interest in terms of features and value than memory cards in this segment.

Axalto also produces a line of contact memory cards for pay parking applications called Primeflex. These cards are mainly sold to operators of parking facilities, including municipalities.

Network Access

Axalto produces a range of microprocessor cards, readers and development tools incorporating PKI technologies to provide authentication and network and information security functions as well as physical access on a single card platform. The need for online security and the growing use of computer networks, both internal and external, by corporations around the world makes network security a growth market that Axalto is well positioned to address thanks to its product portfolio and technology.

Major corporations use the Cryptoflex line of microprocessor cards and access badge solutions providing security features for intranet applications, including secure access, authentication and data transmission through encryption technology as well as physical access and other company management applications. Cryptoflex cards integrate the highly secure Cryptoflex operating system and Axalto has also developed various Cryptoflex products that are capable of working in Java and Windows environments. The Cryptoflex card for Windows 2000, for example, was the first ‘plug & play’ ready microprocessor card to provide the built-in security functions of Microsoft Windows 2000, which allows the card to provide secure log-on, email encryption, digital signature and secure Virtual Private Network (“VPN”) functions in the Windows environment without requiring the installation of additional software. Cryptoflex products are currently used by Axalto’s large corporate clients including Texaco, Nissan, Procter & Gamble and Shell.
The Cyberflex range of Java-based microprocessor cards enable multi-application and comprehensive network security applications, and have been certified for digital signature applications, complying with EU directives for digital signature. Axalto is a member of the consortium that won a major contract for the design and development of a security system for the U.S. Department of Defense in 2001 and has supplied several million Cyberflex Access 32K microprocessor cards under this contract since then. These cards are used as employee access badges that, using advanced cryptographic technology, control physical and computer network access by the Department’s employees. Because of the well-known stringent security requirements of the U.S. government, this project represents a significant milestone in the introduction of microprocessor card technology in the U.S. market and a convincing precedent for other governments and large corporations.

To facilitate the deployment of Cryptoflex and Cyberflex products in corporate and other networks, the vast majority of which are PC-based, Axalto pioneered the development of the first USB-enabled microprocessor card in the industry in 2001. Axalto’s e-gate technology consists of a microprocessor chip that integrates all the necessary USB interface electronics onto the chip to enable cards to connect to and interact with PCs through a simple connector without requiring the insertion of the card in a special and expensive card reader. The e-gate technology also takes full advantage of the fast communication speeds offered by USB, an increasingly important feature for applications such as internet services for which a card needs to hold or process extensive amounts of data in an encrypted form. This technology is compatible with all microprocessor card operating systems, including Java, Cryptoflex and Windows, and may be used in a number of applications beyond network security, such as financial card applications for remote banking and e-commerce.

On November 16, 2004, Axalto announced the first commercial deployment of its .NET-based smart cards to help secure access to Microsoft’s corporate network. Axalto’s Cryptoflex .NET powered smart card is a compact version of Microsoft’s .NET environment. It provides customizable, secure and ultra-miniature authentication similar to that usually found in a PC-based system, as well as a full range of cryptographic capabilities, accessible via the standard Microsoft .NET programming tools and interfaces. Microsoft marks the first enterprise deployment of the Cryptoflex .NET powered smart card.

Pay-TV

According to Frost & Sullivan, Axalto was the second-largest producer of microprocessor pay-TV cards in the world in terms of number of units sold in 2003. It sells its microprocessor pay-TV cards to conditional access providers (“CAPs”), which include the cards in their security and access solutions that enable cable and satellite television companies to regulate and control access to broadcast content and complementary services, such as video-on-demand, provided over cable and satellite television networks. For the most part, chip specifications are designed and standardized by the CAPs. Axalto is currently looking into developing new value-added products and services in the pay-TV market.

Prepaid phone cards

According to Frost & Sullivan, Axalto was the second-largest supplier of phone cards in the world in terms of number of cards sold in 2003. It has sold close to three billion phonecards since entering the phone card market in 1981.

Axalto offers a complete range of phone cards from the highest-specification security cards to simple memory cards. It also offers off-line card authentication security solutions for public telephones utilizing its SAM (“Security Access Module”) product. The Company also provides scratch cards for prepaid fixed-line public telephone services, principally in Central and South America.

The phone card market is reaching maturity and has entered into a period of decline. Although it does not constitute a strategic priority, the Company intends to maintain its ability to process high volume orders of phonecards, with a production capacity that may be re-assigned to process microprocessor card orders (see paragraph 4.1.8 – Production).

4.1.6.2 Point-of-sale terminals and hardware

Axalto offers a complete range of point-of-sale terminals, systems and software and related services, such as consulting and customization, primarily to financial institutions and payment clearance processors. With over 20 years of experience in this market, Axalto markets and sells its POS terminals and hardware through established
commercial links including direct sales to banks, indirect distribution through its sales team or through leasing to retailers. Axalto sold approximately 278,000 terminals in 2004, compared with 210,000 in 2003 and, according to Frost & Sullivan, its global market share in this segment in 2003 was 3.5% in terms of number of units sold and it was ranked sixth in the world.

Axalto’s product offering includes the MagIC line of multi-application terminals and MagIC Evolution software and servers. These terminals offer a range of integrated security, memory and battery communication and printing features to suit various market applications. The MagIC product line has been designed to meet the various mobility needs of a wide range of customers, including fully mobile terminals for delivery, taxi and health services and portable, semi-portable and desktop terminals for restaurants, retailers, hotels and other commercial businesses around the world. In November 2003, capitalizing on its mobile terminals expertise, Axalto introduced a new range of Wi-Fi enabled wireless POS terminals which can accept both off- and on-line remote payment transactions from a docking station at a distance of up to 100 meters. These Wi-Fi enabled POS terminals offer considerable cost savings by eliminating the need for wired lines. The MagIC range also includes terminals that enable larger retailers and supermarkets to integrate a large number of terminals into a single, PC-based network of cash registers and payment points. The MagIC line of terminals is EMV compliant, which will offer users a smooth and cost-effective transition to EMV-compliant systems and will position Axalto to take advantage of the opportunities provided by the worldwide EMV migration. In November 2003, the MagIC 6100 payment terminal was the first POS terminal to receive French EMV certification by GIE Cartes Bancaires in France. Axalto was also the first POS supplier to obtain certification for EMV specifications in France, which has been adopted gradually by French banks since 2004.

MagIC terminals incorporate the MagIC Evolution multi-application platform which allows multiple payment and other value-added applications to run independently on the same terminal. Axalto also sells the MagIC Software Development Kit, which helps users to develop specific software applications that can be used by any Axalto terminal, the MagIC Management System for the management of large installed bases of terminals, and the MagIC EMV Pack, which aids customers in building EMV-compliant applications. In addition, Axalto offers consulting, training and assistance for all of its MagIC products.

4.1.7 Geographical presence

Axalto is a global company with operations and facilities throughout Europe, the Middle East, Africa, the Americas and Asia. Its global operations are organized into three geographic regions: Europe, the Middle East and Africa; North America, Central America and South America; and Asia.

As of December 31, 2004, Axalto had 11 production facilities, nine technology centers and approximately 50 sales and service centers in 35 countries.

4.1.8 Production

The ability to develop, optimize and upgrade its production facilities to improve productivity constitutes a major competitive advantage for Axalto.

Its production operations are organized on a global basis with a view to achieving quality and cost-efficient production and minimizing time to market for customers. The same production practices and similar machinery are used in all production centers, which makes it possible to move orders and equipment from one center to another, reduce production time and adapt capacity at minimal cost. These production centers are designed around a ‘virtual factory’ concept, which allows Axalto to allocate production capacity on a global basis as necessary to meet surges in demand for particular products in particular regions, without having to install maximum production capacity in every region and for each product type. In addition, its equipment allows it to shift production facilities from one center to another to manage regional growth and from one product type to another to optimize delivery of a more profitable product line. This also provides the possibility of temporarily dedicating production lines for microprocessor cards to handle memory cards and vice-versa. Global production needs are evaluated on a monthly basis.

Axalto is able to process small- and medium-sized orders of 1,000 to 50,000 cards on a ‘fast line’ basis with an average delivery time of less than two weeks as well as large orders of 100,000 to 500,000 cards with an average delivery time of four to six weeks.
Axalto’s expertise extends to all aspects of chip card production and services, including:

- **Design of microprocessor operating systems.** Axalto has approximately 200 engineers and software developers dedicated to the design and specification of secure operating systems (“Oss”) for chips. Because the OS is engraved in a silicon read-only memory at the time of production and hence cannot be modified at a later time, it is essential that it be free of defects. The OS manages the various elements of a chip such as memory, communication interfaces and crypto-engines, and provides a standard interface to applications. Oss were initially developed in native programming languages that were specific to an application, which had the effect of restricting software development to those who possessed the programming codes and ultimately limited the number of applications that could be brought to market. Axalto revolutionized chip OS design by introducing a Java-based virtual machine that separates core OS functions from applications and enables the development of new applications using a standard programming language, which increases the number of applications and the speed with which they can be brought to market, and enhances the interoperability of microprocessor cards, which allows a single device to interact with cards made by different manufacturers.

- **Chip design.** Axalto works with its main suppliers to design chips that meet market requirements, including chip geometry, speed and circuit and architecture design. It has dedicated a part of its research and engineering activities to the specification of chip designs which can add value to its products.

- **Personalization.** Axalto provides personalization services that consist of a graphical aspect (the appearance of the card) and an electronic aspect (the data and software - including end user information - stored on the chip) at its personalization centers located close to its customers around the world. Data and application parameters are transferred to the card in encrypted files in a highly secure environment. Axalto’s graphical personalization techniques include embossing, laser engraving and inkjet printing of identification numbers and user information such as photos, names and barcodes on the card body as well as anti-counterfeiting and tamper-proof features such as hidden holograms and special ink marks.

Axalto is also one of the few chip card companies with the necessary expertise in microelectronics technologies to manufacture the micromodules (from silicon chips) that are embedded in the card body to form a chip card.

Axalto is seeking to protect its ideas and expertise through the appropriate use of its intellectual property rights. It licenses out a large part of its expertise in order to encourage development of the use of chip cards, which generally compete with alternative technologies such as secure papers, magnetic tickets and software solutions in the main markets.

As of December 31, 2004, Axalto operated 11 card production centers with a global annual production capacity of over 700 million cards, located in France, Spain, the United Kingdom, the United States, Mexico, Brazil, Hong Kong and China. All of these centers have microprocessor card production and card personalization capabilities.

In the second quarter of 2003, Axalto sold and outsourced its POS terminal manufacturing operations in order to keep its POS activities concentrated on the design, marketing and sale of POS products (see 4.1.9 - Suppliers - Point-of-Sale Terminals).
4.1.9 Suppliers

Axalto obtains the materials and components necessary for the production of its products, including silicon chips, the plastic bodies for the cards and any other necessary production materials from a number of suppliers. In 2004, its five main suppliers (Atmel, Infineon Technologies, Renesas Technology, Samsung and STMicroelectronics) and its 10 main suppliers provided 72% and 82% respectively of production materials.

Cards

The three primary elements of a microprocessor card are the plastic body, the chip and the printed circuit, each of which Axalto procures from third-party suppliers. The Company’s major suppliers are as follows:

- **For chips:** sourcing is extremely critical and is dependent on a combination of market leadership, technology and volume. Axalto obtains chips from the major silicon vendors with microprocessor card expertise such as Atmel, Infineon Technologies, Philips, Renesas Technology (formerly Hitachi Semiconductor), Samsung and STMicroelectronics. No supplier provides more than one-third of the Company’s global annual microprocessor needs. In order to minimize the risk of shortage and to secure better prices, as well as to provide natural hedging of a proportion of currency risks by paying suppliers in the same currency as is used for invoicing end customers, Axalto has implemented a multi-sourcing policy for its main products. In addition to building a strong supplier base to enable it to meet its chip needs from a variety of sources, the Company has developed a flexible software base that allows development teams to adapt quickly to different types of microprocessor while maintaining a level of functionality, quality and optimal security. This versatile platform helps Axalto to minimize the risk of chip shortage by allowing it to adapt to fluctuations in market supply trends.

- **For the plastic body:** Axalto obtains plastic from BASF, Dow Chemical, EVC, General Electric, Klockner and Lucchesi. These companies are long-term partners and have demonstrated their ability to comply with strict criteria in terms of mechanical characteristics and chemical purity for materials required for the card body.

- **For printed circuits:** Axalto’s main suppliers are FCI (a subsidiary of Areva), IBIDEN and Tyco Electronics. The printed circuit is an essential component for the life of the card and must possess a high resistance to corrosion.
Axalto has a dedicated and experienced team handling its logistics and supply chain management. This team contributes to the Company’s product strategy, supplier and component selection, risk evaluation, pricing and overall supply chain management.

**Point-of-sale terminals**

In August 2003, Schlumberger sold its production facilities for a variety of products, including POS terminals, to Flextronics, a leading provider of outsourced electronic manufacturing services headquartered in Singapore. As a result of this transaction, Schlumberger entered into a supply agreement with Flextronics pursuant to which Schlumberger is obligated to purchase, on behalf of its various businesses (including Axalto) from Flextronics a specified overall amount of products and services each year (including POS terminals) for a period of six years from 2003 to 2008 and/or to pay Flextronics an indemnity corresponding to the amount of products and services that have not been bought according to the terms of the agreement. Pursuant to the Separation Agreement between Axalto and Schlumberger, Axalto has undertaken, subject to certain conditions, to pay part of the indemnity owed to Flextronics in the event that the minimum buying obligations are not fulfilled. Through Flextronics’ broad geographic presence, Axalto is able to better meet local manufacturing requirements and decrease time-to-market. The Company also benefits from Flextronics’ size and scope of activities in terms of its bargaining power with respect to suppliers of terminal components, which it expects will reduce its production costs.

4.1.10 Customer

Axalto has a wide range of customers in over 100 countries. Its customers consist mainly of mobile operators, financial institutions, corporations and public sector bodies and agencies, including public transport operators. Its principal customers in each of its major business lines are:

**Cards**

- **Mobile communications**: Bharti, China Mobile, China Unicom, Cingular, Globalcom, Hutchison, Telcel Mexico, Mobile TeleSystem, Telkomsel and Vodafone;
- **Financial cards**: Barclays, CCB (Commercial Bank of China), CEDICAM (Crédit Agricole), ICBC (Industrial and Commercial Bank of China), La Poste, Lloyds TSB Bank and Royal Bank of Scotland;
- **Prepaid phone cards**: China Netcom, Etisalat, Nile Telecom and Telmex;

**Point-of-sale terminals**


In 2004, Axalto’s main customer represented approximately 5% of total revenue and its top five and top 10 customers represented approximately 22% and 34% respectively of total revenue. Most of them are mobile communications operators but they also include customers from the financial services and public sector and access markets.

4.1.11 Sales and marketing

Axalto’s sales and marketing team consisted of approximately 675 people as of December 31, 2004. Its regionally based sales team is responsible for field sales and marketing efforts directly with customers and for managing the Company’s participation in tenders, as well as preparing sales forecasts on a monthly basis and other market information submitted to the central product marketing organization. The regional sales teams also provide on-site technical support to customers. The central product marketing organization is responsible for determining pricing strategy, cost analysis, product launches, product lifecycles and overall marketing strategy.
The objective of Axalto’s marketing and communications efforts is to promote and strengthen, globally and across all of its markets, its position as a partner of choice in the chip card and point-of-sale terminals businesses. In addition to direct customer contacts through the sales force, Axalto’s strategy is to reach out to customers through marketing initiatives targeted at particular geographic regions, customers or markets, including through direct mailings (about, for example, innovative products and new applications) and specific customer events. Axalto also participates routinely in major industry trade shows, including, most importantly, the Cartes Show held annually in Paris, the CardTech/SecurTech (“CT/ST”) trade show in the United States, Card Asia in Asia and the GSM World Congress held each year in southern Europe.

4.1.12 Competition

Cards

The chip card market is highly competitive. Axalto faces competition from chip card manufacturers, software developers, security product and service providers and chip manufacturers. Because chip card activities were initially developed in Europe, Axalto’s key competitors are European chip card manufacturers, most of which have operations in more than one region around the world. Regional competitors exist also in Asia, more frequently with respect to lower-end products such as phone cards and basic SIM cards. Axalto believes that the size of the Asian market, in particular the Chinese market, will lead to the emergence of one or more large international competitors from the region.

The table below sets forth Axalto’s and its main competitors’ respective shares of the global microprocessor card market based on units sold in 2003:

<table>
<thead>
<tr>
<th>Market share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axalto .................</td>
</tr>
<tr>
<td>Gemplus .................</td>
</tr>
<tr>
<td>Giesecke &amp; Devrient ......</td>
</tr>
<tr>
<td>Oberthur Card Systems ...</td>
</tr>
<tr>
<td>Orga ................</td>
</tr>
<tr>
<td>Incard ................</td>
</tr>
<tr>
<td>Other .................</td>
</tr>
<tr>
<td><strong>Total</strong> .............</td>
</tr>
</tbody>
</table>

Source: Gartner.

According to Frost & Sullivan, Axalto is also the second-largest provider of chip cards in the world in terms of units sold with 21% of the global chip card market in 2002 (comprised of microprocessor cards and memory cards). The other major chip card manufacturers are Gemplus, with a market share of 28%, Giesecke & Devrient, with a market share of 17%, as well as Oberthur Card Systems (7%), Orga (5%) and Incard (3.4%). However, due to the diversity of these competitors’ regional coverage and the volatility of the results of tender offers from customers, there are major disparities between and strong volatility in national and regional market shares.

Axalto’s customers and the companies with which it has strategic relationships may become competitors in the future. For example, STMicroelectronics acquired Incard in May 2003 with the intention of participating in the entire chip card value chain and offering a complete range of products and services from chip to card. While the long-term effects of this acquisition are uncertain, it seems that this acquisition will not change the competitive landscape significantly in the short term, as Incard will continue to be a major competitor and will not win additional market share purely as a result of this acquisition.

Mobile communications

The market for mobile communications products and services is characterized by intense competition and rapidly changing technology. Because competition among SIM card manufacturers for sales of basic or lower-capacity SIM cards is based mainly on prices, the market for these earlier generations of SIM cards has become commoditized. Although it is not Axalto’s strategy to increase its market share in the low-end SIM card market, it is determined to defend its position principally by leveraging its market experience and efficient global production process. As the average selling prices of earlier generations of SIM cards decline due to the effects of intense competition, SIM card manufacturers, including Axalto, are continuously looking to develop and market new generations of microprocessor cards with greater capabilities to mobile communications operators willing to
pay higher prices for the additional features and functionalities. Axalto also leverages its market experience and track record in innovation, investing heavily in research and engineering. Other microprocessor card manufacturers, however, regularly bring competing products to market a short time after Axalto launches its new products and these new product generations gradually become subject to intense price competition as similar products become widely available (see paragraph 5.1.2 - Principal factors affecting revenue — Cards division, for a discussion of the impact of this competitive cycle on Axalto’s operating income).

According to Frost & Sullivan, Axalto is the leader in this market with a global market share in SIM cards of 25.7% in 2003 in terms of the number of units sold, followed by Gemplus with 25.4% and Giesecke & Devrient with 15.3%. In 2004, Axalto sold 257 million SIM cards over the full year. Its other main competitors in this market include Orga, Oberthur Card Systems and Incard, as well as a number of local or regional manufacturers such as Setec, XponCard and Microelectronica in Europe or Datang, Eastcom and Watchdata in China.

**Financial cards**

The financial cards market, which includes chip cards and a variety of magnetic-stripe cards, is fragmented and characterized by intense competition. The financial chip card market is currently concentrated mainly in Europe, where competition is based primarily on price, card features and the ability to provide loyalty and CRM support services locally, as well as the quality and specificity of personalization services. According to Frost & Sullivan, Axalto is the leader in the financial chip card segment with a 28% market share in terms of units sold in 2003, followed by Oberthur Card Systems (23%), Gemplus (21%) and Giesecke & Devrient (14%). However, Axalto is a significantly smaller player in terms of volume in the financial cards market as a whole (including magnetic stripe cards for financial institutions sold worldwide), in which there are also a number of non-European, international, regional and local competitors such as Colorado Plastic, Dai Nippon Printing and Plastag.

**Public sector, transport, network access and other products**

The market for public sector, transportation, network access and other products is currently in its development stage. It is characterized by competition with a wide range of alternative technologies. There are a number of nationwide contracts for identification and security chip card-based systems that are currently being offered through public tender procedures. Axalto and its competitors take part in these tenders as members of bidding consortia in association with major system integrators to provide the chip card products used in large-scale projects. Competition is principally based on the quality of the technology provided, the composition of the bidding consortium and price. In this market, apart from the numerous suppliers of alternative chip card technologies and chip manufacturers who promote their products to government agencies and tend to win contracts directly, Axalto’s main competitors on a global basis are IBM, Infineon, Philips, RSA Technologies, Gemplus, Giesecke & Devrient, Oberthur Card Systems, OTI and Setec.

**Prepaid phone cards**

The phone card market is a mature and highly competitive market. According to the Nilson Report, Gemplus was the market leader in 2003, with a 40% market share, followed by Axalto and then Giesecke & Devrient and Oberthur Card Systems. Axalto competes with local producers in the market for prepaid phone cards, particularly in China, where local competitors include Eastcom, Datang and Watchdata.

However, the phone card market is not one of Axalto’s key priorities and its revenue in this business line is continually declining sharply, in terms of both the number of cards sold and the percentage of total revenue, due to the Company’s decision to re-allocate a proportion of its production capabilities and marketing resources to more sophisticated microprocessor cards rather than pursue volume targets.

**Point-of-sale terminals**

The point-of-sale terminals market is currently fast growing and highly competitive and fragmented. The principal POS terminal providers with which Axalto competes on a global basis include Hypercom, Ingenico, Lipman and Verifone, and it also competes in certain countries with strong local competitors such as CyberNet, Sagem Monétel and Thales. Competition is based primarily on price, security, transaction processing and verification speed, multi-application capabilities, the range of features provided and quality of customer support. According to Frost & Sullivan, Axalto has a 3.5% market share, ranking it sixth worldwide. The top three POS terminal providers, Hypercom, Ingenico and Verifone, together represent 64% of the global market in terms of
units sold, according to Frost & Sullivan.

4.2 INTELLECTUAL PROPERTY

As of December 31, 2004, Axalto held approximately 2,150 patent rights (which include both patents granted and patent applications) for some 370 inventions and other intellectual property rights, which is one of the largest portfolios in the microprocessor card industry. This portfolio includes 1,100 patent rights that were acquired as part of the acquisition of Bull-CP8 and over 150 patents in the United States and Europe.

Axalto seeks to take all necessary and appropriate measures to protect its technology. It regularly identifies patentable or potentially patentable inventions and systematically seeks to acquire patent rights on such technologies. It currently files approximately 50 initial patent applications each year.

Axalto develops and patents technology mainly in the fields of security, cryptology, printing, manufacturing processes, contactless cards, microprocessor chip design, mobile communications and financial applications. Security is an important domain, representing approximately one-quarter of the total number of patents filed. Axalto also holds patents on Java technology for microprocessor cards and on USB-compatible microprocessor cards.

Axalto’s patent filing strategy is focused on geographical coverage and the scope of protection. In order to focus its investments on key inventions, proposed patent applications are first subject to an internal evaluation process. The Company then files patent applications in countries with significant current or prospective microprocessor card markets such as the United States, Japan and China.

Axalto has obtained non-exclusive licenses for certain intellectual property rights, in particular from Sun Microsystems with respect to Java (see paragraph 4.8 - RISK FACTORS — Risks relating to the company’s business). The Company may be forced to pay higher costs or change its product offering if the technologies it licenses change or if the price of such technologies or licenses increases. Axalto has also licensed out some of its patented technologies to third parties, in particular to other chip card manufacturers, mobile handset manufacturers and other security technology-related producers. The aim of this strategy is primarily to accelerate growth and deployment of the technology in order to increase utilization and expand the chip card markets, which require multiple sources of compatible products, while also rewarding the risks and the Company’s investment in innovation.

Axalto has developed numerous software applications for which it has copyright protection. It has also granted software licenses to third parties under which it receives royalties.

Axalto has also registered trademarks for certain families of microprocessor cards and for certain technologies and software. These trademarks are protected in countries with significant current or future microprocessor card markets.

4.3 EMPLOYEES

As of December 31, 2004, Axalto had 4,823 employees worldwide, of whom 85% held permanent posts and 15% were temporary staff, broken down as follows: 3,141 production employees, 676 in sales and marketing, 694 in research and engineering (including 523 engineers) and 312 in general administration.

The breakdown of employees by business line as of December 31, 2002, 2003 and 2004 was as follows:

<table>
<thead>
<tr>
<th>Division</th>
<th>Number of employees as of December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Cards</td>
<td>4,343</td>
</tr>
<tr>
<td>POS terminals</td>
<td>171</td>
</tr>
<tr>
<td>Central services</td>
<td>17</td>
</tr>
<tr>
<td>Total</td>
<td>4,531</td>
</tr>
</tbody>
</table>

58
The breakdown of employees by operating region as of December 31, 2002, 2003 and 2004 was as follows:

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of employees as of December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Europe, Middle East and Africa</td>
<td>2,675</td>
</tr>
<tr>
<td>Americas</td>
<td>1,175</td>
</tr>
<tr>
<td>Asia</td>
<td>681</td>
</tr>
<tr>
<td>Total</td>
<td>4,531</td>
</tr>
</tbody>
</table>

Axalto believes that its personnel, in particular their motivation and dedication to customer service worldwide, is one of its major assets.

Axalto generally recruits its employees from candidates who have less than two years’ employment experience with a view to training and promoting future managers from within the business. It encourages its employees to take responsibility early in their careers and rotates them through different areas of the business every few years. This strategy is called a “career without borders” and the Company believes it improves employees’ training and creates strong relations between employees and with the Company, while also offering opportunities for advancement within the business. Axalto also seeks to transfer its employees among different geographic regions and among mature and emerging markets as part of their development. Axalto maintains diversity in its workforce, currently drawing its employees from nearly 65 different nationalities and its policy is to hire individuals who are local and could potentially become Axalto’s future managers in their country of origin. The Company conducts performance reviews on an annual basis and has a system for identifying personnel with high potential and key contributors. Axalto believes that its high employee retention rate is due to these policies and their consistent application over time and around the world.

The number of employees belonging to trade unions varies from country to country and Axalto has entered into several collective bargaining agreements. The Company renews or replaces its various labor arrangements when they expire. There are no material labor agreements or other arrangements whose expiration is pending and which the Company does not expect to be satisfactorily renewed or replaced in a timely manner.

Axalto has not in the past experienced any major strikes or work stoppages. It believes that relations between management and employees are generally good.

4.4 INVESTMENT STRATEGY

4.4.1 Research and engineering

Axalto’s research and engineering initiatives are designed to strengthen its leadership in the innovation of new chip card products and software. The Company’s has implemented a project management system to select research and engineering projects and to manage them from inception to commercialization. As part of this project management system, Axalto analyzes its customers’ requirements such as cost and time-to-market needs, evaluates the profitability of the product over time and analyzes the risks. This system is managed by a committee consisting of representatives from marketing, intellectual property, research and engineering, product development and manufacturing. The committee meets on a monthly basis to manage the current development pipeline and to analyze new concepts and ideas from employees and clients. In addition, Axalto reviews and revises its technology development priorities every year on the basis of extensive analysis of market trends, technological developments and short-, mid- and long-term customer needs.

Axalto’s main research and engineering centers are located in France, the United States and China. It also has research and development facilities in India. In France, Axalto focuses principally on SIM and OTA product development, global personalization solutions, security and healthcare and financial applications, and conducts research concerning high-security certifications in partnership with established scientific institutions such as INRIA (Institut National de Recherche en Informatique et en Automatique), the French National Institute for Research in Computer Science and Control. In the United States, Axalto’s teams focus on Java Card technology, product development for network security and research in partnership with major universities. In Asia, it focuses on product development for mobile communication cards and some financial cards, as well as software tools. As of December 31, 2004, the Company had 523 engineers working in its research and engineering centers around the world. Each of its research and engineering centers is ISO 9001 certified.
Total expenditure allocated for research and engineering projects was $54 million in 2002, $49 million in 2003 and $64 million in 2004, representing 7.4%, 6.4% and 6.7% respectively of total revenue in each of these periods.

4.4.2 Other main investments

A presentation of Axalto’s main investments in 2002, 2003 and 2004, as well as projected investment in 2004 to 2006, is given in paragraph 5.1.6 – Liquidity and capital resources, under capital expenditure.

4.5 QUALITY, SECURITY AND STANDARDS

The implementation and monitoring of quality standards is conducted by the Quality and Security department, which reports directly to the president of the Cards division. As of December 31, 2004, there were approximately 85 people in the Quality and Security department. The Company’s customers have rewarded its commitment to quality. For example, Axalto has twice won the BNP Paribas (France) Cristal Challenge award and the TELKOM (South Africa) Gold Supplier Award, both of which were awarded for quality and time-to-market. The site in Barcelona, Spain has also been certified as Committed to Excellence as part of the European Foundation for Quality Management’s (EFQM) levels of excellence scheme.

Axalto’s facilities and activities must also satisfy a range of criteria and conditions set by various industry bodies and organizations, particularly in the financial services market, in order to become eligible for contracts to supply chip card products and services to members of those bodies and organizations. For example, each of the major payment card organizations, including Visa and MasterCard, have separately defined minimum criteria to be met by card manufacturers in order to be able to supply certain card products and services to members of these organizations. These criteria vary for different products and for the different levels of quality and security required for each product line. In addition, national organizations and standard setting bodies, such as GIE Cartes Bancaires in France or the SAS for GSM operators, typically set their own criteria for manufacturers supplying cards to their members.

Axalto has obtained most of the global certifications issued in its main markets, including the mobile communications, financial cards and security and access markets, as well as a number of local certifications. These certifications are one of its competitive advantages, as they enable it both to compete for a larger number of contracts and projects on a global basis than some of its competitors and to compete against local competitors in a number of key local markets. In March 2002, Axalto received ISO 9001/2000 accreditation for its activities and for each of its production plants. In addition, its production plants are certified by industry organizations with their own specific certification criteria, such as American Express, APACS, Banksys, Diners Club, MasterCard, Visa, Europay, GIE Cartes Bancaires and GIE Sesame Vitale. In the mobile communications market, two of Axalto’s production plants are certified compliant with the new Security Accreditation Scheme established by the GSM Association for microprocessor card manufacturers. Four other plants are also compliant and could, should Axalto wish, obtain certification, a unique situation in the microprocessor card industry. The Company’s products also benefit from several security accreditations. Axalto successfully acquired a landmark FIPS 140-2 Level 3 validation, a U.S. government security standard issued by the National Institute of Standards and Technology for federal computer systems, for the CyberFlex Access 64 K microprocessor card, which is the next generation of corporate badge cards to be supplied to the U.S. Department of Defense. The Cyberflex Crystal Java card was awarded international Common Criteria EAL4+ standard. The International Common Criteria for Information Technology Security Evaluation has enumerated an internationally agreed-upon language for specifying security functionality as well as an evaluation methodology to assess the strength of security applications. These criteria have been adopted by the International Organization for Standardization (ISO) and most companies and government entities are seeking Common Criteria certification. There are eight levels of certification which correspond to the various levels of security used by private corporations and public organizations (EAL 0 through EAL 7).

Standards

Axalto has played major role in the principal industry groups in the development of market standards designed to facilitate the acceptance, expansion and standardization of microprocessor card technology in a broad range of applications.
Axalto is currently a member of the following industry groups, consumer associations and standard-setting bodies:

- **CDMA Development Group**, a consortium of CDMA service providers and equipment manufacturers which promotes the adoption and evolution of open CDMA wireless systems by determining standards for CDMA.

- **European Telecommunications Standards Institute Project Smart Card Platform (ETSI - EP SCP)**, a telecommunications industry working group that aims at developing and maintaining a common integrated circuit (IC) card platform for all mobile communications systems.

- **Eurosmart**, the principal industry organization in Europe that promotes and standardizes microprocessor card systems and aims at creating and developing a dialogue among members of the organization that are involved in the development of secure transaction systems. Olivier Piou, Axalto’s Chief Executive Officer, is the current chairman of Eurosmart.

- **GlobalPlatform**, an industry organization that defines specifications and infrastructure for multi-application open-platform memory cards and aims to establish and maintain standards for an open-platform microprocessor card infrastructure enabling service providers to deploy and manage multiple applications.

- **JavaCard Forum**, an association founded by Sun Microsystems, Axalto and Gemplus to promote Java as the preferred programming language for multi-application open-platform microprocessor cards.

- **PKI Forum**, which was founded by the major security technology developers to promote the use of PKI products and services.

- **SIMalliance**, a non-profit organization founded together with three other large SIM card manufacturers to promote the benefits of SIM cards and SIM-based services for mobile operators.

- **Third Generation Partnership Project**, which validates the technical specifications for 3G wireless transmission standards. In addition to chip card manufacturers, members include regional telecommunications standards institutes, wireless network operators and mobile handset manufacturers.

- **3GPP2**, a collaborative effort between five officially recognized standards development organizations, including the Association of Radio Industries and Businesses (Japan), the China Communications Standards Association (China), the Telecommunications Industry Association (North America), the Telecommunications Technology Association (Korea) and the Telecommunications Technology Committee (Japan).

- **WLAN Smart Card Consortium**, which promotes security and chip-card related services for Wi-Fi technology to mobile communications operators and ISPs. Co-founded by Axalto in 2002, it defines and promotes microprocessor card-related standards this kind of local wireless network across all market segments, including corporate, public and home networks. This working group brings together 23 companies. The consortium published the EAP-SIM V1.0 specification.

4.6 **INTERNAL CONTROLS**

Axalto’s management regards internal control as a series of procedures implemented with the intention of providing a reasonable level of assurance as regards management’s targets concerning the performance of the Company’s activities, the reliability of its financial and management information and compliance with current laws and regulations.

In addition to the Company’s internal audit procedures, the internal audit department works closely with the legal department in the area of risk traceability in particular. The Company has implemented various management tools for this purpose and the legal department conducts audits for the annual certification of production plants and subsidiaries, as well as employee training and confirmation of employees’ compliance with corporate governance requirements.
The organization of Axalto’s internal controls is centralized. Its subsidiaries in the various countries in which the Company operates are responsible for applying the policies, standards, guidelines and procedures defined by Axalto.

For more information about the Company’s internal controls, see paragraph 6.4 – **INTERNAL AUDIT**.

### 4.7 APPLICABLE REGULATIONS: EXPORT CONTROLS, ENVIRONMENTAL MATTERS

**Export controls**

While Axalto’s chip card products and services are in general not heavily regulated, the Company is subject to export control laws and regulations as a result of its global activities, its ‘virtual factory’ production concept and its contractual commitments to certain customers and suppliers. The development, use, transfer and export of encryption technology, including hardware, software, modules and cards, are subject to an increasing number of national and international controls. As a result, Axalto’s security technology is subject in many countries to strict controls and licensing requirements. The Company undertakes regular audits at its plants in order to confirm compliance with all applicable laws and regulations.

**Environmental matters**

Axalto’s production and personalization activities are subject to environmental and occupational health and safety laws and regulations.

Axalto invests considerable financial and human resources in complying with applicable environmental, health and safety laws and regulations in the countries in which it operates. The Company has adopted a comprehensive Quality, Health, Safety and Environment ("QHSE") Policy to ensure and promote health, operational safety, environmental protection, quality enhancement and community goodwill. Axalto proactively integrates QHSE objectives into its management system at all levels through a reward program that recognizes the performance of its employees and contractors. In accordance with this strategy and despite the negative economic environment for its industry, Axalto launched in 2002 a certification program for its main production plants in accordance with the ISO 14001 environmental standard. As of December 31, 2004, nine out of eleven production plants were certified ISO 14001 compliant.

Axalto has developed with Eco-Emballage, the French national association that promotes recycling of domestic waste, a plastic card body made of 100% recycled PET material from plastic bottles which can be further recycled, as well as several environmentally friendly innovations, such as the development of a biodegradable card body prototype made of wheat flour combined with bio glue. Axalto also produces chlorine-free plastic cards for the Asian and Northern European banking markets. These cards have, however, encountered limited commercial success internationally because customers are usually not willing to pay a premium, even if small, for these characteristics.

Axalto is not involved in any legal proceedings relating to environment, health and safety matters and is not aware of any claims or potential liability in this regard that could have a material impact on its business, financial situation or operating performance.

### 4.8 RISK FACTORS

#### 4.8.1 Risks relating to the Company’s business

**4.8.1.1 Risks relating to growth of the mobile communications and financial services markets**

The market for mobile communications products is characterized by gradually declining sales prices for the Company’s products over the life of these products, particularly as Axalto and its competitors bring new, more advanced products to market. For this reason and in order to foster its future growth and profitability, the Company is targeting new market opportunities in the mobile communications market that require high-end microprocessor cards. The Company intends to take advantage of the development of new value-added services,
such as email access, internet browsing, mobile commerce, information services and video conferencing, which are now accessible thanks to new mobile communications standards, to provide increasingly sophisticated microprocessor cards and related software and services. The deployment of these new standards has been delayed, however, by the slowdown in the telecommunications industry since early 2001, which has affected the Company’s revenues and profits in this sector over the past few years. The decline in prices attributable to product lifecycles has been exacerbated in recent years due to a number of factors, including general economic conditions, increased competition from local manufacturers (particularly in China), decreased demand from telecommunications companies, mobile communications operators stepping up their cost-cutting measures and overproduction of microprocessor cards in 2001 and 2002. Despite signs that the slowdown in the global telecommunications industry has come to an end, this trend could continue, albeit at a weaker rate, as mobile communications operators increasingly focus on reducing their supply costs, including the cost of microprocessor cards. Delays in the deployment of new mobile communications standards or the development of new value-added services or slower than expected recovery in the telecommunications industry may lead the Company to record lower revenue and profits in its mobile communications business than projected.

In the financial services segment, the Company hopes to achieve substantial growth in both its financial cards and its POS terminals businesses from the migration from existing magnetic card-based payment systems around the world to systems which rely on microprocessor card technology. An important driver of this change to microprocessor card-based systems will be migration to the Europay, MasterCard and Visa (“EMV”) standard. However, in markets in which magnetic stripe cards are widely used, there is a reluctance to switch to the EMV standard in view of the associated costs. Migration to the EMV standard has been delayed in several countries, while in other countries, such as the United States, there is currently no timetable for migration. Further delays or failure to migrate to EMV-compliant systems in these countries could result in lower than anticipated revenue and profits in this segment. In addition, the migration to EMV-compliant systems has been accompanied in certain countries by severe pricing pressure due to the intense competition surrounding the migration, as most global and regional chip card manufacturers compete for large initial card orders from financial institutions at the time of migration. It has also led to the use of low-end cards rather than high-end cards, which generally generate higher margins. These trends could continue to impact the Company’s revenues and profits in the financial cards segment.

4.8.1.2 Uncertainties relating to certain markets still in an early stage of development

The use of microprocessor card technology is still uncertain in a number of markets that the Company considers to offer strong growth potential, particularly the public sector and access markets. Because these markets are in the early stages of development, currently there are no standard-setting bodies or market-wide standards or specifications that recommend or require the use of microprocessor card technology, as is the case in other more established markets such as mobile communications and financial cards. As a result, there are a number of competing technologies for a wide range of applications in these markets, including for identity, security, access and privacy applications, some of which could be given preference over microprocessor cards. In addition, the adoption of microprocessor card-based systems in the public sector market requires significant investment in infrastructure, including for the nationwide deployment of specialized terminals, servers and software for identity and healthcare applications and, to a lesser extent, for the implementation of contactless technology in the transportation sector. The decision to develop such systems is generally subject to lengthy governmental processes relating to budgeting, planning approvals and competitive bidding that can make microprocessor card technology less competitive than other technologies and hinder the widespread acceptance of the Company’s products. Given the scale of projects in this sector and the fact that chip cards are just one component of the system, Axalto also forms partnerships with system integrators in bidding for certain contracts and its choice of systems integrators can affect its chances of being awarded a contract and consequently increasing its revenues and enhancing its profitability in the sector. Moreover, if the Company succeeds in winning contracts, it may be required to commit significant time and resources during the initial stages of each project without any expectation of revenue until future periods, which may make its profits more variable from period to period and adversely affect its share price. Finally, as Axalto’s products for this market are often tailored for particular projects and because the market is still emerging, clear trends in pricing have yet to emerge. The Company may experience lower than anticipated prices due to intense competition in the bidding process or an overall decline in prices following the introduction of new products or technologies.

4.8.1.3 Risks relating to the rapid development of microprocessor card technology

Axalto’s principal markets are characterized by rapid technological change, continuous improvements in
microprocessor chip technology, new applications, new standards, short product cycles and rapid changes in demand. While some of these developments relate to the card body, they more often affect the core secure software and chip technology that adds the most value to the Company’s products, such as new chip design concepts, the memory capacity and processing power of microprocessor cards and the software loaded on the chips. The rapid pace of technological change requires the Company to commit significant financial and managerial resources to research and engineering in order to introduce new products and improve its existing products as quickly as possible in order to remain competitive. If the Company were to fall behind its competitors, fail to keep up with technological developments due to a lack of sufficient or effective investment or make strategic errors, its products and services may become obsolete and it may not be able to maintain or expand its customer base.

4.8.1.4 Risks relating to the availability of chips, the key component of microprocessor cards

Microprocessor card technology is based principally on microprocessor chips, which are manufactured by chip producers that also supply chips for a large number of other applications, such as personal computers, mobile phones, personal digital assistants and automobiles. Fluctuations in demand for chips have led in the past to shortages in chip supply, which in turn have led to increases in price for chips and caused chip producers to allocate available chips more selectively among their customers. For example, during recent shortages, chip manufacturers have allocated products to clients in other industries, such as the automobile industry, rather than to chip card manufacturers. Certain chip producers that have entered or may enter the market for microprocessor cards may decide in times of shortage to prioritize satisfying the supply needs of their own microprocessor card operations, which may further reduce supply sources. In addition, although the Company has made substantial efforts recently to diversify its chip suppliers with significant global production capacity, its largest chip supplier provides approximately one-third of its total chip requirements. Moreover, there are typically fewer suppliers of new, more advanced chips in the initial stages of commercial development of these new chips. For example, there are currently only four suppliers of chips with 128 KB of erasable memory capacity and just one supplier of the newest generation of chips with 256 KB of erasable memory capacity that are available to use in commercial products. For these reasons, in times of shortage the Company may not be able to secure adequate supplies of chips at commercially acceptable prices. Certain suppliers may also fail to meet the required quality or delivery criteria, which could cause difficulties in fulfilling orders and responding to shifts in demand, which might cause the Company to record lower sales and to lose customers, and could impede it from improving its profitability by shifting the mix of products to include higher-value products that use high-end microprocessor chips. In addition, when a shortage or price increase relates to the chips used to produce higher-margin, value-added products, the Company’s operating margins may be adversely affected.

4.8.1.5 Risks relating to the optimization of chip card production capacity

Because its activities are based on orders varying in size and requiring different delivery schedules, the Company needs to anticipate demand accurately and allocate its production capacity to such demand in order to meet delivery requirements, best recuperate its fixed costs and maximize its operating margins. In particular, it must make judgments about when and how to allocate production capacity so as to generate the highest margins and optimize the use of its facilities. Any failure to forecast demand accurately or to allocate or organize its production capacity optimally might adversely affect revenue and profitability. In addition, the Company must accurately forecast its own need for chips. If it overestimates its requirements, it might be left with high chip inventories that it may not be able to use or may need to use to produce products that could have been produced with less powerful and costly chips, which might lead it to record lower profits on these products.

Finally, recent contracts with customers can include clauses under which the Company will be responsible for indirect damages resulting from a breach of contract including, without limitation, penalties for failure to meet delivery schedules. If these clauses are invoked against the Company, it would likely need to defend against claims in court, which could be time consuming and expensive, and it might be found to be liable under such clauses.

4.8.1.6 Risks relating to the failure to satisfy the standards and criteria of industry organizations to which the Company’s customers belong

Most of Axalto’s customers, particularly in the financial services market, belong to industry organizations. Many of these organizations have issued their own set of standards and criteria relating to chip card manufacturers’ facilities and products, which must be satisfied in order to be eligible to supply products and services to these
customers (see paragraph 4.5 - QUALITY, SECURITY AND STANDARDS). The Company must make significant investments in order to meet these standards and criteria, which tend to change over time. If it fails to meet these standards and criteria, the Company may become ineligible to provide products and services that have constituted in the past an important part of its revenue and profits.

4.8.1.7 Risks relating to the supply of POS terminals

Until recently, the Company produced the majority of its POS terminals at Schlumberger’s production facility in Saint Etienne, France. However, in August 2003, this production plant was sold to Flextronics, a leading manufacturer based in Singapore. In connection with the sale, Schlumberger, acting for its subsidiaries (including Axalto), outsourced the manufacture of these POS terminals and related services to Flextronics. Under the terms of the supply agreement with Flextronics, Schlumberger undertook to cause its subsidiaries (including Axalto and its subsidiaries) to purchase a fixed amount of POS terminals and services from Flextronics, it being stipulated that Flextronics would be indemnified if the conditions of the agreement are not met. Under the Separation Agreement between Axalto and Schlumberger, Axalto will reimburse Schlumberger a portion of the amount that may be owed by Schlumberger to Flextronics if the fixed amount of POS terminals and services are not purchased from Flextronics.

If Flextronics is unable to fulfill its obligations under this supply agreement, the Company and its subsidiaries might not be able to fulfill their customers’ orders, which in turn may lead it lose customers and record lower revenue and profits in the POS terminals division. If the Company and its subsidiaries are not able to sell the fixed amount of POS terminals or use the services to be provided under the supply agreement in any given period, they may record lower than anticipated profits in the POS terminal division.

4.8.1.8 Risks relating to the protection of confidential information and prepaid cards

In connection with its personalization services, the Company routinely handles confidential information relating to its end customers. In the financial market, for example, the Company receives information relating to the card user, including bank account numbers and credit or debit parameters, and generates the PINs that activate and allow use of the card. Although its personalization activities have been accredited the principal security certifications available from industry organizations and bodies, the Company cannot guarantee that it will be able to prevent every attempt, internal or external, to breach its security systems and misappropriate and fraudulently use confidential data. If this were to occur, the Company may be forced to defend itself against claims that it is liable for failure to protect confidential information adequately, which might be time consuming and expensive, even if its activities meet all of the security standards and criteria adopted by the industry. In addition, the Company also loads value onto prepaid cards, particularly prepaid phone cards, which it must protect from theft while they are in its custody. If these cards are stolen while in its custody, Axalto’s customers may seek to hold it liable for the aggregate value amounts loaded onto the stolen cards. Finally, a breach of security systems could also adversely affect the Company’s reputation, particularly in the financial market and the public sector, which it has targeted as important drivers of its future growth.

4.8.1.9 Risks relating to manufacturing defects in the Company’s products

Axalto’s products and services, particularly new products and new versions of existing products, may contain manufacturing defects. As these products and services represent substantial investment and changes in business operations for its customers, serious defects or errors could harm the Company’s reputation and extend the time-to-market, while also requiring it to carry out expensive and time-consuming repairs.

Such manufacturing or functional defects could also cause losses to customers, in which case customers could attempt to seek compensation from the Company. These claims could be time-consuming and costly to defend and generate unfavorable publicity, causing the Company to lose customers. Although its sales and services agreements typically contain provisions designed to limit its exposure to product liability claims, certain laws or unfavorable judicial decisions could limit the effectiveness of these limitation of liability provisions. The Company also has product liability insurance that it believes is consistent with industry practice but it cannot guarantee that its present insurance coverage is sufficient to meet any product liability claim against the Company or that it will be able to obtain or maintain insurance on acceptable terms or at appropriate levels in the future.
4.8.1.10 Risks relating to the protection of intellectual property rights

The Company’s success depends, in part, upon its proprietary technology and other intellectual property rights. If it is not able to defend its intellectual property rights successfully, the Company might lose market share and may no longer be able to license out use of these rights to its competitors. The Company may also be required to pay significant license fees to third parties to be able to use their technology.

To date, the Company has relied primarily on a combination of patent, trade secret and copyright laws, as well as nondisclosure and other contractual restrictions on copying, reverse engineering and distribution, to protect its intellectual property. It cannot guarantee, however, that in future these measures will be sufficient to protect its intellectual property rights or that it will be able to obtain all of the patents for which it applies. Furthermore, the Company’s patents may not cover the scope originally sought or offer meaningful protection. Litigation to enforce the Company’s intellectual property rights could result in substantial costs and may not be successful. In addition, the laws of certain countries may not protect its products and intellectual property rights to the same extent as the laws of the European Union or the United States. Any inability to protect its intellectual property rights could seriously harm the Company’s business, operating performance and financial situation.

Similarly, if third parties claim that the Company is infringing their intellectual property rights, it might be required to incur significant costs and devote substantial resources to defending such claims and ultimately might not be successful. If the Company is not successful in defending such claims, it may be forced to obtain licenses under terms that are not necessarily favorable and/or incur substantial liabilities, including indirect damages which are increasingly provided for in contracts with its customers. The Company may also be forced to suspend the sale of products or the use of production processes requiring such technologies.

4.8.1.11 Risks relating to the development of third-party technologies and increases in licensing costs

The Company benefits from certain licenses, in particular for:

- the Java trademark;
- security and cryptography technology for card operating systems;
- dual interface technology;
- public key infrastructure (PKI) technology.

Technology providers often change their existing products by withdrawing old versions of existing products. The Company may not be able to adapt its products and services in a timely manner to accommodate such changes and might have to discontinue or change certain products and services. Changes in technology may also be accompanied by significant price increases, which would increase the Company’s costs and adversely affect its profitability.

4.8.1.12 Risks relating to the seasonal nature of sales in the mobile communications segment

Axalto generally earns most of its revenue in the mobile communications segment in the fourth quarter of each year. This is due to major promotions typically conducted by mobile communications operators during the Christmas season, resulting in higher sales of SIM card products. As a result of this seasonality, negative developments in the fourth quarter of any year would be likely to have a disproportionate impact on operating income for the year (see paragraph 5.1.4 - Other factors affecting income — Seasonality).

4.8.1.13 Market risks (interest rates, exchange rates, liquidity, equities)

Currency risks

Axalto publishes its audited combined financial statements in U.S. dollars. A significant proportion of its revenue, however, is generated in currencies other than U.S. dollars or U.S. dollar-linked currencies, in particular the euro and sterling. In addition, a significant part of the cost of sale and expenses are generated in currencies other than U.S dollars. As a result, revenue and gross profit can be highly sensitive to exchange rate fluctuations, principally between the U.S. dollar and the euro. The Company may have difficulty managing currency risks and
such fluctuations could affect operating income from one year to the next and impact the Company’s share price (see paragraphs 5.1.4 - Other factors affecting income — Impact of exchange rates and 5.1.8 - Market risks — Management of exposure to exchange rate fluctuations).

**Liquidity risks**

In the past, the Company has financed its growth partly using liquidity generated by its operations and partly through financing from Schlumberger or external borrowing. Under the terms of Schlumberger’s commitments within the framework of the Separation Agreement, at the time of the IPO the Company had a net cash position of $45 million. The Company generated net cash flow from operations and investment activities of $69 million in 2003 and $143 million in 2004. However, it cannot guarantee that the level of net cash will be enough to cover all of the Company’s future cash requirements under any circumstances.

**Equity risks**

As the Company does not own any significant equity or portfolio investments, there is no significant risk relating to a change in the value of these investments.

4.8.1.14 Risks relating to the Company’s international activities

Given the international nature of its business, Axalto is subject to a number of political, regulatory and trade risks, including:

- restrictions on the repatriation of capital, in particular regulations relating to transfer pricing and withholding taxes on payments made by subsidiaries and joint ventures;
- unexpected regulatory reforms;
- customs duties, export controls and other trade barriers;
- longer accounts receivable payment cycles and difficulties in collecting accounts receivable in certain countries;
- limited legal protection of intellectual property rights in certain countries;
- social and political instability (in particular strikes and work stoppages).

The Company cannot guarantee that it will be able to manage these risks, many of which are outside its control, or that it will be able to ensure compliance with all applicable regulations without incurring additional costs.

In particular, the Company conducts a significant portion of its business in the People’s Republic of China. Conducting business in China is subject to particular risks which may not arise in other countries, particularly with regard to the regulation of certain chip prices, uncertainties regarding the application of Chinese laws to the chip card industry, as well as the interpretation and enforcement of these laws, currency fluctuations and restrictions on conversion or repatriation of profits.

4.8.1.15 Risks relating to acquisitions and joint ventures

Axalto has in the past made acquisitions and entered into joint ventures. It may enter into acquisitions, joint ventures or strategic alliances in the future, which may require it to make potentially dilutive issuances of shares, incur debt and incur amortization expenses related to goodwill and other intangible assets. In addition, the Company may be required to record impairment charges with respect to acquired assets, such as, for example, the $93 million impairment charge recorded in the fourth quarter of 2002 relating to Bull-CP8’s patent portfolio and core and existing technologies. These events have had, and similar events in the future may have, an adverse effect on the Company’s operating performance, financial situation and share price. Acquisitions involve numerous other risks relating to integration, including the failure to achieve the expected benefits and synergies, the diversion of management’s attention from other business concerns and the loss of key employees. Joint ventures present the risk of conflicts of interest or strategy. Axalto’s joint venture partners may also be unable to fulfill their obligations under the joint venture agreement or experience financial or other difficulties. If the
Company is unable to manage all of these risks efficiently, it may be forced to incur extraordinary expenses or charges which may have an adverse effect on its financial situation.

4.8.1.16 Risks relating to environmental, health and safety regulations

Axalto’s production and personalization operations are subject to environmental, health and safety regulations including local, national and international laws and regulations relating to the handling, transportation, disposal and emission of hazardous wastes and materials such as ink. The Company generally does not maintain reserves for environmental remediation. Although it has adopted systems for identifying and managing potential environmental, health and safety liabilities, there can be no assurance that it has identified and is adequately addressing all potential sources of environmental, health and safety risks. As a result, the Company cannot guarantee that it will not incur environmental, health or safety losses or that any losses incurred will not have an adverse effect on its operating performance or its financial situation. In addition, potential changes in environmental, health and safety laws or regulations may have an adverse effect on its operating performance or its financial situation.

4.8.1.17 Risks relating to the introduction of new accounting standards

Axalto currently prepares its combined and consolidated audited financial statements in accordance with U.S. GAAP. European Union regulations currently require that all companies whose securities are listed in the European Union must apply IFRS (International Financial Reporting Standards) in preparing their financial statements for fiscal years beginning on or after January 1, 2005 (see paragraph 5.3 – FIRST-TIME ADOPTION OF IFRS).

4.8.2 Risks relating to the industry

4.8.2.1 Risks relating to competition

The market for chip card products and services is highly competitive. The Company expects competition to increase as existing markets mature and new markets are created. For example, in the mobile communications market, which is one of the largest markets for microprocessor cards, competition has become increasingly fierce for low-end microprocessor cards in all regions. This has led the Company and some of its competitors to seek to strengthen their market positions by offering higher-end products in the mobile communications and other markets that require a higher degree of sophistication and expertise. If the Company is not able to continue to compete successfully against current or future competitors, it will lose market share, which would affect its operating performance and financial situation.

Axalto’s current main competitors include chip card producers such as Gemplus, Oberthur Card Systems and Giesecke & Devrient. In the SIM card and financial card markets, the Company also has to compete with regional manufacturers such as Setec, XponCard, MicroElectronica and AustriaCard, as well as local manufacturers, particularly in China such as Datang, Eastcom and Watchdata, which are seeking to leverage their positions in the Chinese market and expand internationally. In addition, as the number of markets for chip card products and services increases, the Company may experience competition from companies that are currently its suppliers and strategic partners. For example, chip manufacturers that currently supply it with the microprocessor chips used in Axalto’s products, such as Infineon Technologies, Samsung and STMicroelectronics, could decide to enter the chip card market through acquisitions or joint ventures, as evidenced most recently by STMicroelectronics’ acquisition of Incard, one of the Company’s competitors. Other potential competitors include:

- operating system developers, such as Sun Microsystems and Microsoft;
- electronic security product and service providers, such as Entrust, RSA Security and Verisign;
- wireless device manufacturers such as Nokia, Ericsson and Motorola;
- systems integrators such as IBM and EDS;
- wireless infrastructure software providers, such as Amdocs, SmarTrust and Aether Systems.
Some of the Company’s current and potential competitors have greater financial and other resources, larger workforces (including research and engineering staff) and customer bases and greater name recognition. These competitors may be able to develop more attractive products and services which are priced more competitively. For example, some of its competitors have greater capabilities in the area of security printing and biometrics, which enables them to offer a broader range of products in these areas and which may serve as a better platform to develop further products. In addition, Axalto’s competitors may be able to negotiate strategic partnerships on more favorable terms. Many of its competitors have also established relationships with the Company’s existing and prospective customers. Increased competition may result in reduced profitability, loss of sales or decreased market share, which in turn could harm the Company’s business, operating performance and financial situation.

4.8.2.2 Risks relating to technological developments

Axalto spends considerable time and resources promoting the use of microprocessor cards in all of its markets, including through the development of new applications and by participating actively in the creation of industry-wide standards and specifications that include microprocessor card technology. There are, however, a number of alternatives to microprocessor card technology, including wireless devices that do not require microprocessor cards, software-based solutions, magnetic stripe cards, MMC/SD cards and USB tokens and products. If these alternative systems develop and become the industry standard, microprocessor card producers would suffer loss of sales and growth opportunities, and may need to invest in new markets. In particular, the use of microprocessor cards in the mobile communications market, which has been one of the main growth drivers in the global microprocessor card industry in the past decade, may be challenged if mobile phone manufacturers decide to incorporate the functions that are currently performed by microprocessor cards directly into the handset. Given the size of the market, a decision of this kind would have a substantial negative effect the Company’s business and its financial situation.

4.8.2.3 Risks relating to the decoding of encryption programs

Microprocessor cards are equipped with keys that encrypt and decode messages in order to secure transactions and maintain the confidentiality of data. The security afforded by this technology depends on the integrity of the key and the complexity of the algorithms used to encrypt and decode information. Any significant advance in techniques for attacking cryptographic systems could result in a decline in the security of Axalto’s technology, which in turn could significantly affect the acceptance of or demand for microprocessor card-based products, slow down growth and impact the Company’s revenue and anticipated profits.

4.8.3 Risks relating to the Reorganization and the Company’s operating as an independent entity

Risks relating to the Separation Agreement with Schlumberger

After the IPO, Axalto continues to have relationships with Schlumberger under the Separation Agreement (see paragraph 4.1.1.2 – Reorganization). Under the Separation Agreement, Schlumberger has agreed to indemnify Axalto for all direct losses and associated costs Axalto or one of its subsidiaries suffers as a result of the Reorganization and not to compete with Axalto for a period of three years nor to solicit Axalto’s employees for a period of one year from May 21, 2004 (the settlement date of the Axalto shares sold by Schlumberger as part of the IPO). The Separation Agreement provides for certain conditions, exceptions and limitations on these obligations. In addition, in the event of a change of control of Axalto, Schlumberger’s indemnity obligations to Axalto will terminate. The Company’s business or financial situation may be adversely affected if it incurs losses or has to pay costs that are not related to its activities and are not covered by Schlumberger under the Separation Agreement.

Also, under the Separation Agreement, Axalto has agreed:

- to indemnify Schlumberger for direct losses and associated costs relating to Axalto’s activities (the Company will continue to be bound by this obligation even if Schlumberger’s indemnification obligation to the Company ceases as indicated above);

- not to compete with Schlumberger’s businesses at the date of the IPO during a three-year period from May 21, 2004 (the settlement date of the Axalto shares sold by Schlumberger as part of the IPO);
not to solicit Schlumberger’s employees during a one-year period from the settlement date of the Axalto shares sold by Schlumberger as part of the IPO.

These arrangements could adversely affect Axalto’s financial situation and profits. In addition, legal disputes over the implementation of these arrangements, or the termination of these arrangements other than in accordance with their terms, may also adversely affect the Company’s financial situation and profits.

Consequences of the Company’s separation from the Schlumberger group

Prior to the IPO, as part of Schlumberger, Axalto benefited from the financial, administrative and other resources of a larger company. Under the Separation Agreement, Schlumberger has agreed to continue to provide some of these services for a transitional period of up to 18 months. The Company has implemented and is continuing to implement the systems and procedures required in order to operate as a stand-alone public company. If it is not able to do so successfully before the end of the transitional period, its business, financial situation and profits may suffer. In addition, the Company may not be able to leverage Schlumberger’s relationships and global contacts as an independent company. The perception of the Company by some of its customers, who may be reluctant to buy Axalto products because its brand name and reputation are not as well known as those of Schlumberger, may also be affected.

Risks relating to Axalto’s financing

In the past, Axalto’s capital requirements have been satisfied by Schlumberger. However, since the IPO, this is no longer the case. The Company’s future capital requirements will depend on many factors, including the rate of revenue growth, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products and enhancements to existing products and the market acceptance of its products. The Company may need to raise additional funds through a rights issue with or without public equity or debt financing. It may not be able to obtain financing with interest rates as favorable as those that Schlumberger could obtain. If it cannot raise funds on acceptable terms, if and when needed, the Company may not be able to develop its business further, invest in new products and services, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could seriously harm its business.

Dependence on the core management team and key personnel

Axalto’s future success depends in part on the loyalty of its existing core senior management team, which has managed its business for a substantial period of time and has significant experience in the industry, as well as on other key personnel, particularly in the areas of research and engineering, product development, marketing, production, supply chain management, financial management and human resources management, as well as field personnel trained in card deployment and management services. The Company’s core senior managers and key employees are not obligated to remain with the Company for a specified period of time and may choose to leave the Company at any time. If it loses the services of one or more of its core senior managers or key employees, or if one or more of them decide to join a competitor or otherwise compete directly or indirectly with Axalto, the Company may not be able to manage its business as efficiently as in the past, which could prevent it from growing as quickly or as profitably as it hopes.

Risk that the financial statements presented in this annual report may not be representative

Axalto’s business had historically been a part of the Schlumberger Products group, which was regrouped and transferred to Axalto during the second half of 2003 and the first quarter of 2004 (see paragraph 4.1.1.2 – Reorganization). Because Schlumberger did not prepare separate financial statements in respect of Axalto’s business prior to the IPO, the Company’s combined financial statements have been derived from Schlumberger’s consolidated financial statements for the periods presented. Although Axalto did not own the companies and businesses comprising its operations during the periods presented, the combined financial statements present on a combined basis the historical assets, liabilities, revenue and expenses that were directly related to the Company’s business within Schlumberger during the periods presented, subject to certain adjustments described in Note 1 of the appendices to the audited consolidated financial statements.

In this annual report, Axalto has chosen to present the highlights of its unaudited pro forma financial statements which include pro forma adjustments to the pro forma combined financial statements intended to reflect the
Company’s financial situation and profits as if it had operated as a separate, stand-alone public company from January 1, 2003, based on management’s assumptions and estimates.

Neither the combined financial statements nor the unaudited pro forma condensed financial information, however, is necessarily indicative of what the Company’s financial situation and profits would have been if it had operated as a separate, stand-alone public company during the periods presented in this annual report and may not be indicative of its future performance.

4.8.4 Exceptional events and legal proceedings

Within the framework of its day to day activities, Axalto may be subject to lawsuits, in particular involving the infringement of intellectual property rights and third-party rights. To date, there have been no lawsuits against Axalto relating to such infringements. There are no legal disputes that may have or have had in the recent past a significant impact on Axalto’s financial situation, business and profits.

On August 19, 2002, Axalto received a €12.5 million claim from a distributor for damages suffered and costs incurred resulting from the Company’s alleged failure to deliver POS terminal software on time and to agreed specifications. The court ordered an evaluation of damages by an expert, which is still ongoing. In documents submitted by the plaintiff in the context of this evaluation, the plaintiff estimates its damages at €8.3 million. Axalto believes that it has good arguments to contest this case strongly and is awaiting a hearing.

On August 8, 2003, Axalto received a claim from a banking customer for approximately $5.5 million in connection with losses and legal fees incurred by the bank resulting from an alleged fraud in which certain Axalto employees were allegedly involved. Axalto and its customer agreed on a transaction combining a limited cash payment and the signature of a multi-year contract to supply financial cards. The case is now closed.

One of Axalto’s pay-TV customers took Axalto S.A to the Paris Commercial Court on June 11, 2004, to claim compensation of €15 million for failure to execute contractual obligations for the customer, in particular as regards security attacks on its products. The parties are still exchanging their conclusions at present. Axalto believes that it has a valid defense and intends to contest this claim strongly. A hearing is due to take place on April 6, 2005.

Although the outcome of these lawsuits is unknown for the time being, Axalto does not believe that they will have a significant unfavorable impact on its financial situation, profits and cash flow.

4.9 INSURANCE AND RISK COVERAGE

Axalto has purchased various insurance policies to cover the main risks inherent to its activities subject to the usual exemptions and exclusions imposed by the market. Its main policies cover damage to property and business interruption as well as third-party liability and directors and officers liability, both civil and contractual. The property and business interruption insurance policy covers all of Axalto’s assets wherever they are in the world for their replacement value in the case of partial or total loss.

Axalto has additionally taken out insurance against damage caused to goods or persons as a result of its activities as well as against legal liability with respect to professional services including any third party consequential loss for claims of €50 million. Finally, its directors and officers liability insurance covers claims alleging financial loss arising from any wrongful act or mismanagement by directors or officers. Axalto has also taken out a number of specific or local policies as required by local regulations in various countries.

Axalto believes that the type and relative amounts of insurance it holds are in accordance with what is customary in the industry and the countries in which it operates. As the insurance market is highly volatile, Axalto consistently checks the adequacy of its insurance policies against others available in the market for groups of similar size and activity.
CHAPTER V  ASSETS, FINANCIAL POSITION AND RESULTS

5.1 FINANCIAL POSITION AND OPERATING RESULTS: COMMENTARY AND ANALYSIS

5.1.1 Introduction

Axalto is the world's leading provider of microprocessor cards, with a global presence and expertise in all major areas of card applications. We operate our business through two segments: Cards and POS Terminals.

Our Cards segment, which includes our Mobile Communications, Financial Cards, Public Sector, Network Access and Other Products and Prepaid Phonecards businesses, has generated more than 91% of our total revenue and, excluding exceptional charges, over 94% of our gross profit each year since 2002, with the remainder reflecting the contribution of our POS Terminals segment. Within the Cards segment, our Mobile Communications business has been the largest contributor to revenue and gross profit during each of these periods.

Our global business operates in three geographic regions: EMEA (Europe, the Middle East and Africa), Asia and NSA (North America, Central America and South America). EMEA has historically represented the largest portion of total revenue and gross profit for our Cards and POS segments.

5.1.2 Principal Factors Affecting Revenue

Our Cards segment sells cards (including embedded software and related servers) and intellectual property rights licenses, while our POS segment sells POS terminals (including embedded software and related servers) and related technical support services. We typically sell our products through purchase orders under contracts that include fixed or determinable prices and that generally do not include a right of return or similar provisions or other significant post-delivery obligations. We are also increasingly providing a range of services to our customers in both of our segments. While a relatively small portion of services are sold separately, services are primarily bundled with our card and POS product offerings. Revenue derived from our services, however, has constituted a small portion of our total revenue during the periods under review.

Cards segment

Revenue from sales of our cards products varies according to sales volumes, the prices of our products and the mix of products sold. Although the importance and effect of these are different in each of our different card businesses, revenue from our card products generally varies significantly depending on the technology used in these products. Our card products cover a wide range of technologies, including plastic cards (with little or no technological content), magnetic stripe cards, memory cards and microprocessor cards. In addition, we sometimes sell modules to other card manufacturers when we consider it commercially reasonable to do so. Although we intend to continue to sell modules in this manner, we do not currently consider this to be a major focus of our business. Generally, the more sophisticated the technology used in our products, the higher the price we can obtain for these products. As a result, revenue in our Cards segment tends to increase when sales volumes of more technologically advanced products increase.

Mobile Communications

Generally, we sell our Mobile Communications products to mobile operators pursuant to one-year contracts granted through competitive public tender processes. Contracts may be shorter than one year, particularly those involving large volumes. Upon expiration of such contracts, we are required to participate in new public tenders alongside a large number of card companies to obtain new contracts to provide products for the next year. This results in a high level of competition. As a result, the portion of our revenue attributable to a particular mobile operator will vary from year to year, though our worldwide operations and investments in new technology provide opportunities for new contracts and increased revenue under existing or renewed contracts with other mobile operators.

Sales volumes of Mobile Communications products are also directly affected by developments in the overall wireless market, including wireless penetration and subscriber growth rates in new or emerging digital wireless markets, increased competition for existing subscribers in mature wireless markets through the introduction of
new value-added services by wireless operators and the deployment of new wireless standards that use microprocessor cards.

The rapid growth in North and South America is an indication of a “GSM effect”, due to the adoption of GSM standards by existing mobile networks and a simultaneous increase in subscriber numbers on these networks. Similarly, the first roll-outs of third-generation technology (3G or UMTS) require cards offering specific functions at the very top end of the market. These roll-outs are therefore leading to the replacement of previous generations of microprocessor cards.

Our Mobile Communications products range from low-end products with basic security and other features to high-end products with enhanced capabilities and features that allow operators to benefit from additional functionalities and to offer more advanced applications - which may be downloaded remotely - to their clients. Operators in countries that are starting to deploy digital wireless networks generally purchase low-end and mid-range products, even if some operators opt for much more advanced microprocessor cards to enhance network performance and achieve marketing differentiation. However, as penetration rates increase and the market matures, demand generally shifts away from these products to higher-end products as operators seek to improve their competitiveness and increase average revenue per subscriber. This trend has been particularly pronounced in Western Europe and certain Asian countries in recent years, and is now spreading to all regions, particularly North and South America. The introduction of new high-end products, in turn, typically leads to the gradual phase-out of low-end and mid-range products.

The selling prices of our different Mobile Communications products mainly depend on the sophistication, embedded software and memory capacity of these products, as well as the availability of competing products. We attempt to achieve revenue growth in our Mobile Communications business by regularly launching new and more sophisticated products to complement and eventually replace prior product generations. Shortly after we introduce new higher-value products, however, other chip card manufacturers often launch competing products and, as competition among these new products intensifies, we experience strong downward pressure on prices. As a result, we also seek to maximize our revenue by anticipating and promoting demand for such new, high-end products, by entering markets for new, high-end products in advance of our competitors and by supplying products to our mobile operator customers quickly through our flexible global production processes. To the extent that we are able to do this faster and more effectively than our competitors, we increase the opportunity to earn higher revenue before competing products are introduced and put downward pressure on prices.

Developments in the wireless industry can also have a significant impact on prices for our Mobile Communications products. The 1990s were characterized by the rapid expansion of Mobile Communications, which caused operators to focus primarily on growth in their subscriber bases. As the wireless industry has matured in Western Europe, operators in this region have been increasingly focusing on profitability and particularly on the management of their costs. This focus has had a significant effect on operators’ relationships with chip card manufacturers as these operators seek to reduce costs of supplies, including chip cards, and improve supply management by entering into global purchasing arrangements with increasingly standard terms and conditions. In 2002 and the first half of 2003, the global downturn in the wireless industry exacerbated the downtrend in prices. In the second half of 2003 and in 2004, Axalto saw the decline in average selling prices slow due to increased demand for more sophisticated products. This shows that Axalto's customers are focusing on providing a higher value-added range of products and services to their subscribers, while still pursuing cost reduction objectives.

The factors noted above led to a general decline in average selling prices for our Mobile Communications products during the periods under review. This decline is likely to continue in the future. However, average selling prices should benefit from an improving business environment and the continuous launching of new products. These launches address the growing demand by mobile operators for SIM cards that enable advanced applications, as operators seek to increase revenue per subscriber and reduce the complexity and cost of managing their networks.

We also record revenue from sales of our plastic scratch card products in our Mobile Communications business. We sell scratch cards to mobile operators in connection with their prepaid offerings. Although volumes in this business are high, unit prices are very low. Revenue from sales of scratch cards, however, represented less than 5% of our Mobile Communications revenue during 2003 and 2004. We do not consider scratch cards to be a strategic area of our business.
Financial Cards

We supply Financial Cards to financial institution customers. The average contract term is generally one year. Financial cards expire on average within two to three years of their issuance, after which they are automatically replaced. As a result, annual contracts are awarded largely for the supply of replacement cards. In some cases, however, contracts are awarded for the initial deployment of a financial card base, particularly in markets adopting EMV standards, which require the issuance of new microprocessor cards complying with their individual specifications. This initial deployment may last for several years, as is currently the case in the UK, which started its EMV migration in 2003 and where demand grew strongly in 2004.

Although we offer a full range of financial card products, including standardized plastic magnetic stripe cards, we concentrate on designing, manufacturing and marketing microprocessor cards ranging from cards that enable basic banking applications to sophisticated multi-application cards. We sell magnetic stripe cards in Latin America, the USA and some European countries. Our magnetic stripe cards activities constitute a conventional volume business, which means that, because these cards are generally sold at low prices, revenue from sales of these cards varies mainly as a function of volumes sold. Although revenue attributable to magnetic stripe cards has represented a material portion of our Financial Cards revenue during the periods under review, our revenue from these products at historical exchange rates decreased to 10% of total Financial Cards revenue in 2004 from 11% in 2003 and 15% in 2002. Meanwhile, the percentage attributable to financial microprocessor cards increased to 73% in 2004 from 68% in 2003 and 62% in 2002. Revenue from personalization services and sales of modules to card embedders accounted for the remainder of our Financial Cards revenue.

We have typically recorded most of our revenue from sales of financial microprocessor cards in Western Europe (which was our main market for these cards during the periods under review), particularly in France, and more recently, the UK. However, financial institutions around the world are increasingly demanding the enhanced security offered by microprocessor cards in terms of authenticating holders and authorizing transactions, which helps to reduce fraud. This shift from magnetic stripe cards to microprocessor cards accelerated in 2004 as financial institutions sought to comply with the required migration to EMV standards in Europe, particularly in the UK. This trend is likely to continue in Europe, Asia and Latin America. We believe that these factors will lead to higher volumes of sales of financial microprocessor cards in future periods.

In general, each financial card issuer chooses the specifications for its financial microprocessor cards as part of national consortia, and imposes these specifications on its clients. As a result, our Financial Cards business is characterized by a lower degree of product differentiation within a given country than our Mobile Communications business. This increases price competition among card manufacturers and reduces our ability to increase functionality or prices by innovating or introducing higher-end products. To date, our financial institution customers have generally chosen to issue microprocessor cards for basic banking applications in connection with EMV migration, rather than high-end open platform microprocessor cards that enable additional value-added services or applications. Accordingly, these more basic microprocessor card products represented a substantial part of our sales of financial microprocessor cards during the periods under review. However, once the EMV migration is complete, card replacement may provide financial institutions with an opportunity to differentiate their positions by offering multi-application cards, for which purchase price is a less crucial factor.

We also record revenue from sales of our Proton e-purse products which, since our acquisition of CP8 in April 2001, has contributed significantly to our Financial Cards revenue during the periods under review.

Public Sector, Network Access and Other Products

The Public Sector, Network Access and Other Products business combines several growing market segments in which it appears that microprocessor card technology has clear advantages over alternative technologies, due to its versatility, portability and the guarantees it provides in terms of respecting individual freedoms. At historical exchange rates, revenue from the Public Sector, Network Access and Other Products business represented 11% of the overall Cards segment revenue in 2004 compared with 9% in 2003 and 14% in 2002. As described below, the volatility of revenues in this business is mainly due to:

- The size and the currently limited number of projects. Decision-making procedures are long and complex, particularly in the public sector.
The wide diversity of products supplied. Selling prices can vary significantly depending on how sophisticated they are.

The non-recurrent nature of a large portion of revenues resulting from intellectual property licensing.

Contracts for Public Sector, Network Access and Other Products projects, which often require significant investment and lead times, are typically offered through public tender and procurement procedures. Because these projects typically involve significant consulting and infrastructure elements, we generally compete in these tenders in association with local partners and the world's leading systems integrators to provide chip card products and related services required by the projects. Contracts generally specify delivery of significant volumes of cards over long periods of time. We also typically tailor our products on a project-by-project basis. There is significant volatility in our revenue from such tenders in view of the currently limited number of projects, their size and the fact that we may or may not be part of the winning consortia. As our products are often tailored to particular projects and because the market is still in a build-up phase, clear trends in pricing have yet to emerge. Our product offering in this market, however, generally consists of sophisticated microprocessor card products, particularly for applications in the public sector such as identity, healthcare and security.

Revenue attributable to the licensing of intellectual property rights is also included in our Public Sector, Network Access and Other Products business. This revenue includes non-recurrent licensing revenue, which usually results from efforts to assert Axalto's intellectual property rights. It varies substantially from one period to the next depending on the level of revenues and the date on which they are recognized in the company's books.

Prepaid Phonecards

Historically, we have earned significant revenue from sales of our prepaid phonecard products. Because these products are generally sold at significantly lower prices than our microprocessor card products due to their relative lack of technological sophistication, revenue in our Prepaid Phonecards business is driven mainly by our ability to obtain large card orders. The volume of products sold in this market has been declining in recent periods as users are increasingly relying on other means of communication, including mobile phones and scratch card-based calling, instead of public payphones. We have decided not to continue to compete for prepaid phonecard orders at prices that we do not believe are commercially reasonable, and do not intend to continuously expand our business in this market. Instead, we intend to allocate our resources to higher-value products in our other businesses.

POS Terminals segment

The volume of products we sell in our POS segment depends on our ability to supply products that meet a broad range of local standards and to deliver products on a timely basis in different geographic markets, as well as on changes in technical specifications that require our customers to purchase new compliant terminals. While prices were essentially stable during 2002, we began to experience increasing pricing pressure on our POS terminal products in 2003 and 2004, due to the increased competition that has developed as our long-standing markets have matured. As a result, in the first quarter of 2004, the company refocused its activities on geographical zones and applications in which it can make the most of its competitive advantages. These advantages consist of the security, mobility and versatility of its products, its leading skills in the complex EMV migration process and its strong organization in terms of after-sales service, which it provides both itself and through experienced specialists. Following the adoption of this strategy and due to the acceleration in growth in the second half of 2004, particularly in Europe - due to financial institutions switching to the new EMV standard - the POS Terminals business posted strong growth. It now has a number of core customers that are leaders in their markets and want to build a close relationship for the supply and support of POS Terminals. These customers consist mainly of major financial institutions and approved international resellers.
We expect that the migration of card-based payment systems to EMV standards that began in 2004 will continue and will have a positive impact on the POS terminal market. However, the impact of this migration on our sales may vary depending on the particular circumstances of each market. Axalto has strong positions in certain countries outside Europe, particularly India, based on the same competitive advantages.

5.1.3 Principal Factors Affecting Gross Profit

We define gross profit as revenue less cost of revenue. We define gross margin as the percentage of revenue represented by gross profit. Cost of revenue includes, principally, the cost of silicon chips, printed circuits (usually gold-plated) and plastic needed to produce cards, depreciation of tangible assets, amortization of intangible assets and, when applicable, impairment charges of goodwill and intangible assets, royalties paid to third parties in respect of technology used in our products, supply chain management costs, quality and security management costs, delivery costs and personnel costs attributable to our production and personalization processes. Cost of revenue for our POS segment also includes, through the period ended August 2003, the cost of electronic and plastic-molded components to produce POS terminals, and, following the sale of our POS manufacturing operations to Flextronics in August 2003, payments made under our outsourcing contract with Flextronics. Charges related to restructuring measures are also accounted as cost of revenue in cases where the costs associated with the function or position made redundant or the assets being impaired or written-down are normally recorded as cost of revenue.

Cost of revenue does not include operating expenses, including research and engineering, sales and marketing and general and administrative expenses.

Cards segment

The main factors affecting gross profit and gross margin are microprocessor card sales volumes, the product mix in each product line, revenues from the patent portfolio, silicon chip purchasing prices, productivity and control over fixed manufacturing costs.

- Microprocessor card sales volumes are the main factor affecting gross profit. Rising sales volumes lead to rising gross profit and gross margin in all product areas and geographical regions in which Axalto operates. Sales volumes have a major impact on the purchase price of the main components, particularly silicon chips, and on capacity utilization rates and therefore absorption of fixed production costs.

- The second significant factor is the product mix, meaning the ratio of sales volumes of more sophisticated and hence higher-priced products to sales volumes of prior generations of products that are less sophisticated and subject to intense price competition. Axalto's product mix is a key factor for profitability across all of our geographic regions and businesses. In particular, because we typically generate a significant part of our revenue from our Mobile Communications business, the mix of our wireless products sold around the world has been a key element of our gross profit over the past three years. Our Financial Cards business is characterized by a significant difference in gross margin between microprocessor cards and magnetic stripe cards, since our microprocessor cards typically generate higher gross margins than our magnetic stripe cards. As a result, overall gross profit in the Financial Cards business is affected by the relative percentage of microprocessor card and magnetic stripe card sales volumes. Within the microprocessor card range, those offering advanced functions, combining traditional credit- and debit-card features with electronic purse functions or loyalty card functions relating to one or more brands, generate substantially wider margins. On the other hand, since products in our Public Sector, Network Access and Other Products business are often tailored to particular projects and because the market is still emerging, clear trends in gross margins in this business have not yet emerged and gross margins fluctuate widely.

- The third main factor for gross profit and gross margin is the level of sales from intellectual property licensing. The cost of revenues in this business consists of amortization charges on the patent portfolio, and costs incurred to maintain the validity of existing patents, file new patents and assert the Company's rights with respect to users. These costs are mainly fixed. As a result, due to the low variable costs associated with our licensing activities, gross profit trends in these activities are aligned with revenue trends, except in the event that we determine that an impairment of our patent portfolio is necessary.
The fourth key factor for gross profit is the cost of revenue for microprocessor cards, particularly silicon chip purchasing costs. Due to its diversified procurement policy and its large purchasing volumes, Axalto has in the past been able to negotiate price reductions when buying silicon chips. This has enabled it to increase gross profit or, in periods of weaker growth, to limit the decline in gross profit when the price of cards was falling. However, the decrease in chip prices may sometimes lag behind the drop in the selling prices of our products by several months, which can have a negative effect on gross profit.

The final factor affecting gross profit consists of productivity and control over fixed manufacturing costs. Axalto strives constantly to reduce its production costs, particularly in low-end and mid-range products. It does this by adjusting its production and procurement processes, and increasing the flexibility of its production system, which is based on the "virtual factory" concept (see section 4.1.8 - Production).

**POS Terminals**

Axalto seeks to optimize gross profit in the POS segment by giving its products unique features that meet its customers' requirements as closely as possible, and by providing long-term technical support services. To reduce production costs, Axalto designs products around a common platform and hence reduces the number of component parts. The sale of our POS terminal manufacturing operations (our facility in St. Etienne, France) to Flextronics in August 2003 and the resulting outsourcing of POS terminal manufacturing have had a gradual positive impact on gross profit in the POS segment.

**Exceptional, restructuring and impairment charges**

Gross profit in both our Cards and POS segments has also been affected by a certain number of exceptional charges and restructuring and impairment charges.

In 2002, gross profit for our Cards segment included an exceptional $93 million impairment charge relating to CP8’s patent portfolio and core technologies, of which $82 million was recorded in our Public Sector, Network Access and Other Products business, $9.5 million in our Mobile Communications business and $1.5 million in our Financial Cards business. This patent portfolio and these technologies were valued by independent appraisers in the fourth quarter of 2000, prior to the completion of the acquisition of CP8. However, subsequent difficulties experienced by the main players in the telecommunications and technology industries led us to review and impair the value of these assets in the fourth quarter of 2002.

In 2002, an exceptional restructuring charge of $1.5 million was recorded in the Financial Cards business, relating to the closure of our Felixstowe factory in the UK. This followed our decision to consolidate our UK manufacturing operations in the new factory in Fareham, UK, which we acquired as part of our acquisition of CP8 in April 2001.

Gross profit in our POS segment in 2003 included a $1.3 million write-down of inventory not purchased by Flextronics as part of its acquisition of our POS terminal manufacturing operations in St. Etienne in August 2003.

In 2004, Axalto's cost of revenue included the following restructuring and impairment charges: $2.8 million of impairment on certain technologies acquired from Bull in 2001, $0.7 million relating to the continuous performance improvement plan and $2.8 million of impairment on a production site.

These charges were booked mainly in the second half of the year. The impact on gross profit across the various product areas broke down as follows: $2.1 million in Mobile Communications, $3.7 million in Financial Cards, $0.3 million in Public Sector, Network Access and Other Products and $0.2 million in Prepaid Phonecards.

**5.1.4 Other Factors Affecting Results of Operations**

**Acquisitions**

In the past, acquisitions have affected our results of operations, not only by increasing the size or scope of our operations, but also due to related reorganizations, integration and accounting implications. Axalto made no acquisitions in 2002, 2003 or 2004.
Impact of Foreign Currency Exchange Rates

We prepare our combined and consolidated financial statements in US dollars. We have chosen the US dollar as the reporting currency of our financial statements because we conduct a significant and increasing portion of our business in US dollars or currencies which are pegged to the US dollar. However, we record revenue, expenses, assets and liabilities in a number of different currencies other than US dollars, principally the euro.

Assets and liabilities denominated in local currencies are translated into US dollars at exchange rates prevailing at the balance sheet date. The resulting adjustments are recorded in total invested equity on the combined balance sheet. Revenue and expenses are translated at weighted-average exchange rates over the relevant period. We include realized and unrealized foreign currency transaction gains (losses) in net income (loss) in the period in which they occur. In addition, in determining the cash flow provided by or used in the changes in assets and liabilities in our combined statements of cash flows, we deduct from the year-end balances of those assets and liabilities the amount corresponding to the variations in the functional currencies of group companies against the US dollar over the period.

Historically, although a significant portion of Axalto's revenue has been in US dollars or currencies linked to the US dollar (such as the Chinese renminbi), we incurred a higher portion of our costs of revenue in euros since several of our suppliers of chips were located in Europe and charged us in euros. Because our revenue and our cost of revenue were recorded to a significant extent in different currencies, our gross profit could be significantly affected by fluctuations in exchange rates, principally between the US dollar and the euro. For several years, Axalto has been seeking to reduce this exposure to euro/dollar exchange rate risk by trying to establish natural hedging through increasing the proportion of its costs denominated in US dollars. As a result, Axalto has increased production capacity locally and in markets showing the strongest growth potential, and has taken into account billing currency when selecting chip suppliers. Furthermore, the Company has used currency hedging instruments for its remaining exposure (see section 5.1.8 - Market Risk).

As a result of these efforts, Axalto has significantly reduced its gross profit's exposure to fluctuations in the euro/dollar and sterling/dollar exchange rates. On the other hand, the rally in the euro against the US dollar had a negative impact on operating income in 2003 and 2004, due to the large portion of operating expenses denominated in euro and sterling.

For information, and based on the breakdown of revenue and expenses affecting operating margin by currency in 2003, the company has estimated that the conversion effect of a 1% fall in the US dollar against the euro and sterling is as follows:

- a 0.5% increase in revenue
- no significant change in gross profit, due to the aforementioned natural hedging that Axalto has gradually created; however, gross margin would fall due to the increase in revenue
- a 0.7% increase in operating expenses, with a negative impact on operating income.

To mitigate the adverse impact of exchange rate fluctuations, Axalto has since 2003 used currency options and forward contracts to protect the value of a certain percentage of its forecasted, but not firmly committed, foreign currency intra-group costs. These instruments, their impact on the income statement and their year-end balance sheet value are described in notes 2 and 16 to the audited combined and consolidated financial statements.

In order to isolate the effects of fluctuations in foreign currency exchange rates on revenue and gross profit during the periods under review, the discussion below includes revenue and gross profit figures at constant exchange rates. To calculate these figures at constant exchange rates, we applied the monthly exchange rates used in a given month of the period under review to the amount of revenue recorded in euro and British pounds (which, together, cover approximately 80% of our non-US dollar revenue) recorded in the same month in the previous year. We then add the adjusted monthly figures for the previous year to derive annual figures for this year at constant exchange rates. The discussion below of our results of operations is, unless otherwise indicated, based on our results of operations at constant exchange rates.

The table below sets forth the US dollar/euro exchange rates for the periods indicated used in the preparation of our combined and consolidated financial statements.
(1) Represents the exchange rate on the last business day of the applicable period. The US dollar/euro exchange rates on the last business days of January, February and March 2005 were 1.30, 1.32 and 1.30 to the euro respectively.

(2) Represents the average of the exchange rates used to convert income statement items in each month during the relevant period. The US dollar/euro exchange rates used to convert income statement items in January, February and March 2005 were 1.36, 1.30 and 1.32 dollars to the euro respectively.

(3) Based on the average of the exchange rates used to convert income statement items in each month during the relevant period.

### Seasonality

The majority of Axalto's revenue and gross profit traditionally comes in the second half of each year. This is due to the following factors:

- The Mobile Communication business makes a stronger contribution to total Cards segment revenue during the second half. This business generates a higher gross margin than the other Cards businesses.

- Card sales volumes increase significantly in the second half, mainly due to the previous factor, resulting in better absorption of fixed production costs and a reduction in component prices through volume discounts previously negotiated with suppliers.

- The full positive impact of productivity gains achieved during the year is seen towards the end of the year.

Our revenue and gross profit are generally lowest in the first half of each year, despite the positive impact on our Mobile Communications business of higher sales of mobile phones in Asia during the Chinese New Year season. This latter effect is diminishing each year. This first-half dip is mainly the result of:

- The introduction of new selling prices at the start of the year, negotiated as part of annual contracts with mobile operators, which are generally lower on a constant product mix basis.

- The fact that the positive impact on margins caused at the start of the year by the introduction of new component purchasing prices negotiated with suppliers - usually lower for any given component type - is cancelled out by the negative adjustment to the value of the component inventories at the start of the year to reflect these new prices.

Trends in the industry may, however, affect the seasonal pattern of revenue and gross profit, and therefore of operating margin. Seasonality does not have a material impact on the POS segment.

### 5.1.5 Results of Operations for the Three Years Ended December 31, 2004

#### Revenue by Segment

The following table sets forth the breakdown of our revenue by segment at historical exchange rates for the periods indicated in millions of US dollars and as a percentage of total revenue:
## Gross Profit by Segment

The following table sets forth the breakdown of our gross profit by segment at historical exchange rates for the periods indicated in millions of US dollars and as a percentage of total gross profit:

<table>
<thead>
<tr>
<th>Segment</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards segment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mobile Communications</td>
<td>111</td>
<td>161</td>
<td>67</td>
</tr>
<tr>
<td>Financial Cards</td>
<td>9</td>
<td>27</td>
<td>11</td>
</tr>
<tr>
<td>Public Sector, Network Access and Other Products (1)</td>
<td>(50)</td>
<td>30</td>
<td>13</td>
</tr>
<tr>
<td>Prepaid Phonecards</td>
<td>18</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Total Cards</td>
<td>88</td>
<td>227</td>
<td>95</td>
</tr>
<tr>
<td>POS Terminals</td>
<td>13</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td>238</td>
<td>100</td>
</tr>
</tbody>
</table>

(1) Percentage amounts for 2002 are not presented due to the negative impact on gross profit in our Mobile Communications, Financial Cards and Public Sector, Network Access and Other Products businesses caused by the impairment charge recorded in December 2002 in respect of CP8’s patent portfolio and its core technologies, the bulk of which was recorded in our Public Sector, Network Access and Other Products business. Furthermore, the closure of our factory in Felixstowe, UK had a negative impact on gross profit in our Financial Cards business. Excluding these exceptional items, the Cards segment’s total gross profit would have increased to $183 million for 2002. Gross profit in our Mobile Communications, Financial Cards and Public Sector, Network Access and Other Products businesses would have represented 61%, 6% and 16%, respectively, of total gross profit for 2002.

(2) Includes gross profit from the licensing of intellectual property.

## Revenue by Geographic Region

The following table sets forth our revenue for our Cards and POS Terminals segments at historical exchange rates by geographic region for the periods indicated in millions of US dollars and as a percentage of total revenue:

<table>
<thead>
<tr>
<th>Segment</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards segment</td>
<td></td>
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<tr>
<td>Mobile Communications</td>
<td>111</td>
<td>161</td>
<td>67</td>
</tr>
<tr>
<td>Financial Cards</td>
<td>9</td>
<td>27</td>
<td>11</td>
</tr>
<tr>
<td>Public Sector, Network Access and Other Products (2)</td>
<td>(50)</td>
<td>30</td>
<td>13</td>
</tr>
<tr>
<td>Prepaid Phonecards</td>
<td>18</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Total Cards</td>
<td>88</td>
<td>227</td>
<td>95</td>
</tr>
<tr>
<td>POS Terminals</td>
<td>13</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td>238</td>
<td>100</td>
</tr>
</tbody>
</table>

(1) Percentage amounts for 2002 are not presented due to the negative impact on gross profit in our Mobile Communications, Financial Cards and Public Sector, Network Access and Other Products businesses caused by the impairment charge recorded in December 2002 in respect of CP8’s patent portfolio and its core technologies, the bulk of which was recorded in our Public Sector, Network Access and Other Products business. Furthermore, the closure of our factory in Felixstowe, UK had a negative impact on gross profit in our Financial Cards business. Excluding these exceptional items, the Cards segment’s total gross profit would have increased to $183 million for 2002. Gross profit in our Mobile Communications, Financial Cards and Public Sector, Network Access and Other Products businesses would have represented 61%, 6% and 16%, respectively, of total gross profit for 2002.

(2) Includes gross profit from the licensing of intellectual property.
Revenue and Gross Profit

At historical exchange rates, our revenue increased by 25% to $960 million in 2004 from $768 million in 2003. At constant exchange rates, revenue increased by 19% to $960 million in 2004 from $807 million in 2003. At historical and constant exchange rates, gross profit increased by 32% to $315 million in 2004 from $238 million in 2003.

The following discussion of our results of operations is, unless otherwise indicated, based on our results of operations at constant exchange rates.

Revenue and Gross Profit by Segment

Cards Segment

At historical exchange rates, revenue in the Cards segment increased by 23% to $883 million in 2004 from $717 million in 2003. At constant exchange rates, revenue rose by 17% to $883 million in 2004 from $752 million in 2003. This increase in revenue in the Cards segment was driven by all product lines except Prepaid Phonecards.

At historical exchange rates, gross profit in our Cards business increased by 31% to $297 million in 2004 from $227 million in 2003. At constant exchange rates, gross profit increased by 32% to $297 million in 2004 from $226 million in 2003. This increase was due to higher gross profit in all product lines except Prepaid Phonecards.

Mobile Communications

At historical exchange rates, revenue in the Mobile Communications product line rose by 24% to $549 million in 2004 from $444 million in 2003. At constant exchange rates, revenue increased by 19% to $549 million in 2004 from $460 million in 2003. Growth was strong in all regions, coming in at 32% in NSA, 17% in Asia and 15% in EMEA. The increase in revenue was due to an increase in volumes and an improvement in the product mix. These factors were partially offset by the impact of decreases in average selling prices for our wireless SIM products.

We recorded a significant increase in SIM card sales volumes in all of our geographic regions in 2004. This increase in SIM card volumes, which reached 257 million units in 2004, resulted in an additional $167 million in revenue in 2004. In volume terms, growth was strongest in NSA, particularly Latin America, reflecting the
acceleration of the migration to the GSM standard by major North American and Latin American operators, as well as growth in the subscriber base of existing GSM mobile operators. Volume growth was also strong in Asia, particularly India and Southeast Asia, due to the increasing penetration of GSM mobile phone networks and the move by some operators to replace scratch cards with SIM-based microprocessor cards. EMEA also experienced rapid volume growth driven by increased penetration of GSM mobile telephones in Eastern and Central Europe and Africa, along with the roll-out of new service offerings across Europe and the initial roll-out of third generation (3G) mobile phone technology.

Improvements in the product mix also boosted revenue in this product line, contributing $92 million. In 2004, in addition to strong volume growth, the proportion of high-end products sold increased to 27%, from 14% in 2003. This rise came at the expense of mid-range products (down from 57% of volumes in 2003 to 49% in 2004) and, to a lesser extent, low-end products, (24% of volumes versus 29% in 2003). The smaller reduction in the portion of sales volumes coming from low-end products was due to a sharp increase in deliveries in Asia. This was in order to meet demand resulting from the expansion of mobile telephony in the region, particularly Southeast Asia and India, and from operators committed to replacing scratch cards with microprocessor cards. All regions contributed to the improvement in the product mix. The improvement was particularly pronounced in NSA in the fourth quarter.

The positive volume and product mix effects on our revenue was partially attenuated by decreases in selling prices for SIM products of the same type in all regions, which is usual for this type of product. Asia's share of total sales volumes increased year-on-year in the second half of 2004, due to higher quantities of low-end cards being delivered, as mentioned above. Selling prices are lower in Asia than elsewhere, due to the size of contracts and lower production costs. As a result, Asia's greater proportion of total volumes in 2004 automatically dragged down average selling prices relative to 2003.

The overall average SIM card selling price, factoring in changes in the product mix, fell by 13% at constant exchange rates in 2004. The decline was most pronounced in Asia and EMEA. Although the improvement in the Asian sales mix accelerated in the fourth quarter throughout the region, it was slower over the year as a whole, particularly in China. As a result, the improvement only partly offset the price impact of stiffer competition. The product mix improvement was more pronounced in EMEA, where moves by operators to adopt more sophisticated cards limited the impact of price cuts on the average selling price. The improvement was strongest in NSA, due to efforts to encourage customers to adopt our high-end cards en masse, which they did in the second half. As a result, the average selling price fell least in this region.

Revenue from scratch cards fell to $15 million in 2004, from $21 million in 2003 at historical exchange rates ($22 million at constant exchange rates), mainly due to lower volumes. In addition, revenue from software applications and services, which include services sold separately from cards, rose by $6 million, with the three regions contributing equally to the increase.

At historical exchange rates, gross profit in the Mobile Communications product line rose by 33% to $214 million in 2004 from $161 million in 2003. At constant exchange rates, gross profit increased by 34% to $214 million in 2004 from $160 million in 2003. Gross margin was 39% in 2004 compared with 36% in 2003. This rise was mainly due to the better product mix and the fall in unit production costs, the effects of which more than offset the negative impact of lower selling prices, including in low-end products. The fall in unit production costs resulted mainly from lower silicon chip purchasing prices, due to the Company's diversified procurement policy and the sharp increase in purchasing volumes. Other factors included specific efforts to support the profitability of low-end products, and improved absorption of fixed costs resulting from higher production volumes and capacity utilization rates.

Financial Cards

At historical exchange rates, revenue in our Financial Cards business increased by 22% to $196 million in 2004 from $160 million in 2003. At constant exchange rates, revenue increased by 13% to $196 million in 2004 from $174 million in 2003. Strong sales growth in EMEA accounted for most of this increase. Growth in NSA was more modest, while Asia saw a substantial fall in the first half, partly offset by a strong recovery in the second. Revenue growth in the Financial Cards product line was due to the combination of a strong increase in microprocessor card sales volumes ($31 million) and higher average selling prices ($2 million), partly offset by a less favorable product mix ($7 million). The rise in microprocessor card sales volumes resulted from the faster migration to the EMV standard in the UK, which led to strong demand from UK financial institutions. The less
favorable product mix reflects the sharp increase in UK EMV card sales relative to total sales. The average price of UK EMV cards is lower than those of other microprocessor cards delivered, since they require fewer functions, and because competition is stiff in this high-volume market.

At historical exchange rates and constant exchange rates, gross profit increased to $42 million in 2004 from $27 million in 2003. Gross margin rose to 21% in 2004, up from 17% in 2003 at historical exchange rates and 16% in 2003 at constant exchange rates. This improvement was mainly due to the rapid rise in microprocessor card volumes, particularly in the UK. This led to better coverage of fixed production costs and a fall in component procurement costs. Higher gross profit also reflects productivity gains achieved in manufacturing, logistics and personalization work specific to this product line. Impairment charges booked in the second half (described in section 5.1.3. - Principal Factors Affecting Gross Profit - Exceptional, restructuring and impairment charges) reduced the positive impact of the fall in production overheads expenses allocated to this product line relative to 2003.

Public Sector, Network Access and Other Products

At historical exchange rates, revenue in our Public Sector, Network Access and Other Products business increased by 57% to $98 million in 2004 from $63 million in 2003. At constant exchange rates, revenue rose by 49% to $98 million in 2004 from $66 million in 2003.

Excluding the impact of our intellectual property licensing activities - which was $28 million in 2004 versus $10 million in 2003 - revenue in our Public Sector, Network Access and Other Products business rose by 33% to $70 million in 2004, from $53 million in 2003. At constant exchange rates, non-licensing revenue increased by 26% to $70 million in 2004 from $56 million in 2003. $8 million of the increase was due to the sharp rise in pay-TV microprocessor card sales in EMEA, while $6 million came from higher deliveries of microprocessor cards, card readers and related services for digital network access in NSA and EMEA. Revenue growth in network access applications reflects strong demand from the US Department of Defense and other government departments, along with demand for access badges, card readers and related services from large corporations in NSA and EMEA. Revenue from public sector and transport applications remained stable. A $4 million decline in EMEA, due in particular to lower revenue from the French healthcare administration, was offset by growth in NSA and Asia. Deliveries to the Puerto Rico healthcare agency accounted for the growth seen in NSA, while sales of modules for the transport system in Seoul, South Korea was the main factor behind sales growth in Asia.

At historical exchange rates, gross profit in the Public Sector, Network Access and Other Products business was $38 million in 2004, compared with $30 million in 2003, an increase of 26%. At constant exchange rates, gross profit rose by 29% to $38 million in 2004 from $29 million in 2003. Gross margin was 38% in 2004, compared with 45% in 2003. The fall in gross margin in 2004 was mainly due to a weaker product mix in pay-TV and digital network access applications, particularly relative to the very strong product mix in 2003. It also resulted from a fall in average selling prices in some high volume, reduced-function products for the public sector.

Prepaid Phonecards

At historical exchange rates, revenue in our Prepaid Phonecards business decreased by 20% to $40 million in 2004 from $50 million in 2003. At constant exchange rates, revenue fell by 24% to $40 million in 2004 from $52 million in 2003. This decline was mainly caused by lower average selling prices ($8 million) and lower volumes ($3 million), due to the ongoing fall in global demand for these products, particularly in Asia and EMEA. Delivery volumes dropped sharply in Asia and, to a lesser extent, in EMEA, although selling prices fell more in EMEA. However, volumes rose in NSA, due to a less severe reduction in demand in some Latin American countries and the Company's selective approach to this market.

At historical exchange rates, gross profit in our Prepaid Phonecards business decreased by 67% to $3 million in 2004 from $9 million in 2003. At constant exchange rates, gross profit fell by 66% to $3 million in 2004 from $9 million in 2003. Gross margin decreased to 8% in 2004 from 17% in 2003. The fall in gross profit was attributable mainly to lower average selling prices.

POS Terminals

At historical exchange rates, revenue in the POS Terminals segment increased by 52% to $77 million in 2004 from $51 million in 2003. At constant exchange rates, revenue rose by 41% to $77 million in 2004 from $55
million in 2003. This improvement was mainly due to the success of Axalto's products and services with EMEA financial institutions involved in EMV migration, particularly in France and the UK. Revenue also advanced in Asia, albeit at a slower rate, due in particular to Axalto's efforts to set up appropriate service and technical support structures.

At historical exchange rates, gross profit in our POS segment rose by 58% to $18 million in 2004 from $11 million in 2003. At constant exchange rates, gross profit increased by 47% to $18 million in 2004 from $12 million in 2003. Gross margin in 2004 came in at 23% versus 22% in 2003. Gross margin increased sharply in the final nine months after Axalto refocused its activities on regions in which its products and services are particularly well suited to customer needs.

Operating Expenses

At historical exchange rates, operating expenses rose by 20% to $229 million in 2004 from $190 million in 2003. At constant exchange rates, operating expenses increased by 13% to $229 million in 2004 from $203 million in 2003. This increase compares with revenue growth of 25% at historical exchange rates and 19% at constant exchange rates. It was caused mainly by higher R&D spending, increased spending on sales, marketing and technical support resources in order to support business growth and geographical expansion, and additional administrative costs resulting from Axalto's new status of independent, listed company.

Research and Engineering Expenses

At historical exchange rates, research and engineering expenses increased by 30% to $64 million in 2004 from $49 million in 2003. At constant exchange rates, research and engineering expenses rose by 20% to $64 million in 2004 from $53 million in 2003. The main factor behind this rise was additional investment in response to strong demand for innovative new applications, both expressed by our customers and identified by our marketing teams and research centers. This investment is beneficial to all microprocessor card applications, particularly those in the Mobile Communications and Public Sector, Network Access and Other Products product lines. $2 million of product development costs relating to third generation Mobile Communications applications were capitalized in compliance with US GAAP in 2004, the same amount as in 2003.

Sales and Marketing Expenses

At historical exchange rates, sales and marketing expenses increased by 19% to $110 million in 2004 from $92 million in 2003. At constant exchange rates, sales and marketing expenses rose by 12% to $110 million in 2004 from $98 million in 2003. A large proportion of this increase in spending went on technical support teams working in the field, to ensure the rapid roll-out of applications supported by high-end Mobile Communications cards at Operators which were receptive to Axalto's marketing support for these products.

General and Administrative Expenses

At historical exchange rates, general and administrative expenses rose by 12% to $55 million in 2004 from $49 million in 2003. At constant exchange rates, general and administrative expenses increased by 6% to $55 million in 2004 from $52 million in 2003. This rise reflects the additional general and administrative expenses incurred by Axalto since it became an independent, listed company on May 18, 2004. When it was a division of Schlumberger, Axalto benefited from a shared services base, since some services - legal, tax, accounting, internal audit, employee savings and pension plans, real estate management, insurance, IT, treasury and some other administrative tasks - were carried out centrally and on a larger scale by Schlumberger. The proforma 2003 income statement - published in section 5.1.2.2. ("Pro Forma Condensed Financial Information") of the prospectus registered by the AMF on March 22, 2004 under reference number I.04-037 - included an estimate made by Axalto regarding the additional general and administrative expenses that the Company would have had to bear if it had been a separate, independent and listed company throughout 2003. This estimate was $5 million, based on the level of revenue and average exchange rates seen in 2003.

The increase in administrative expenses in 2004, at constant exchange rates, is in line with the estimate provided in the 2003 pro forma income statement.
Interest Expense, Net

Axalto recorded net interest income of $0.3 million in 2004, as opposed to a net expense of $5.3 million in 2003. Interest income in 2004 resulted from the net cash position in place since the start of the year, in preparation for the IPO, in line with Schlumberger's commitment to ensure that Axalto would have net cash of $45 million at the time of the IPO. This cash position grew constantly during the year, and was invested in short-term instruments. As a result, interest income exceeded interest expenses on the credit facilities that Axalto had opened or maintained for the benefit of some group entities.

Other Income, Net

At historical exchange rates, other income increased to $4.3 million in 2004 from $1.7 million in 2003. The increase in 2004 resulted from the final settlement of litigation with Groupe Bull over the acquisition of its CP8 smartcard business in 2001.

Tax Benefit (Expense)

A tax expense of $25 million was recorded in 2004, up from $7 million in 2003. This increase was generally the result of higher profitability. The effective tax rate rose from 20.1% in 2003 to 29.9%, due to stronger business growth in EMEA and NSA, where nominal tax rates are higher, and slower relative growth in Asia, where tax rates are generally lower.

Minority Interests

At historical exchange rates, minority interests in income fell to $0.7 million from $2.4 million in 2003, due to lower net income from joint ventures in China.

5.1.1.1 Year Ended December 31, 2002 Compared with Year Ended December 31, 2003

Revenue and Gross Profit

At historical exchange rates, revenue increased by 5% to $768 million in 2003 from $730 million in 2002. At constant exchange rates, however, revenue decreased by 2% to $768 million in 2003 from $786 million in 2002. At historical exchange rates, gross profit increased strongly to $238 million in 2003 from $101 million in 2002. At constant exchange rates, gross profit rose to $238 million in 2003 from $97 million in 2002. Excluding exceptional charges, at historical exchange rates gross profit increased by 22% to $240 million in 2003 from $196 million in 2002, and, at constant exchange rates, gross profit increased by 14% to $240 million in 2003 from $209 million in 2002 (see section 5.1.3 - Principal Factors Affecting Gross Profit - Exceptional, restructuring and impairment charges).

The following discussion of our results of operations is, unless otherwise indicated, based on results of operations at constant exchange rates.

Revenue and Gross Profit by Segment

Cards segment

At historical exchange rates, revenue in the Cards segment increased by 5% to $717 million in 2003 from $680 million in 2002. At constant exchange rates, however, revenue decreased by 2% to $717 million in 2003 from $732 million in 2002. This decline in revenue reflected lower revenue in each of our Financial Cards, Public Sector, Network Access and Other Products and Prepaid Phonecards businesses, which was partially offset by higher revenue in our Mobile Communications business.

At historical exchange rates, gross profit in our Cards business increased by 158% to $227 million in 2003 from $88 million in 2002. At constant exchange rates, gross profit increased by 173% to $227 million in 2003 from $83 million in 2002. Excluding exceptional charges, gross profit for the Cards segment increased by 24% to $227 million in 2003 from $183 million in 2002 (see section 5.1.3 - Principal Factors Affecting Gross Profit - Exceptional, restructuring and impairment charges). This rise was due principally to higher gross profit in our
Mobile Communications and Financial Cards businesses, which was partially offset by lower gross profit in our Prepaid Phonecards and Public Sector, Network Access and Other Products businesses.

**Mobile Communications**

At historical exchange rates, revenue in our Mobile Communications business increased by 22% to $444 million in 2003 from $363 million in 2002. At constant exchange rates, revenue increased by 16% to $444 million in 2003 from $383 million in 2002. Revenue increased by 94% in NSA and by 30% in EMEA, but decreased by 4% in Asia during the period. The increase in revenue was due to higher volumes and an improvement in the product mix. These factors were partially offset by the impact of lower average selling prices for our wireless SIM products.

We recorded a significant increase in SIM card sales volumes in all of our geographic regions in 2003. This increase in SIM card volumes, which reached 186 million units in 2003, contributed an additional $153 million in revenue in 2003. Based on the number of cards sold, volume growth was strongest in Asia, particularly in China, India and Southeast Asia, due to increased market penetration of GSM mobile networks. We also experienced significant volume growth in NSA reflecting faster migration to the GSM standard by major North American and Latin American operators, as well as growth in the subscriber base of existing GSM mobile operators. In addition, EMEA experienced strong growth driven by increased penetration of GSM mobile telephones in Eastern and Central Europe and Africa, by the roll-out of new service offerings across Europe, such as multimedia messaging services, which require new, more sophisticated wireless SIM cards, and by initial orders of cards designed for third generation networks. In terms of the percentage of total sales volumes, the largest increase took place in NSA, followed by EMEA and Asia.

Revenue was also positively affected by a shift in our product mix to higher-end products. Low-end products, which include 8KB and non-Java 16KB cards, constituted 29% of shipments in 2003 (40% in 2002). Mid-range products, which include Java-based 16KB cards and 32KB cards, accounted for 57% of shipments in 2003 (51% in 2002). High-end products, which include all SIM cards with memory capacity of 64KB or greater, made up 14% of shipments in 2003 (9% in 2002). This more favorable product mix contributed an additional $74 million of revenue in 2003. In Europe, the improvement in the product mix was driven mainly by increased demand for 64KB and 128KB SIM cards from Western European mobile operators in anticipation of their third generation network roll-out and for 64KB SIM cards from second generation operators who introduced new SIM-based services, such as prepaid top-up cards which allow over-the-air topping up of prepaid mobile services. Sales of 128KB wireless (U)SIM cards in 2003 occurred principally in the Philippines and in Italy, Latin America also experienced an improvement in the product mix, driven by the introduction of new services, particularly by subsidiaries of European mobile operators which had previously successfully introduced these services in Europe.

The positive effect of higher volumes and an improved product mix on revenue was partially offset by decreases in average selling prices for our wireless SIM products in all geographic regions. The average selling price for wireless SIM products decreased by 16% overall in 2003 compared with 2002. This decrease was most pronounced in NSA where there was strong demand for 32KB cards and competition among card suppliers was intense. Average selling prices in Asia and EMEA also decreased, but to a lesser extent than in NSA. This was mainly because of most of the world’s mobile operators adopting centralized purchasing processes, which led to further pricing pressures on wireless SIM products. In addition, in China, competition from local suppliers increased and a major mobile operator moved from an annual, regional tendering process to a quarterly, national tendering process, resulting in further pressure on prices. Trends in average selling prices during 2003, however, were different. After a further decline in average selling prices relative to 2002, the average selling price for our wireless SIM products increased by 8% in the second half of 2003 compared with the first half. This increase was mainly due to the second-half launch of new generation high-end products, including our 128KB cards in EMEA and Asia. The increase in average selling prices during the second half of the year was, however, partially offset by an increase in shipments to NSA and a less favorable product mix in Asia, both of which took place in the fourth quarter of 2003.

Revenue from scratch cards decreased slightly to $21 million in 2003 from $23 million in 2002 due to lower prices. Revenue from module sales decreased by $6.3 million. This was because our sole customer for this product (in Asia) stopped sourcing modules from third-party suppliers in mid-2002. Accordingly, we recorded no revenues from module sales in 2003. In addition, revenue from software applications and services, which includes services sold separately from cards, decreased by $7.4 million, principally in EMEA as a result of lower revenue due to the completion in 2002 of two contracts with large European operators. In addition, in 2003, more
of our service revenue was packaged with products and consequently was included in revenues from product sales.

At historical exchange rates, gross profit in our Mobile Communications business increased by 45% to $161 million in 2003 from $111 million in 2002. At constant exchange rates, gross profit increased by 36% to $161 million in 2003 from $118 million in 2002. Gross margin was 36% in 2003 compared with 31% in 2002. Excluding the $9.5 million exceptional charge relating to CP8’s core technology and allocated to our Mobile Communications business in 2002, gross profit increased by 34% at historical exchange rates to $161 million in 2003 from $120 million in 2002. Excluding this exceptional charge, gross profit increased by 25% at constant exchange rates to $161 million in 2003 from $129 million in 2002, reflecting an increase in gross margin to 36% in 2003 from 34% in 2002. This increase in gross profit was primarily due to an improvement in our product mix and a 27% decrease in production costs which was primarily attributable to a lower silicon chip costs and an improvement in coverage of fixed costs through increased production volumes and better capacity utilization.

**Financial cards**

At historical exchange rates, revenue in our Financial Cards business increased by 7% to $160 million in 2003 from $149 million in 2002. At constant exchange rates, however, revenue decreased by 4% to $160 million in 2003 from $167 million in 2002. Revenue rose in EMEA and Asia, and fell sharply in NSA. The overall decrease in revenue for Financial Cards reflected a substantial increase in the volume of microprocessor cards sold, which boosted revenue by $21 million. However, this was more than offset by lower average selling prices for our Financial Cards and changes in the product mix, which together dragged revenue down by $27 million. Within this $27 million decrease, $7 million was due to the decision to reduce production of low-end magnetic stripe cards in NSA, while $4 million was due to the completion in 2002 of a contract with a large US financial institution covering cards, readers and related services. The increase in microprocessor card sales volumes was mainly attributable to higher sales in the UK, where local financial institutions initiated a large-scale deployment of cards in connection with the UK’s continuing transition to EMV-compliant systems, and to higher shipments of Proton e-Purse cards in Malaysia. Average selling prices for our microprocessor cards declined mainly in the UK, due to intense competition in this high-volume market.

At historical exchange rates, gross profit increased to $27 million in 2003 from $9 million in 2002. At constant exchange rates, gross profit rose to $27 million in 2003 from $10 million in 2002. At both historical and constant exchange rates, gross margin increased to 17% in 2003 compared with 6% in 2002. Excluding the $1.5 million restructuring charge in 2002 attributable to the closure of the factory in Felixstowe, UK and the $1.5 million impairment charge relating to CP8's core technologies, gross profit increased to $27 million in 2003 from $12 million in 2002 at historical exchange rates, and from $14 million in 2002 at constant exchange rates. Excluding these exceptional items, gross margin increased to 17% in 2003 from 8% in 2002 at constant exchange rates. This increase primarily reflects the lower proportion of revenue attributable to magnetic stripe cards, the improved efficiency of our customization services due to higher volumes in 2003, in particular in the UK, and improved coverage of fixed manufacturing costs due to higher production volumes in the UK.

**Public Sector, Network Access and Other Products**

At historical exchange rates, revenue in our Public Sector, Network Access and Other Products business decreased by 34% to $63 million in 2003 from $96 million in 2002. At constant exchange rates, revenue decreased by 41% to $63 million in 2003 from $106 million in 2002. This decline was due mainly to a significant fall in non-recurring revenue from the licensing of technology from CP8 patents. In 2003, we recognized $10 million in revenue from such licensing, $7 million of which was non-recurring. In 2002, we had recognized $34 million in licensing revenue, $31 million of which was non-recurring.

Excluding the impact of our intellectual property licensing activities, revenue in the Public Sector, Network Access and Other Products business decreased by 16% to $53 million in 2003 from $63 million in 2002 at historical exchange rates. At constant exchange rates, non-licensing revenue decreased by 26% to $53 million in 2003 from $72 million in 2002. 73% of this decrease took place in EMEA, 11% in NSA and 16% in Asia. This decline was due mainly to a fall in sales volumes to the French health administration (following strong volumes in 2002) and the decision by the French health administration to insource a significantly greater volume of the customization services relating to card renewals in 2003 (representing a decrease in revenue of $6 million). In addition, two of our main pay-TV customers in Europe completed large deployments in 2002. This resulted in lower volumes in these customers’ orders in 2003, although this decline was partially offset by sales under a new
contract with a pay-TV customer in NSA in 2003, resulting in an overall net decrease in revenue from pay-TV of $7 million. Finally, we received lower orders for cards in 2003 under our US Department of Defense contract as well as under contracts for high-end corporate badge products in 2003 (representing a decrease in revenue of $10 million) following the large volumes delivered in 2002 and 2001. This decrease was partially offset by increased revenues from sales of microprocessor and contactless cards for the transportation sector. Higher sales volumes in the UK (London Underground) and in France (SNCF, Mairie de Paris and Paris RATP) together accounted for an increase in revenue of $5 million.

At historical exchange rates, gross profit in the Public Sector, Network Access and Other Products business was $30 million in 2003, compared with gross loss of $50 million in 2002. The gross loss in 2002 was mainly attributable to the exceptional $82 million impairment charge we recorded in December 2002 relating to CP8’s patent portfolio and core technologies. Excluding this impairment charge, gross profit in 2003 amounted to $30 million, representing a decrease of 6% from $32 million in 2002 at historical exchange rates and a fall of 9% from $33 million in 2002 at constant exchange rates. Excluding the impairment charge, gross margin in 2003 was 48% compared with 31% in 2002. In 2003, our product mix was more heavily weighted towards higher-margin activities. In addition, amortization charges on the CP8 patent portfolio and core technologies decreased significantly following the impairment charge recorded in 2002.

*Prepaid Phonecards*

At historical exchange rates, revenue in our Prepaid Phonecards business decreased by 30% to $50 million in 2003 from $71 million in 2002. At constant exchange rates, revenue decreased by 34% to $50 million in 2003 from $76 million in 2002. 74% of this decline took place in EMEA, 23% in NSA and 3% in Asia. This fall was mainly attributable to lower sales volumes (representing a decrease in revenue of $20 million) and lower average selling prices (representing a decrease in revenue of $6 million). Volumes fell by 48% in EMEA and by 24% in NSA, but rose by 13% in Asia. The decrease in volumes and average selling prices was mainly attributable to the continuing overall global decline in the phonecards market. The fall in volumes was also attributable to the completion of contracts in 2002 with two large EMEA operators.

At historical exchange rates, gross profit in our Prepaid Phonecards business dropped by 50% to $9 million in 2003 from $18 million in 2002. At constant exchange rates, gross profit decreased by 53% to $9 million in 2003 from $19 million in 2002. Gross margin narrowed to 18% in 2003 from 25% in 2002. The decrease in gross profit was mainly driven by lower average selling prices and by reduced coverage of fixed costs in the phonecard business due to lower sales volumes.

*POS Terminals*

At historical exchange rates, revenue in the POS Terminals segment increased by 2% to $51 million in 2003 from $50 million in 2002. At constant exchange rates, revenue fell by 6% to $51 million in 2003 from $54 million in 2002. This decrease was mainly due to price erosion in EMEA, mainly in Greece and Turkey, as well as in South America. In 2003, we decided to withdraw from certain markets due to excessive price pressure. In addition, revenue declined in 2003 as a result of the delay in the deployment of EMV-compliant terminals in France, as customers postponed investments in POS terminals until suppliers received EMV certification. We received such certification in the fourth quarter of 2003, and were the first card manufacturer to do so. This decline in revenue was partially offset by increased sales volumes in India and the UK.

At historical exchange rates, gross profit in our POS segment decreased by 15% to $11 million in 2003 from $13 million in 2002. At constant exchange rates, gross profit decreased by 21% to $11 million in 2003 from $14 million in 2002. Gross margin decreased to 22% in 2003 from 26% in 2002. Excluding the exceptional $1.3 million charge resulting from the write-down of inventory not purchased by Flextronics as part of its acquisition of our POS manufacturing operations in Saint-Etienne, France in 2003, gross profit at historical exchange rates remained stable at $13 million in 2003 relative to 2002. Excluding the exceptional charge, gross profit decreased by 7% at constant exchange rates to $13 million in 2003 from $14 million in 2002. Excluding the exceptional charge, gross margin contracted to 25% in 2003 from 26% in 2002. This fall was mainly due to the strong price erosion worldwide on POS terminals.
**Operating expenses**

At historical exchange rates, operating expenses decreased by 1% to $190 million in 2003 from $192 million in 2002. At constant exchange rates, operating expenses decreased by 10% to $190 million in 2003 from $211 million in 2002. This fall was mainly attributable to lower research and engineering and general and administrative expenses.

**Research and engineering expenses**

At historical exchange rates, research and engineering expenses decreased by 9% to $49 million in 2003 from $54 million in 2002. At constant exchange rates, research and engineering expenses fell by 20% to $49 million in 2003 from $61 million in 2002. This decline resulted primarily from the benefits recognized in 2003 of the ongoing rationalization of research and engineering activities, resulting in a $7 million reduction in research and engineering expenses. In addition, in 2003 we subcontracted out less work and terminated a joint development project in the USA, which together accounted for a decrease of approximately $2 million. Moreover, $2 million of product development costs relating to third generation Mobile Communications applications were capitalized in compliance with US GAAP in 2003, compared with $1 million of costs for the same type of development expensed in 2002.

**Sales and marketing expenses**

At historical exchange rates, sales and marketing expenses increased by 8% to $92 million in 2003 from $85 million in 2002. At constant exchange rates, sales and marketing expenses remained stable at $92 million in 2003 relative to 2002.

**General and administrative expenses**

At historical exchange rates, general and administrative expenses decreased by 9% to $49 million in 2003 from $54 million in 2002. At constant exchange rates, general and administrative expenses fell by 16% to $49 million in 2003 from $58 million in 2002. This decline was due to a $3 million decrease in corporate expense allocations relating to a portion of the cost of SchlumbergerSema’s management and support functions (mainly finance, human resources, legal and marketing) following a restructuring of our business within Schlumberger in 2002 in anticipation of the divestiture of Schlumberger’s Products businesses, including Axalto. In addition, we recorded a $4 million decrease in charges for doubtful accounts in 2003.

As a stand-alone, public company, we estimate that we would have incurred an additional $5 million in general and administrative expenses (see section 5.1.2.2 – “Pro Forma Condensed Financial Information” - of the prospectus registered by the AMF on March 22, 2004 under reference number I.04-037).

**Interest expense, net**

At historical exchange rates, net interest expense decreased by 29% to $5.3 million in 2003 from $7.5 million in 2002. This decrease was mainly due to the reimbursement in 2003 of cash advances made to our company by Schlumberger under its centralized treasury and cash pooling arrangement, which we funded from cash flows from operating activities.

As a stand-alone public company, taking into account the funding structure of our company and the availability of additional cash as of January 1, 2003, we estimate that our net interest expense would have been $0.3 million in 2003 (see section 5.1.2.2 – “Pro Forma Condensed Financial Information” - of the prospectus registered by the AMF on March 22, 2004 under reference I.04-037).

**Other income, net**

At historical exchange rates, other income, net, increased to $1.7 million in 2003 from $1.3 million in 2002.

**Tax benefit (expense)**

We recorded a tax expense of $7 million in 2003, compared with a tax expense of $1 million in 2002, due to the improved profitability of our business in 2003. Our effective tax rate of 20% in 2003 resulted from a favorable
geographic mix, with profits in Asia are taxed at a lower nominal rate, and lower profitability in certain South American and European countries, where nominal tax rates are higher.

Our tax expense in 2002 was mainly due to the impact of exceptional valuation allowances recorded against deferred tax assets in 2002. We record valuation allowances when it is more likely than not that the deferred tax assets will not be realized. In 2002, we recorded valuation allowances on deferred tax assets resulting from net operating losses and on deferred tax assets relating to the French patent portfolio, the value of which was written down in 2002.

**Minority interests**

At historical exchange rates, minority interests in income decreased by 14% to $2.4 million in 2003 from $2.8 million in 2002, reflecting slightly lower cumulative net income in our two Chinese joint ventures.

### 5.1.6 Liquidity and capital resources

**Liquidity**

Axalto's main sources of liquidity in 2004 consisted of cash provided by operating activities after capital expenditure, recapitalizations and cash contributions made by Schlumberger in preparation for Axalto's IPO, along with drawings on the syndicated loan arranged in 2004 and the use of bank credit facilities negotiated for certain entities not covered by the syndicated loan.

Our main sources of liquidity in 2002 and 2003 consisted of cash provided by our operating activities, short-term bank borrowings and cash advances from Schlumberger, notably through cash pooling arrangements and intra-group loans.

**Cash flows**

The following table sets forth the cash flows from operations for each of the fiscal years ended December 31, 2002, 2003 and 2004.

<table>
<thead>
<tr>
<th>Year ended December 31</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>(in thousands of US dollars)</td>
</tr>
<tr>
<td>Net cash provided by (used in) operating activities</td>
<td>56,480$^{(*)}$</td>
<td>83,920$^{(*)}$</td>
<td>167,081</td>
</tr>
<tr>
<td>Net cash provided by (used in) investing activities</td>
<td>(18,298)</td>
<td>(16,038)</td>
<td>(38,923)</td>
</tr>
<tr>
<td>Net cash provided by (used in) financing activities</td>
<td>(61,982$^{(*)}$</td>
<td>(46,754$^{(*)}$</td>
<td>41,659</td>
</tr>
</tbody>
</table>

$\^{(*)}$ In the prospectus registered by the AMF on March 22, 2004 under reference number I.04-037, the "long-term debt" caption on the balance sheet included financing resulting from the sale with recourse of some POS terminal rental contracts to a French financial institution, in an amount of $11.9 million in 2002 and $14.7 million in 2003. Due to the non-financial nature of this liability, the decision was made in 2004 to reclassify these amounts from "long-term debt" to "other long-term liabilities" on the balance sheets for the three years presented.

**Cash flows from operating activities**

Net cash provided by operating activities was $167 million in 2004, compared with $84 million in 2003. The increase in cash flows from operating activities resulted mainly from the improvement in net income which, after adding back operating items with no impact on the cash position, generated a positive cash flow of $111 million in 2004 as opposed to $63 million in 2003. Positive movements in assets and liabilities also boosted the increase in cash provided by operating activities, by $56 million in 2004 and $20 million in 2003, after neutralizing currency translation effects as described in section 5.1.4 - Other Factors Affecting Results of Operations - Impact of exchange rates.
This shows the success of Axalto's ongoing efforts to reduce its working capital requirement.

The main changes that contributed to the increase in the cash position in 2004 were:

- A $43 million rise in staff-related liabilities and other liabilities, as opposed to a $7 million increase in 2003. This rise was generally attributable to strong revenue growth in the fourth quarter of 2004 relative to the year-earlier period, and was mainly due to increases in:
  - Deferred revenue at year end of which $10 million related to POS Terminals and $7 million to the Cards segment;
  - Accrued expenses in an amount of $14 million, made up mainly of sales commissions payable to agents and distributors;
  - Accrued VAT on sales in the last four months of the year ($4 million);
  - Amounts due in respect of the personnel and management incentive and bonus plans, directly related to the improvement in earnings ($10 million);
- A $22 million increase in accounts payable in an amount up from $5 million in 2003, reflecting strong business levels in the fourth quarter together with longer payment terms granted by our main suppliers;
- An increase in the estimated liability for taxes on income ($9 million), reflecting the improvement in profitability in 2004, compared with an $3 million increase in 2003;
- The settlement of accounts receivable and other amounts due from and to Schlumberger, other than those resulting from commercial relations maintained between the two companies since the IPO, in accordance with the terms of the Master Separation Agreement. This settlement led to a $17 million reduction in receivables from related parties, as opposed to a $7 million increase in 2003, along with a $12 million reduction in payables to related parties, as opposed to $15 million in 2003. This therefore led to positive net cash flow of $5 million in 2004, as opposed to negative net cash flow of $22 million in 2003.

The positive impact of these changes was partly offset by increases in some asset captions, all related to growth in Axalto's business. (i) Inventories (up $11 million in 2004 as opposed to a fall of $12 million in 2003), (ii) other net assets and liabilities (up $14 million versus $17 million in 2003), mainly relating to the increase in VAT to be recovered, unbilled receivables and the mark-to-market of foreign exchange hedging instruments, (iii) accounts receivable (up $2 million in 2004 versus a fall of $33 million in 2003). The rise in accounts receivable was limited relative to the growth in revenue in the fourth quarter of 2004, reflecting a substantial reduction on our Days of Sales Outstanding.

Net cash provided by operating activities was $84 million in 2003, compared with $56 million in 2002. The increase in cash flows from operating activities resulted mainly from the improvement in our operating results which, after adjustment for the main non-cash items affecting net income (including impairment charges and depreciation and amortization) increased by $27 million in 2003. The $20 million increase in assets and liabilities in 2003 was similar to that seen in 2002. The principal changes in assets and liabilities that contributed to the increase in cash flow for 2003 were:

- A greater decrease in accounts receivable, net, which declined $33 million in 2003 compared with $11 million in 2002 due to improved collections in all geographic regions;
- An increase in accounts payable of $5 million in 2003, compared with a decrease of $18 million in 2002;
- A $3 million rise in the estimated charge for taxes on income, reflecting our profitability in 2003, compared with an $8 million decrease in 2002.

These favorable changes were offset by a lower decrease in inventory ($12 million in 2003 compared with $29 million in 2002), a rise in receivables from related parties ($7 million in 2003, compared with a fall of $6 million in 2002) due to the invoicing to Schlumberger of separation charges incurred by Axalto entities, which Schlumberger has agreed to assume, as well as a greater decrease in payables to related parties ($15 million in
2003 compared with $6 million in 2002) due to the settlement of outstanding payables due to SchlumbergerSema in anticipation of its disposal to Atos Origin S.A. (which occurred in January 2004).

Cash flows from investing activities

Net cash used in investing activities was $39 million in 2004, compared with $16 million in 2003. This increase was mainly due to a $18 million rise in investments in fixed assets.

Net cash used in investing activities was $16 million in 2003, compared with $18 million in 2002. The decrease in cash flows used in investing activities was mainly attributable to a $3 million rise in proceeds from the sale of fixed assets, of which the sale of our POS Terminals manufacturing facility in Saint Etienne, France to Flextronics accounted for $1 million.

Cash flows from financing activities

Net cash from financing activities amounted to $42 million in 2004, compared with net cash used in financing activities of $47 million in 2003. $31 million of the positive cash flow from financing activities in 2004 was due to recapitalizations and cash contributions made by Schlumberger in the first months of the year, in accordance with the commitment made in the Master Separation Agreement to provide Axalto with net cash of $45 million at the time of its IPO. The remaining $11 million relates to residual reductions in overdrafts and short-term debt, mainly following the recapitalizations carried out in the first months of the year, along with drawings on the syndicated loan arranged in 2004 and the use of bank credit facilities negotiated on behalf of certain entities not covered by the syndicated loan.

Net cash used in financing activities was $47 million in 2003, compared with $62 million in 2002. The net cash outflow in 2003 was due to the repayment of bank overdrafts and short-term loans ($3 million) and of cash advances ($220 million) from Schlumberger under its centralized treasury and cash pool arrangements, which are recorded in our combined balance sheet under total invested equity. Those repayments were funded by the cash flows provided by operating and investing activities and by capital increases of $179 million made by Schlumberger.

Debt

Our bank overdrafts and short-term loans as of December 31, 2004, 2003 and 2002 were $9 million, $22 million and $23 million, respectively. As of the same dates, our long-term debts totalled $30 million, $2 million and $2 million respectively, taking into account the reclassification under ”other long-term liabilities” of financing resulting from the sale with recourse of some POS terminal rental contracts to a French financial institution.

Our bank overdrafts and short-term loans as of December 31, 2002 consisted mainly of the $16 million loan granted by a UK bank to finance the cost of restructuring the Felixstowe operations in the UK, which totalled $19 million as of December 31, 2003. The remaining $7 million in bank overdrafts and short-term loans outstanding as of December 31, 2002, and the remaining $3 million in bank overdrafts and short term loans outstanding as of December 31, 2003, consisted mainly of bank overdrafts incurred in the ordinary course of our operations around the world, and the short-term portion of our finance leases.

Axalto’s long-term debt of $30 million as of December 31, 2004 related to drawings on the syndicated loan arranged in 2004 and the use of bank credit facilities negotiated on behalf of certain entities not covered by the syndicated loan.

Capital Expenditures

Our capital expenditures for the years ended December 31, 2004, 2003 and 2002 were $37 million, $19 million and $17 million, respectively. In 2004, capital expenditure consisted mainly of manufacturing equipment ($31 million, including $14 million on personalization equipment) and building improvements ($4 million). In 2003, capital expenditure consisted mainly of manufacturing equipment ($9 million, including $4 million on personalization equipment) and building improvements ($4 million). In addition, we incurred capital expenditures of $1 million relating to the separation of our intranet (including servers, cables and routers) from that of Schlumberger, while our capital expenditures in 2002 were mainly for marginal improvements in existing capacity and the conversion of equipment from memory to microprocessor card production.
We anticipate that our capital expenditures for the years 2005, 2006 and 2007 will be approximately 2.5% to 4% of revenue. The actual amount of such expenditures may differ and will depend on a number of factors, such as market conditions and the availability of financing. We expect to continue to finance our activities through cash flow from operating activities and short-term and long-term borrowings. We believe that our liquidity position is sufficient to meet our foreseeable capital expenditure needs.

5.1.7 Off-Balance Sheet Arrangements

Axalto's off-balance sheet arrangements consist of leases and lease commitments under non-cancelable operating lease contracts primarily in respect of real estate and equipment relating to premises occupied by Axalto. Aggregate lease commitments between the years ending December 31, 2005 and 2013 amount to $34 million. Rental expense under our operating leases was $13 million in 2004, $10 million in 2003 and $12 million in 2002. We have no other material off-balance sheet arrangements.

5.1.8 Market Risk

General Market Risks and Management

Our risk management policies formed part of Schlumberger’s global policy until the IPO. These policies included centralized treasury management, covering the management of exposure to foreign exchange risk, currency risk and credit risk. As a result, it was not possible in 2002 and 2003 to identify separate risk management transactions corresponding to our business for the periods under review, except for our contract review process which set forth management approval procedures before contractual commitments were made. However, when preparing its IPO, Axalto took direct responsibility for managing its exchange rate risks as of the start of 2004, and set up its own hedging operations.

Similarly, Axalto set up in 2004 its own centralized cash management department. This enabled it to manage its own cash position as of the IPO. As part of this process, we have policies relating to financial risks, including limits as to what risks we are prepared to accept and how risks should be identified and managed. The principal risks to which our business is exposed consist of foreign exchange risks and customer credit risks.

Management of Exposure to Exchange Rate Fluctuations

We operate production and research and engineering facilities in 9 countries and sell our products and services in more than 100 countries. Our functional currencies are primarily local currencies, which means that our sales are generally made in the local currency of the place of delivery or in certain cases in one of the major trading currencies such as the US dollar or the euro, while our production costs are incurred in the local currencies of our production sites. We purchase our raw materials, notably electronic chips, in US dollars and euros. Although we attempt to match the currencies of our revenue and expenses in order to naturally hedge our exposure to foreign currency fluctuations, our results of operations may be affected by such fluctuations. We also record our assets and liabilities in local currencies, which are translated into US dollars at the exchange rate on the balance sheet date. A decline in the US dollar against other currencies increases our reported assets and liabilities, revenues and expenses recorded in other currencies, while a rise in the US dollar against other currencies decreases these items. Foreign currency effects have in the past had, and may in the future have, a significant effect on our reported assets, liabilities, income and losses, and on the comparability of our results of operations between financial periods. The exposure of Axalto's earnings and cash flows to exchange rate fluctuations and its efforts to reduce their effect are described in section 5.1.4. - Other Factors Affecting Results of Operations - Impact of exchange rates, and in notes 2 and 16 to the audited consolidated financial statements.

Axalto arranges hedging contracts to mitigate, in part or in full, the negative impact of exchange rate movements on certain items on the balance sheet, as well as on income and cash flow. We cannot guarantee that our hedging strategies will be effective or that currency transaction losses can be minimized or forecast accurately. We do not intend to enter into such contracts for speculative purposes.

Concentration of Credit Risk

Financial instruments which potentially subject us to concentration of credit risk consist primarily of accounts receivable. We maintain an allowance for uncollectible accounts receivable based on expected collectibility. We
assess the expected collectibility of our accounts receivable periodically or when events lead us to believe that collectibility is uncertain. Additionally, we perform ongoing credit evaluations of our customers’ financial condition.

5.1.9 Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with US GAAP requires us to make estimates and assumptions that affect the amounts reported in the combined and consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate any significant estimates used in preparing our financial statements, including those related to revenue recognition, doubtful accounts, valuation of inventories and investments, valuation of goodwill and intangible assets, income tax provision and recoverability of deferred taxes, contingencies and litigation and actuarial assumptions for employee benefit plans. We base our estimates on historical experience and various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual amounts or values will differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the combined and consolidated financial statements.

Revenue Recognition

Revenue from product sales is generally recognized at the time the product is shipped, provided that persuasive evidence of an arrangement exists, that title and risk of loss has transferred to the customer, that the selling price is fixed or determinable and that collection of the related receivable is reasonably assured. For sales, a binding purchase order, signed license agreement or a written contract is used as evidence of an arrangement. For transactions where legal title does not transfer at shipment, revenue is recognized when legal title passes to the customer based on receipt of proof of delivery. A provision for the estimated cost of warranty is recorded when revenue is recognized. Whether the fee is fixed and determinable is assessed based on the payment terms associated with the transaction. Collection is assessed based on a number of factors, including past transaction history and the creditworthiness of the customer. We do not request collateral from our customers. If we determine that collection is not reasonably assured, we defer revenue until receipt of cash. For services contracts, revenue is recognized when services are rendered and collectibility is reasonably assured. Revenue for royalties is recognized when income is earned and collectibility is reasonably assured.

Revenue from contracts with multiple elements is recognized as each criteria for each element is met as described above. Revenue of each element is based on the relative fair value of each element and when there are no undelivered elements that are essential to the use of the delivered elements.

Revenue for certain services is recognized on a percentage of completion basis as the services are provided. These services include installation and integration. We follow this method when reasonably dependable estimates of the revenue and costs applicable to various stages of a project can be made. Recognized revenue and profit are subject to revisions as the project progresses to completion. Revisions in profit estimates are charged or credited to income in the period in which the facts that give rise to the revision become known. Losses on long-term contracts are provided for when such losses become probable and can be reasonably estimated.

The amount and timing of our revenue for any period may have differed materially had we made different judgments and estimates.

Income Taxes

Our operating results historically were included in Schlumberger’s consolidated US income tax returns until April 30, 2004 and in the tax returns of some of Schlumberger’s other foreign subsidiaries until December 31, 2003.

The provision for income taxes reflected in our combined financial statements for 2002 and 2003 was determined on a separate return basis, which meant that we were required to estimate our taxes in each of the jurisdictions in which we operate.

For 2004, the provision for income taxes reflected in our consolidated financial statements was calculated on the basis of tax returns from each Group company.
The effective tax amount is estimated taking into account permanent and temporary differences resulting from differences in the accounting and tax treatment of some items. Axalto regularly assesses the likelihood that deferred tax assets will be recoverable against future taxable income. Depending on the earnings outlook in each country, impairment provisions are booked and existing provisions may be reversed.

**Inventories**

We value our inventory at the lower of its actual cost or its current estimated market value. We periodically assess the value of our inventory and periodically write down its value for estimated excess and obsolete inventory based on management’s assumptions about future demand and market conditions.

On a quarterly basis, we review inventory quantities on hand and on order, under non-cancellable purchase commitments, in comparison with our estimated forecast of product demand. Demand for our products can fluctuate significantly and if actual demand is lower than our forecasted demand, we could be required to record additional inventory write-downs, which could have a negative effect on our gross profit.

**Long-lived Assets and Goodwill**

We assess the impairment of identifiable intangibles, long-lived assets and goodwill at least annually, or whenever events or changes in circumstances indicate that the carrying value may not be adequate. Factors that could trigger an impairment review include:

- significant underperformance relative to initially projected operating results;
- significant changes in the manner in which we use the acquired assets or the strategy for our overall business; and
- significant negative industry or economic trends.

When we determine that the carrying value of goodwill, an intangible asset or a long-lived asset is not adequate based on the existence of one or more of indicators of impairment, including those listed above, such carrying value is impaired based on the present value of projected net cash flows expected to result from that asset, including the potential proceeds of a disposition.

5.1.10 Recent Accounting Pronouncements

Note 2 to our combined and consolidated financial statements describes recent changes in the accounting principles and practices that the company considers most significant with respect to its business.


This annual report contains Axalto's audited combined financial statements for the periods ended December 31, 2002 and 2003, and audited consolidated financial statements for the period ended December 31, 2004 (together, the "Combined and Consolidated Financial Statements"). For information on the presentation of data for the periods ended December 31, 2002 and 2003, see note 1 to the combined and consolidated financial statements.
## 5.2.1 Combined balance sheets ended December 31, 2002 and 2003 and consolidated balance sheet ended December 31, 2004

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002 (In thousands of US $)</th>
<th>2003 (In thousands of US $)</th>
<th>2004 (In thousands of US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term investments and cash</td>
<td>28,069</td>
<td>50,154</td>
<td>223,820</td>
</tr>
<tr>
<td>Receivables, less allowance for doubtful accounts of $20,409, $19,436 and $17,996</td>
<td>204,743</td>
<td>190,466</td>
<td>202,160</td>
</tr>
<tr>
<td>Receivables from related parties (Note 18)</td>
<td>4,913</td>
<td>12,666</td>
<td>1,895</td>
</tr>
<tr>
<td>Inventories, net (Note 9)</td>
<td>104,080</td>
<td>103,827</td>
<td>122,492</td>
</tr>
<tr>
<td>Deferred taxes on income (Note 13)</td>
<td>5,774</td>
<td>6,835</td>
<td>11,288</td>
</tr>
<tr>
<td>Other current assets (Note 10)</td>
<td>33,495</td>
<td>34,894</td>
<td>54,565</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>381,074</td>
<td>398,842</td>
<td>616,220</td>
</tr>
<tr>
<td><strong>Property, plant and equipment, net (Note 7)</strong></td>
<td>104,939</td>
<td>105,410</td>
<td>108,899</td>
</tr>
<tr>
<td><strong>Deferred taxes on income (Note 13)</strong></td>
<td>11,462</td>
<td>14,515</td>
<td>42,740</td>
</tr>
<tr>
<td><strong>Goodwill (Note 8)</strong></td>
<td>245,044</td>
<td>287,621</td>
<td>311,310</td>
</tr>
<tr>
<td><strong>Intangible assets (Note 8)</strong></td>
<td>29,401</td>
<td>31,016</td>
<td>24,964</td>
</tr>
<tr>
<td><strong>Other long term assets</strong></td>
<td>5,888</td>
<td>8,978</td>
<td>9,705</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$ 777,808</td>
<td>$ 846,382</td>
<td>$ 1,113,838</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders’ equity / net investment</th>
<th>2002 (In thousands of US $)</th>
<th>2003 (In thousands of US $)</th>
<th>2004 (In thousands of US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank overdrafts and short-term loans</td>
<td>$ 23,020</td>
<td>$ 21,615</td>
<td>$ 8,592</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>76,631</td>
<td>94,812</td>
<td>126,644</td>
</tr>
<tr>
<td>Payables to related parties (Note 18)</td>
<td>24,903</td>
<td>10,263</td>
<td>42,740</td>
</tr>
<tr>
<td>Employee, other payables and accrued liabilities (Note 11)</td>
<td>104,939</td>
<td>105,410</td>
<td>108,899</td>
</tr>
<tr>
<td>Liability for taxes on income</td>
<td>11,462</td>
<td>14,515</td>
<td>42,740</td>
</tr>
<tr>
<td>Deferred tax liabilities (Note 13)</td>
<td>4,913</td>
<td>6,835</td>
<td>11,288</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>242,939</td>
<td>267,957</td>
<td>343,916</td>
</tr>
<tr>
<td><strong>Long-term debt (Note 12)</strong></td>
<td>2,300</td>
<td>2,287</td>
<td>30,249</td>
</tr>
<tr>
<td>Pensions and other employment benefits (Note 14)</td>
<td>8,763</td>
<td>11,175</td>
<td>15,013</td>
</tr>
<tr>
<td>Deferred tax liabilities (Note 13)</td>
<td>4,999</td>
<td>5,047</td>
<td>6,307</td>
</tr>
<tr>
<td><strong>Other long-term liabilities</strong></td>
<td>15,674</td>
<td>8,827</td>
<td>6,267</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>274,175</td>
<td>295,293</td>
<td>401,752</td>
</tr>
<tr>
<td><strong>Commitments and contingencies (Note 20)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minority interest in subsidiaries</strong></td>
<td>14,854</td>
<td>9,876</td>
<td>7,059</td>
</tr>
<tr>
<td><strong>Stockholders’ equity / net investment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Invoted Equity</strong></td>
<td>488,779</td>
<td>541,213</td>
<td>705,027</td>
</tr>
</tbody>
</table>

*Common stock at Euro 1 par value, 150 million shares authorized, 40,490,668 shares outstanding*

*Additional paid-in capital* 550,312

*Net income* 59,099

*Accumulated other comprehensive income/(loss)* 45,012

**Total stockholders’ equity / net investment**

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002 (In thousands of US $)</th>
<th>2003 (In thousands of US $)</th>
<th>2004 (In thousands of US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Liabilities and stockholders’ equity / net investment</strong></td>
<td>$ 777,808</td>
<td>$ 846,382</td>
<td>$ 1,113,838</td>
</tr>
</tbody>
</table>
### 5.2.2 Combined income statements ended December 31, 2002 and 2003 and consolidated income statement ended December 31, 2004

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>(In thousands of US $)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>$ 730,211</td>
<td>$ 767,662</td>
<td>$ 960,427</td>
</tr>
<tr>
<td>Cost of revenue</td>
<td>629,350</td>
<td>529,447</td>
<td>645,027</td>
</tr>
<tr>
<td>Gross profit</td>
<td>100,861</td>
<td>238,215</td>
<td>315,400</td>
</tr>
</tbody>
</table>

**Operating expenses**

- Research and engineering: 53,575, 49,034, 63,962
- Sales and marketing: 84,874, 91,935, 109,842
- General and administrative: 53,937, 49,355, 55,216

**Total operating expenses**: 192,386, 190,324, 229,020

**Operating income**: (91,525), 47,891, 86,380

**Foreign currency transaction loss, net**: (10,669), (9,939), (5,715)

**Interest income (expense), net**: (7,515), (5,309), 291

**Other income, net**: 1,344, 1,672, 4,297

**Income (loss) before taxes and minority interest**: (108,365), 34,315, 85,253

**Tax expense (Note 13)**: (1,383), (6,910), (25,466)

**Income (loss) before minority interest**: (109,748), 27,405, 59,787

**Minority interest**: (2,830), (2,396), (688)

**Net income (loss)**: $(112,578), $ 25,009, $ 59,099

**Basic earnings per share (in US dollars)**: 1.47

**Diluted earnings per share (in US dollars)**: 1.45

**Average number of shares outstanding**: 40,295

**Average number of shares outstanding assuming dilution**: 40,697
5.2.3 Combined statements of cash flows ended December 31, 2002 and 2003 and consolidated statements of cash flows ended December 31, 2004

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>(In thousands of US $)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Cash flows from operating activities**

- **Net income (loss)**
  - $ (112,578)
  - $ 25,009
  - 59,099

  Adjustments to reconcile net income (loss) to Net Cash provided by operating activities:
  - **Depreciation Intangible assets Bull-CP8 (Note 8)**
    - 93,160
    - -
    - 2,758
  - **Depreciation and amortization**
    - 53,312
    - 37,321
    - 42,156
  - **Deferred taxes**
    - 961
    - (1,011)
    - 2,303
  - **Non cash loss on disposal of fixed assets and write-offs**
    - 1,096
    - 1,866
    - 3,988
  - **Share of losses of equity investees, net of dividends received**
    - 752
    - 245
    - 806

**Changes in assets and liabilities:**

- **Accounts receivables, net**
  - 10,526
  - 32,509
  - (1,838)

- **Receivables from related parties**
  - 6,206
  - (7,065)
  - 17,054

- **Inventories, net**
  - 29,362
  - 12,077
  - (10,750)

- **Accounts payable**
  - (18,217)
  - 5,335
  - 22,215

- **Payables to related parties**
  - (6,013)
  - (15,348)
  - (12,321)

- **Employee, other payables and accrued liabilities**
  - (5,758)
  - 7,006
  - 43,305

- **Pensions**
  - (498)
  - (338)
  - 2,814

- **Estimated liability for taxes on income**
  - (7,577)
  - 2,887
  - 9,055

- **Other assets and liabilities, net (1)**
  - 11,746
  - (16,573)
  - (13,563)

**Net cash provided by operating activities**

- 56,480
- 83,920
- 167,081

**Cash flows from investing activities**

- **Capital expenditures (fixed assets)**
  - (16,661)
  - (18,802)
  - (36,783)

- **Capital expenditures (intangible assets)**
  - (2,973)
  - (1,145)
  - (2,547)

- **Proceeds from sale of fixed assets**
  - 1,336
  - 3,909
  - 407

**Net cash used in investing activities**

- (18,298)
- (16,038)
- (38,923)

**Cash flows from (used in) financing activities**

- **Net equity / Invested equity**
  - 128,436
  - (40,649)
  - 30,699

- **Bank overdrafts and short term loans**
  - (188,734)
  - (3,367)
  - (15,380)

- **Long term debt (1)**
  - (1,684)
  - (2,558)
  - 26,340

**Net cash provided by (used in) financing activities**

- (61,982)
- (46,574)
- 41,659

**Net increase (decrease) in cash and short-term investments**

- (23,799)
- 21,308
- 169,817

**Translation effect on cash and short-term investments**

- 485
- 777
- 3,849

**Cash and short-term investments, beginning of period**

- 51,384
- 28,069
- 50,154

**Cash and short-term investments, end of period**

- $ 28,069
- $ 50,154
- 223,820

(1) In the Offering Circular published before the IPO and on which is the AMF visa dated May 17, 2004, the long term debt account included for $11,978 and $14,698, in 2002 and 2003 respectively, a financing arrangement consisting of a sale by Axalto, on a recourse basis, to a French financial institution of certain of our POS terminal operating lease contracts. As this debt was considered a non financial debt, it was decided to reclassify these debts from “Long-term debt” to “Other long-term liabilities” which therefore aggregates in “Other assets and liabilities, net” in the Statement of Cash flow instead of “Long-term debt”. 

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5.2.4 COMBINED AND CONSOLIDATED STATEMENTS OF STOCKHOLDER’S EQUITY / NET INVESTMENT

All amounts are in thousands of US dollars unless otherwise stated.

<table>
<thead>
<tr>
<th>In thousands of US$</th>
<th>Common stock</th>
<th>Shareholder’s net investment</th>
<th>Net income</th>
<th>Other comprehensive income (loss)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares</td>
<td>Amount</td>
<td>Added paid-in capital</td>
<td>Shareholder’s invested equity</td>
<td>Accumulated Other Comprehensive Income</td>
</tr>
<tr>
<td>COMBINED ACCOUNTS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested equity as of December 31, 2002</td>
<td>433 704</td>
<td>55 075</td>
<td>488 779</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>25 009</td>
<td>(46 693)</td>
<td>25 009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested equity</td>
<td>(46 693)</td>
<td>(46 693)</td>
<td>(46 693)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value adjustments for cash flow hedges</td>
<td>2 491</td>
<td>2 491</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency translation adjustment</td>
<td>70 631</td>
<td>70 631</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alternative minimum pension liability</td>
<td>975</td>
<td>975</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gain (loss) on marketable securities</td>
<td>21</td>
<td>21</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested equity as of December 31, 2003</td>
<td>412 020</td>
<td>129 193</td>
<td>541 213</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CONSOLIDATED ACCOUNTS

| Stockholder’s equity as of December 31, 2003 | 18,000 | 23 | 1 610 | 1 633 |
| Contribution (Distribution) from Schlumberger | 51 191 | 51 191 | 51 191 |
| Recapitalization and issuance of common stock, net capital contribution by Schlumberger Ltd | 40,027,000 | 50 034 | 542 370 | 592 404 |
| Capital increase reserved to employees | 445,668 | 547 | 6 332 |
| Net income | 59 099 | 59 099 |
| Other comprehensive income |
| Market value adjustments for cash flow hedges | 5 998 | 5 998 |
| Foreign currency translation adjustment | 40 490 | 40 490 |
| Alternative minimum pension liability |
| Unrealized gain (loss) on marketable securities | (1 476) | (1 476) |
| Stockholder’s equity as of December 31, 2004 | 40,490,668 | 50 604 | 550 312 | 59 099 | 45 012 | 705 027 |
5.2.5 Notes

Note 1 Background and basis of Presentation

Background

In the fourth quarter of 2002, Schlumberger Limited (“Schlumberger”) announced its intention to divest various businesses, including certain of its Products Group. On March 19, 2004, Schlumberger and Axalto (the “Company”) entered into a Master Separation Agreement (“Separation Agreement”) under which Schlumberger agreed to transfer to Axalto the assets and liabilities associated with the businesses of Smart Cards (“Cards”) and Point of Sales Terminals (“POS”), which belonged to the Schlumberger Products Group, in connection with the listing of Axalto’s shares on the Euronext Paris. Cards includes microprocessor, magnetic stripe, memory and other cards and related services for mobile communications, financial cards, public sector and access applications including licensing of intellectual property rights, and prepaid phone cards. POS includes point of sales terminals, systems and related services. Axalto was first listed on the Euronext Paris on May 18, 2004. Schlumberger sold 87.5% of the stock of Axalto Holding NV through the Initial Public Offering, and divested its remaining 12.5% stake on September 17, 2004.

Basis of Presentation

The accompanying audited consolidated financial statements of Axalto and its subsidiaries as of December 31, 2004, have been prepared in accordance with generally accepted accounting principles for financial information in the United States of America. All intercompany transactions and balances have been eliminated in consolidation.

The combined financial statements of Axalto for 2002 and 2003 were derived from the consolidated financial statements of Schlumberger Limited. The combined financial statements include the historical assets, liabilities, revenues and expenses that were directly related to the Axalto business within Schlumberger during the period presented.

Certain amounts of Schlumberger’s corporate expenses, including the cost of services relating to legal, tax, accounting, employee benefits, internal audit, real estate management, insurance and information technology, as well as treasury and other corporate and infrastructure costs, although not directly attributable to Axalto’s operations, have been allocated to Axalto on the bases that Schlumberger and Axalto consider to be a reasonable reflection of the utilization of services provided or the benefit received by Axalto (see Note 16). These allocations have been based upon revenue, headcount or other methods depending on the nature of the costs that reflect assumptions management believes are reasonable. However, the financial information provided herein may not reflect the combined financial position, operating results, changes in invested equity and cash flows of Axalto in the future or what they would have been had Axalto been a separate, stand alone company during the periods presented.

During 2003, Axalto did not operate as a separate, stand-alone company. Axalto’s results were included in the consolidated financial statements of Schlumberger on a divisional basis, and there was no separate meaningful historical equity accounts for Axalto. Changes in total invested equity represented Schlumberger’s net investment in Axalto after giving effect to the net earnings (losses) of Axalto, dividends paid and net transfers (including cash) to and from Schlumberger. As the result of the contribution by Schlumberger to Axalto of the assets and liabilities related to the Cards and POS businesses, Schlumberger’s net investment in Axalto converted to common stock and additional paid-in capital. 40,027,000 common stock of Axalto Holding NV were issued and subscribed by Schlumberger prior to the first listing with Euronext Paris on May 18, 2004.

Reclassification

Certain items from prior years have been reclassified to conform to the current year presentation.

Note 2 Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements of Axalto have been prepared in accordance with accounting principles generally accepted in the United States of America. All majority owned subsidiaries of Axalto have been consolidated in the consolidated financial statements. Investments representing 20-50% of the equity of the investee are accounted for under the equity method and are reflected within Other long-term assets in the balance sheet. Axalto’s pro-rata share of after-tax earnings of these equity method investees is included in Other income, net. Investments representing less than 20% of the equity of the investee are carried at cost less any decrease in value deemed to be other than temporary in nature. All intercompany accounts and transactions within Axalto are eliminated.
Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, Axalto evaluates its estimates, including those related to doubtful accounts, valuation of inventories and investments, recoverability of goodwill and intangible assets, income tax provision and recoverability of deferred taxes, contingencies and litigation and actuarial assumptions for employee benefit plans. Axalto bases its estimates on historical experience and on various other assumptions that, in management’s opinion, are reasonable under the circumstances. These results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition

Products and Services Revenue

Axalto’s products and services are generally sold based upon contracts or purchase orders with the customer that include fixed and determinable prices and that do not include right of return, other similar provisions or other significant post delivery obligations. Revenue is recognized for products upon delivery when title and risk pass, the price is fixed and determinable and collectibility is reasonably assured. Revenue for services is recognized over the period when services are rendered and collectibility is reasonably assured. Revenue for royalties is recognized when income is earned and collectibility is reasonably assured.

Certain revenues are recognized using the percentage of completion method as services are provided. These services include installation and integration services. Under the percentage of completion method, the extent of progress towards completion is measured based on actual costs incurred to total estimated costs. Losses on contracts are recognized during the period in which the loss first becomes probable and can be reasonably estimated.

Multiple Element Arrangements

Revenue from contracts with multiple elements, such as those including services, is recognized as each element is earned based on the relative fair value of each element and when there are no undelivered elements that are essential to the functionality of the delivered elements.

Collectibility

As part of the revenue recognition process, Axalto determines whether trade and notes receivables are reasonably assured of collection based on various factors, including the ability to sell those receivables and whether there has been deterioration in the credit quality of customers that could result in the inability to sell those receivables. Axalto defers revenue and related costs when it is uncertain as to whether receivables will be collectable. Axalto defers revenue but recognizes related costs when it determines that the collection of receivables is unlikely.

Deferred and unbilled Revenue

Deferred revenue includes amounts that have been billed per contractual terms but have not been recognized as income. Revenue in excess of amounts invoiced on long-term contracts is recorded as work in progress and included in inventory.

Concentration of Credit Risk

Axalto’s financial instruments, which potentially subject Axalto to concentration of credit risk, consist primarily of accounts receivable. Axalto maintains an allowance for uncollectible accounts receivable based on expected collectibility. Axalto performs ongoing credit evaluations of its customers’ financial condition.

Foreign Currency Accounting

Axalto’s functional currencies are primarily local currencies.

All assets and liabilities recorded in functional currencies other than U.S. dollars are translated at current exchange rates as of the balance sheet date. The resulting adjustments are charged or credited directly to the equity section of the combined or consolidated balance sheet.
Revenue and expenses are translated at the weighted-average exchange rates for the period.

Realized and unrealized transaction gains and losses are included in income in the period in which they occur. They reflect the cumulative impact of the change in values due to currency fluctuation between the booking and settlement dates of assets and liabilities denominated in currencies other than the functional currency in each of the Axalto entities.

The combined financial statements of Axalto for the years ended December 31, 2002 and 2003, did not include the gains or losses relating to the foreign currency exchange contracts entered into as a hedge against the risk attached to the future settlement of assets and liabilities denominated in a currency other than the functional currency. These contracts were entered into at Group level by Schlumberger and the corresponding gains (losses) were not allocated back to the Cards or POS businesses. Foreign currency transaction gains (losses) included in the results of operations were $(10.7) million and $(9.9) million in 2002 and 2003 respectively.

For the year ended December 31, 2004, Axalto entered directly into foreign currency exchange contracts as a hedge against the risk attached to the future settlement of assets and liabilities denominated in a currency other than the functional currency. The consolidated income statement as of December 31, 2004 therefore includes a net transaction loss of $(1.6) million after taking into account the result on these hedging instruments.

**Research and Engineering**

All research and engineering costs are expensed as incurred, including costs related to patents or rights that may result from such expenditures, except for certain software development costs qualifying for capitalization in accordance with SFAS 86.

Axalto capitalizes eligible software development costs upon achievement of technological feasibility subject to net realizable value considerations. Based on Axalto’s development process, technological feasibility is generally established upon completion of a working model. Research and engineering standard costs prior to a determination of technological feasibility are expensed as incurred. Amortization of capitalized software development costs begins when the products are available for general release over their estimated useful life, which usually varies between 3 and 6 years. Unamortized capitalized software development costs determined to be in excess of the net realizable value of the product are expensed immediately. The costs qualifying for capitalization were insignificant during the year ended December 31, 2002, because the period between achievement of technological feasibility and the general release of Axalto’s products was of relatively short duration. In 2003, capitalized software development costs amounted to $2.6 million, of which $0.4 million were amortized as of December 31, 2003. In 2004, additional capitalized software development costs were incurred for $1.6 million, bringing the total balance at year end to $4.2 million of which $1.4 million were amortized as of December 31, 2004.

**Inventories**

Inventories are stated at lower of cost or market. Axalto provides inventory allowances for excess and obsolete inventories.

**Property, Plant and Equipment**

Property, plant and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets as follows:

- Leasehold improvements: 5-10 years
- Machinery and equipment: 3-10 years

Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or the lease term. When assets are retired or otherwise disposed of, the cost and accumulated depreciation are removed from their separate accounts, and any gain or loss on such sale is reflected in operations. Maintenance and repair costs are expensed as incurred. Expenditures that substantially increase an asset’s useful life are capitalized.

**Impairment of Long-lived Assets**

On an annual basis, Axalto reviews the carrying value of its long-lived assets. In addition, whenever events or changes in circumstances indicate that the carrying value of an asset may no longer be appropriate, a review is performed. Axalto assesses recoverability of the carrying value of the asset by estimating the future net cash flows expected to result from the asset, including the proceeds from its eventual sale. If the sum of future undiscounted net cash flows is less than the carrying value of the asset, an impairment loss is recorded equal to the difference between the asset’s carrying value and fair value.
Taxes on Income

Historically, the operating results of the Axalto activities have been included in tax returns filed by the Schlumberger companies that held the assets and liabilities related to these activities. In accordance with US GAAP applicable to the carved-out financial statements, the provision for income taxes reflected in our combined financial statements has been determined on a separate return basis which means that they were recorded as if each company comprising our business was not part of a tax group and could not benefit from tax benefits resulting from losses accruing in other Schlumberger companies or activities. These principles were applied to the years ended on December 31, 2002 and 2003.

In addition, we determined our tax assets and liabilities for the years ended on December 31, 2002 and 2003 taking into consideration whether any of our subsidiaries and joint ventures belonged to a Schlumberger tax group in any relevant jurisdiction in each such year. To the extent that any of our tax assets and liabilities were held by companies that belonged to a Schlumberger tax group in any of these years, such tax assets and liabilities were transferred at the end of the relevant year to the Schlumberger company that constituted the head of such Schlumberger tax group in the relevant countries. As a result, these tax assets and liabilities have been eliminated from our combined balance sheet, and our total invested equity has been adjusted by the corresponding net amount.

The provision for income taxes presented in the consolidated financial statements for the year ended December 31, 2004 was computed in accordance with the tax rules and regulations of the taxing authorities where the income is earned. All tax assets and liabilities belonging to Axalto entities are shown in the consolidated balance sheet as of December 31, 2004.

Fair Value of Financial Instruments

The fair value of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses is not materially different from their carrying value as reported as of December 31, 2002, 2003 and 2004 because of their short maturities.

Cash and Cash Equivalents

Cash and cash equivalents are comprised of cash and short-term investments that do not have original maturities in excess of three months. The short-term investments are stated at cost plus accrued interest, which approximates market value. These investments are mainly comprised of bank deposits and marketable securities with major banks.

Goodwill

Effective January 1, 2002, Axalto adopted SFAS No. 142 (Goodwill and Other Intangible Assets). Under SFAS No. 142, goodwill and intangible assets with indefinite useful lives are no longer amortized, but are subject to impairment tests, initially upon adoption of SFAS No. 142 and subsequently on at least an annual basis. All other intangible assets (i.e. those with a definite useful life) must be amortized over their estimated useful lives, and are subject to tests if an impairment event occurs which indicates the asset may be impaired.

The main effects of adopting SFAS No. 142 on Axalto’s financial statements for the year ended December 31, 2002 are:

- Assembled workforce, previously identified and amortized by Axalto as intangible asset, has been reclassified as goodwill as of January 1, 2002;
- Goodwill, previously amortized, is no longer amortized as from January 1, 2002.

As required by SFAS No. 142, Axalto undertook an initial review of goodwill impairment in the first quarter of 2002 and completed annual assessments in the fourth quarter of each of 2002, 2003 and 2004 where no impairment charge was recognized.

Product Warranties

Axalto provides for future warranty obligations upon product delivery. The warranties are generally for 12 to 18 months from the date of sale depending on local legislation and contractual terms. Axalto’s liability under these warranties is to provide a replacement product or issue a credit to the customer. Factors that affect Axalto’s warranty liability provision include the number of units delivered, historical experience and Axalto’s judgment regarding anticipated rates of warranty claims and cost per claim. Axalto assesses the adequacy of its recorded warranty liability provision at each period end and makes adjustments to the provision if necessary.
Changes in Axalto’s warranty liability provision, which is included as a component of “Employee, other payables and accrued liabilities” on the combined balance sheet, for the periods under review are as follows:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>3,941</td>
<td>3,335</td>
<td>3,840</td>
</tr>
<tr>
<td>Changes during the period (net)</td>
<td>(606)</td>
<td>505</td>
<td>1,141</td>
</tr>
<tr>
<td>Ending balance</td>
<td>3,335</td>
<td>3,840</td>
<td>4,981</td>
</tr>
</tbody>
</table>

**Currency Risk Management Contracts**

Prior to June 30, 2003, the impact of foreign currency fluctuations on the company’s forecasted cash flows was not hedged by Axalto or Schlumberger Limited. Since June 30, 2003, Axalto began to hedge a portion of the impact on forecasted cash flows of foreign currency movements through forward and option contracts.

Axalto formally documents all relationships between these hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various hedge transactions.

Axalto characterizes the financial instruments as hedges of forecasted transactions. When the forecasted transactions being hedged are no longer expected to occur, Axalto recognizes the gain or loss on the designated hedging financial instruments in the combined income statement.

Forward and option contracts are recorded in the balance sheet at their fair market value as “Other current assets”. Unrealized gains and losses on hedging contracts are recorded in the Stockholders’ Equity under Accumulated Other Comprehensive Income. Realized gains and losses from hedging instruments are recognized in the combined and consolidated income statement consistently with the underlying transactions being hedged (see Note 16).

**Recent Accounting Pronouncements**

In January 2003, the Emerging Issues Task Force (EITF) issued No.00-21 (Accounting for Revenue Arrangements with Multiple Deliverables). This EITF establishes the criteria for recognizing revenue in arrangements when several items are bundled into one agreement. EITF 00-21 does not allow revenue recognition unless the fair value of the undelivered element(s) is available and the element has stand-alone value to the customer. EITF 00-21 also provides guidance on allocating the total contract revenue to the individual elements based upon the standard fair value of each deliverable. This pronouncement did not have a material impact on Axalto’s financial position, results of operations or cash flows.

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No.46, (Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51). The primary objective of the interpretation is to provide guidance on the identification of financial reporting for entities over which control is achieved through means other than voting rights; such entities are known as variable-interest entities (VIEs). FIN 46 provides guidance that determines (1) whether consolidation is required under the “controlling financial interest” model of Accounting Research Bulletin No. 51 (ARB 51), Consolidated Financial Statements, or other existing authoritative guidance, or, alternative, (2) whether the variable-interest model under FIN 46 should be used to account for existing and new entities. This pronouncement did not have a material impact on Axalto’s financial position, results of operations or cash flows.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, (Amendment of Statement 133 on Derivative Instruments and Hedging Activities.) SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. The new guidance amends SFAS No. 133 for decisions made as part of the Derivatives Implementation Group (“DIG”) process that effectively required amendments to SFAS No. 133, and decisions made in connection with other FASB projects dealing with financial instruments and in connection with implementation issues raised in relation to the application of the definition of a derivative and characteristics of a derivative that contains financing components. In addition, it clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. This pronouncement did not have a material impact on Axalto’s financial position, results of operations or cash flows.
In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The adoption of SFAS No. 150 in the third quarter of 2003 did not have a material impact on Axalto’s results of operation or financial position.

On November 24, 2004, the FASB issued SFAS No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* (FAS 151). The standard adopts the IASB view related to inventories that abnormal amounts of idle capacity and spoilage costs should be excluded from the cost of inventory and expensed when incurred. Additionally, the Board made the decision to clarify the meaning of the term 'normal capacity'. The provisions of FAS 151 are applicable to inventory costs incurred during fiscal years beginning after June 15, 2005. This pronouncement will not have a material impact on Axalto’s financial position, results of operations or cash flows.
## Note 3 Consolidated entities

The consolidated financial statements as of December 31, 2004, include the accounts of Axalto Holding NV and of the following entities:

<table>
<thead>
<tr>
<th>Country of incorporation</th>
<th>Company name</th>
<th>Direct or indirect ownership</th>
<th>Percentage held by the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Axalto GmbH</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Netherlands Antilles</td>
<td>Cards &amp; Terminals N.V.</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Australia</td>
<td>Axalto Pty Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Brazil</td>
<td>Axalto do Brazil Cartoes e Terminais Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Canada</td>
<td>Axalto Canada Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>China</td>
<td>Axalto (Beijing) Smart Cards Technology Co Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>China</td>
<td>Hunan Telecommunications Equipment Co Ltd</td>
<td>Indirect</td>
<td>51%</td>
</tr>
<tr>
<td>China</td>
<td>Shanghai Axalto IC Cards Technology Co Ltd</td>
<td>Indirect</td>
<td>51%</td>
</tr>
<tr>
<td>China</td>
<td>Shanghai Solaic Smart Card Co Ltd</td>
<td>Indirect</td>
<td>31%</td>
</tr>
<tr>
<td>Spain</td>
<td>Axalto SP S.A.</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>United States</td>
<td>Axalto Inc</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>United States</td>
<td>Axalto CP8 Inc</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>France</td>
<td>CP8 Technologies S.A.</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>France</td>
<td>Electronics Transactions Integration Services S.A.</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>France</td>
<td>Axalto S.A.</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>France</td>
<td>Axalto International S.A.S.</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>France</td>
<td>Trusted Logic S.A.</td>
<td>Indirect</td>
<td>38%</td>
</tr>
<tr>
<td>France</td>
<td>Xiring S.A.</td>
<td>Indirect</td>
<td>22.7%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Axalto Terminals Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Axalto UK Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Axalto Cards Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>CP8 Hong Kong Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Axalto Technologies Asia Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Hungary</td>
<td>Axalto Hungary Commercial and Services Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>Axalto Cards &amp; Terminals Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>Axalto Technology Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>India</td>
<td>Axalto Cards &amp; Terminals India Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>PT Axalto Indonesia</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Italy</td>
<td>Axalto SPA</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Japan</td>
<td>Axalto KK</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Japan</td>
<td>SPOM Japan KK</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Axalto International Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Axalto (M) Sdn Bhd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Mexico</td>
<td>Distribucion S.A. de CV</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Mexico</td>
<td>Axalto Cards Mexico S.A. de CV</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Mexico</td>
<td>CP8 Mexico SA de CV</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Panama</td>
<td>Axalto Eastern Holdings Inc</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Axalto BV</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Philippines</td>
<td>Axalto Philippines Inc</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Axalto SRO</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Singapore</td>
<td>Axalto Singapore Pte Ltd</td>
<td>Direct</td>
<td>100%</td>
</tr>
<tr>
<td>Sweden</td>
<td>Axalto AB</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Thailand</td>
<td>Boolanakarn Holdings (Thailand) Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Thailand</td>
<td>Axalto Industries (Thailand) Ltd</td>
<td>Indirect</td>
<td>100%</td>
</tr>
<tr>
<td>Turkey</td>
<td>Axalto Cards &amp; Terminals Ltd Sirketi</td>
<td>Direct</td>
<td>100%</td>
</tr>
</tbody>
</table>
**Note 4  Earnings per share**

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31, 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income</td>
</tr>
<tr>
<td>Basic</td>
<td></td>
</tr>
<tr>
<td></td>
<td>59,099</td>
</tr>
<tr>
<td>Dilutive effect of options</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Diluted</td>
<td>59,099</td>
</tr>
</tbody>
</table>

The company presents both basic and diluted earnings per share (EPS) amounts.

Basic EPS is calculated by dividing net income by the weighted average number of common shares outstanding during the period.

Diluted EPS is calculated according to the Treasury Stock method, i.e. by dividing net income by the average number of common shares outstanding assuming dilution, the calculation of which assumes that all stock options which are in the money are exercised at the beginning of the period and the proceeds used by Axalto to purchase shares at the average market price for the period.

For the purpose of determining the average number of common shares over 2004, all the capital increases of Axalto Holding NV (except that reserved to Axalto employees, effective on June 9, 2004, following the May 18, 2004 Initial Public Offering) were considered as having occurred on January 1, 2004.

In the combined accounts for the years ended on December 31, 2002 and 2003, no direct ownership relationship existed among all the various units comprising Axalto prior to the reorganization which occurred shortly before its listing with Euronext Paris. Therefore, no historical earnings per share are presented.

**Note 5  Restructuring and Impairment Charges**

**Restructuring Charges**

Restructuring charges are allocated to the cost item of the combined income statement based on the functions or positions that were made redundant and the nature of the assets being impaired or written down.

In 2002, Axalto recorded a pre-tax net charge of $11,187, of which $5,540 was recorded in cost of revenue, $2,449 in research and engineering expenses, $2,059 in sales and marketing expenses and $1,139 in general and administrative expenses. The provision included severance costs for 350 employees, and reflected the rationalization of Axalto’s activities. As of December 31, 2002, Axalto had a remaining provision for restructuring charges of $4,025, relating to expected severance payments.

In 2003, $1,135 of the remaining provision for restructuring charges recorded as of December 31, 2002 was utilized. The remaining $2,890 was credited to the corresponding expense line in the combined income statement. A continuous operating performance improvement plan was implemented in 2003, which caused Axalto to incur severance and termination expenses of $2,077 and to record a pre-tax provision of $1,505. This provision related to expected severance payments for 8 employees for Cards and 5 for POS to be made in early 2004. The total impact of the plan for the period was a net charge of $692, of which $617 was recorded in cost of revenue, $705 in sales and marketing and $387 in general and administrative expenses, partially offset by $1,017 income in research and engineering expenses mainly due to the reversal of the provision recorded as of December 31, 2002. In addition Axalto recorded, in connection with the disposal of its POS manufacturing operations, an inventory write-down of $1,289 corresponding to the inventory not purchased by the buyer.

In 2004, Axalto used all of the provision accrued as of December 31, 2003. As part of the continuous operating performance improvement plan, Axalto incurred severance and termination expenses of $1,744 and recorded a pre-tax provision of $1,797. This provision relates to expected severance payments for employees to be made in early 2005. The total impact of restructuring for the period is a net charge of $3,541, of which $720 was recorded in cost of revenue, $494 in research and engineering expenses, $1,822 in sales and marketing and $505 in general and administrative expenses.

**Impairment Charges**

In the fourth quarter of 2002, following the annual impairment test and to reflect management’s best estimate of the fair value of the intangible assets, Axalto recorded in cost of revenue a total impairment charge of $93,160 ($81,275 on the CP8 patent
portfolio and $11,885 on the CP8 core and existing technologies) of which $82,160 relates to the Public Sector, Network Access and Other Products, $9,500 to the mobile communication product line and $1,500 to the financial cards product line. The impairment mainly reflected lower projections for future cash flows generated by licensing fees and products based on these technologies due to the difficulties experienced by the telecommunication and technology industries.

In the fourth quarter of 2004, following the annual impairment test, to reflect management’s best estimate of the fair value of the intangible assets, Axalto recorded in cost of revenue a total impairment charge of $2,758 on the CP8 core and existing technologies, all in the financial cards sector. This impairment was made necessary following the decrease of sales of products based on these CP8 core and existing technologies, which are being progressively replaced by more recent developments.

**Note 6 Investment in Affiliated Companies**

Axalto, Shanghai Post & Telecommunication Development Co, and Shanghai Feilo Co. Ltd operate a joint venture in which Axalto owns a 31% interest. Axalto records income from this joint venture using the equity method of accounting. The value of the investment is included in Other Long Term Assets in the combined balance sheets. Axalto’s investment as of December 31, 2002, 2003 and 2004 was $2.4 million, $2 million and $1.8 million respectively. Axalto’s equity income from this joint venture was $1,071 in 2002, $51 in 2003 and $76 in 2004.

Axalto holds a 51% interest in H.S.T.E, a company located in China. A portion of H.S.T.E’s business includes Schlumberger’s public phones equipment business in China, which is not within the scope of Axalto’s operations. As part of the reorganization, Schlumberger has agreed to assume all risks and rewards of the past and future operations of the public phone equipment business in H.S.T.E as specified in the separation agreement. As a result, it was not considered appropriate to include the results of operations of the public phones equipment business in the income statement of Axalto.

**Note 7 Property, Plant and Equipment, net**

Property, plant and equipment (net) consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>571</td>
<td>2,483</td>
<td>1,937</td>
</tr>
<tr>
<td>Buildings and improvements</td>
<td>48,865</td>
<td>69,746</td>
<td>76,942</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>204,014</td>
<td>206,354</td>
<td>247,202</td>
</tr>
<tr>
<td><strong>Total cost</strong></td>
<td>253,450</td>
<td>278,583</td>
<td>326,081</td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td>148,511</td>
<td>173,173</td>
<td>217,182</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>104,939</td>
<td>105,410</td>
<td>108,899</td>
</tr>
</tbody>
</table>


Depreciation expense in 2004 includes a $2.8 million write-down expense related to an industrial site located in an area subject to development restrictions likely to affect the realizable value of the asset.

The portion of fixed assets represented by the capitalization of leases amounts to $8.7 million for year ended December 31, 2002, $10.2 million for year ended December 31, 2003 and to $4.4 million (after the $2.8 million write-down) for the year ended December 31, 2004. It corresponds to the lease of one of Axalto’s production facility as well as the assets in relation to a financing arrangement consisting of the sale of Point of Sales terminals operating lease contracts, on a recourse basis to a French financial institution.

**Note 8 Goodwill and Other Intangible Assets**

Goodwill recorded in the combined financial statements represents actual purchase price paid, less liabilities and assets assumed, for Schlumberger acquisitions that relate to the business of Axalto. It does not include any goodwill generated from other Schlumberger acquisitions. The majority of the net book value of goodwill relates to the acquisition in 2001 of the Cards division of the Bull Group, named Bull CP8 and is denominated in Euros.

The carrying value of Goodwill and intangible assets for each of the years ended December 31, 2002, 2003 and 2004 amounted to:
Gross book value | 424,928 | 506,607 | 550,904
--- | --- | --- | ---
Less: Accumulated amortization and impairment charges | (150,483) | (187,970) | (214,630)
--- | --- | --- | ---
Net book value | 274,445 | 318,637 | 336,274

The changes in carrying amount of goodwill in 2002 are as follows:

Balance at beginning of year | 196,532
Bull CP8 Goodwill adjustment (a) | 13,700
Reclassification of Assembled Workforce net of deferred taxes (b) | 2,237
Foreign Currency Translation adjustment | 32,575
Balance at end of year (c) | 245,044

(a) Write-off of deferred taxes and increase in the purchase accounting reserve
(b) Following adoption of SFAS 142 on January 1, 2002
(c) Including $181.6 million in goodwill relating to Bull CP8

The changes in the carrying amount of goodwill in 2003 were as follows:

Balance at beginning of year | 245,044
Foreign Currency Translation adjustment | 42,577
Balance at end of year | 287,621

The changes in the carrying amount of goodwill in 2004 were as follows:

Balance at beginning of year | 287,621
Foreign Currency Translation adjustment | 23,689
Balance at end of year | 311,310

Intangible assets principally comprise patents, software and technology. The following table shows the gross book value, accumulated amortization and amortization periods of intangible assets for each of the years ended December 31, 2002, 2003 and 2004:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Book Value</td>
<td>165,266</td>
<td>202,007</td>
<td>231,310</td>
</tr>
<tr>
<td>Amortization</td>
<td>42,705</td>
<td>170,991</td>
<td>31,016</td>
</tr>
<tr>
<td>Impairment charge</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net book value</td>
<td>93,160</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Amortization Periods</td>
<td>3 - 5 years</td>
<td>3 - 5 years</td>
<td>1 - 15 years</td>
</tr>
</tbody>
</table>
The amortization of the other intangibles included in Axalto’s results amounted to $19.0 million in 2002, $5.4 million in 2003 and $6.8 million in 2004.

Based on the December 31, 2004 gross book value, amortization charges related to other intangibles for the next five years are expected to be $4.9 million in 2005, $3.9 million in 2006, $3.4 million in 2007, $3.3 million in 2008 and $3.3 million in 2009.

### Note 9  Inventory

Inventory consists of the following:

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Raw materials and spares</td>
<td>63,254</td>
</tr>
<tr>
<td>Work in progress</td>
<td>15,750</td>
</tr>
<tr>
<td>Finished goods</td>
<td>25,076</td>
</tr>
</tbody>
</table>

The provision for obsolete and excess inventory aggregated $12,261 as of December 31, 2002, $17,324 as of December 31, 2003 and $18,661 as of December 31, 2004.

### Note 10  Other current assets

Other current assets consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>3,924</td>
</tr>
<tr>
<td>VAT recoverable &amp; tax receivable</td>
<td>4,758</td>
</tr>
<tr>
<td>Advances to suppliers and related</td>
<td>4,106</td>
</tr>
<tr>
<td>Unbilled customers</td>
<td>12,430</td>
</tr>
<tr>
<td>Fair market value of currency risk hedging contracts</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>8,277</td>
</tr>
</tbody>
</table>

The increase between 2003 and 2004 of the line Prepaid expenses is explained for $1.8 million by the prepaid expenses incurred in relation with certain contracts of the POS activity which are amortized over the duration of each contract.

In 2004, the increase of the line “VAT recoverable” is explained by the increase of the suppliers accounts in relation with our increased activity.
Note 11  Employee, other payables and accrued liabilities

Employee, other payables and accrued liabilities consist of the following:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll, vacation and employee benefits</td>
<td>45,249</td>
<td>51,502</td>
<td>70,405</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>36,072</td>
<td>36,644</td>
<td>50,700</td>
</tr>
<tr>
<td>Accrued VAT</td>
<td>11,210</td>
<td>6,836</td>
<td>11,112</td>
</tr>
<tr>
<td>Trade, warranty and accrued project losses</td>
<td>8,822</td>
<td>16,326</td>
<td>14,210</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>3,884</td>
<td>16,419</td>
<td>33,812</td>
</tr>
<tr>
<td>Other</td>
<td>4,865</td>
<td>2,459</td>
<td>7,627</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>110,102</strong></td>
<td><strong>130,186</strong></td>
<td><strong>187,866</strong></td>
</tr>
</tbody>
</table>

The increase in “Payroll, vacation and employee benefits” is mainly due to increases in accruals related to management incentive plans (for $7.1 million) and profit sharing plans in several countries where Axalto operates (for $2.6 million), the consequence of the increased profitability of operations in 2004.

“Accrued expenses” include sales commissions to third parties, which have increased in relation with the growth of our activity.

The increase in “Deferred revenue” is explained for $9,956 by the deferral of revenue related to certain contracts of the Point of Sales terminals activity, in compliance with the provisions of the EITF 00-21 relative to the Accounting for Revenue Arrangements with Multiple Deliverables; higher deferred revenue in the Cards segment accounts for the balance of the increase.

Note 12  Long-Term Debt

For the year ended December 31, 2004, long-term debt includes:

- a finance lease for a production facility, amounting to $1.4 million,
- a drawing of $28.8 million on a syndicated bank facility of $150 million, negotiated during 2004 with major commercial banks.

Note 13  Taxes on Income

Pretax income/(loss) subject to Netherlands and foreign income taxes for each of the three years ended December 31, 2002, 2003 and 2004 are as follows:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>-</td>
<td>-</td>
<td>(2,383)</td>
</tr>
<tr>
<td>Foreign</td>
<td>(108,365)</td>
<td>34,315</td>
<td>87,636</td>
</tr>
<tr>
<td>Total</td>
<td>(108,365)</td>
<td>34,315</td>
<td>85,253</td>
</tr>
</tbody>
</table>

The provision for income taxes for the years ended December 31, 2002, 2003, and 2004 consisted of the following benefit/(expense):

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>-</td>
<td>-</td>
<td>(76)</td>
</tr>
<tr>
<td>Foreign</td>
<td>(4,676)</td>
<td>(8,787)</td>
<td>(19,362)</td>
</tr>
<tr>
<td>Deferred tax:</td>
<td>(4,676)</td>
<td>(8,787)</td>
<td>(19,438)</td>
</tr>
</tbody>
</table>
As of December 31, 2002, 2003 and 2004, net deferred tax assets were $12,697, $16,258 and $47,601, respectively. The principal components of net deferred tax assets are as follows:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Tax Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Operating Losses</td>
<td>10,637</td>
<td>14,034</td>
<td>36,348</td>
</tr>
<tr>
<td>CP8 Technologies Patents Write Down</td>
<td>29,320</td>
<td>30,842</td>
<td>29,335</td>
</tr>
<tr>
<td>Employee and retiree benefits</td>
<td>2,217</td>
<td>2,577</td>
<td>6,004</td>
</tr>
<tr>
<td>Warranty, reserves and accruals</td>
<td>2,625</td>
<td>2,961</td>
<td>3,312</td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>2,852</td>
<td>4,651</td>
<td>2,450</td>
</tr>
<tr>
<td>Inventory reserve</td>
<td>878</td>
<td>1,396</td>
<td>541</td>
</tr>
<tr>
<td>Other</td>
<td>90</td>
<td>2,022</td>
<td>6,228</td>
</tr>
<tr>
<td>Less: Valuation Allowance</td>
<td>48,619</td>
<td>58,483</td>
<td>84,218</td>
</tr>
<tr>
<td>Total Deferred Tax Assets</td>
<td>(31,383)</td>
<td>(37,133)</td>
<td>(30,190)</td>
</tr>
<tr>
<td>Deferred Tax Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>(4,499)</td>
<td>(5,047)</td>
<td>(6,368)</td>
</tr>
<tr>
<td>Other</td>
<td>(40)</td>
<td>(45)</td>
<td>(59)</td>
</tr>
<tr>
<td>Total Deferred Tax Liabilities</td>
<td>(4,539)</td>
<td>(5,092)</td>
<td>(6,427)</td>
</tr>
<tr>
<td>Net Deferred Tax Assets</td>
<td>12,697</td>
<td>16,258</td>
<td>47,601</td>
</tr>
</tbody>
</table>

A valuation allowance has been provided against a portion of Axalto’s deferred tax assets, as it is more likely than not that such assets will not be realized.

As a result of the separation from Schlumberger, other deferred tax assets relating to losses carry-forward available to Axalto were recorded in 2004 for $34.2 million on the basis of losses carry-forward existing as of December 31, 2003.

As of December 31, 2004, deferred tax assets relating to losses carry-forward available to Axalto, net of valuation allowances amount to $33.4 million.

Reconciliation between the Netherlands income tax rate and the effective tax rate is:

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands income tax</td>
<td>37,386</td>
<td>(11,839)</td>
<td>34.5</td>
</tr>
<tr>
<td>Impact of foreign operations &amp; permanent differences</td>
<td>(7,386)</td>
<td>4,281</td>
<td>(6.81)</td>
</tr>
<tr>
<td>Changes in valuation allowance</td>
<td>(31,383)</td>
<td>648</td>
<td>(28.96)</td>
</tr>
<tr>
<td>(1,383)</td>
<td>(6,910)</td>
<td>20.13</td>
<td>(25,466)</td>
</tr>
</tbody>
</table>
Note 14  Pension and Other Benefit Plans

US Employee Benefit Plans

Since May 18, 2004, Axalto employees in the United States benefit from an individual savings plan commonly named “401k” in the United States. According to this plan, the employer matches dollar for dollar the contribution of the employee up to a certain percentage of the eligible compensation. Funds are managed by Fidelity. As this plan qualifies as a defined contribution plan per SFAS 87, no liability in the balance sheet was recognized as of December 31, 2004.

In 2002, 2003 and until its first listing, Axalto employees were covered by several defined benefit pension plans in the name of Schlumberger Technology Corporation, a wholly owned subsidiary of Schlumberger. Schlumberger Technology Corporation also provides certain health care benefits to former employees who have retired under the US pension plans. Upon the separation from Schlumberger, Schlumberger retained the obligations and liabilities associated with US defined benefits plans.

As Schlumberger managed its US employee benefit plans on a global basis for all the employees of its various activities, separate company information was not readily available. Therefore, Axalto’s share of the Schlumberger US plans’ assets and liabilities is not included in the combined balance sheets for the years ended December 31, 2002 and 2003. The combined income statements for 2002 and 2003 and the consolidated income statement for 2004 include, however, an allocation of the costs of the US employee benefit plans. These costs were allocated based on Axalto’s US active employee population for each of the years presented. In relation to these US plans, Axalto recorded pension expense of $1,250, $1,429 and $477 for the years ended December 31, 2002, 2003, and 2004 respectively.

Non US Employee Benefit Plans

Outside the US, Axalto has sponsored since its first listing several defined contribution plans that cover substantially all employees who are not covered by statutory plans.

In the United Kingdom, during 2004, the employees of Axalto remained under the defined benefit or defined contribution plans managed by Schlumberger at UK level. As of December 31, 2002 and 2003, as separate company information was not readily available, the combined balance sheets did not reflect Axalto’s share of the plans’ assets and liabilities. Schlumberger will retain the obligations and liabilities related to the UK defined benefits plans at the date when employees of Axalto in the UK join the Axalto UK defined contribution plan currently being set up. For the UK plan, Axalto recorded for the defined benefits plans a pension expense of $111, $163 and $130 for the years ended December 31, 2002, 2003 and 2004 respectively.

In Germany, the Company recorded a pension expense of $27 for the year ended December 31, 2002. In 2003, this pension expense was not significant. For the year ended December 31, 2004, the pension expense recorded in the income statement amounts to $95 and the liability recorded in the balance sheet to $397.

In France, in addition to state social security and other compulsory plans, Axalto provides the following benefits to its employees:

- Pursuant to applicable French law and labor agreements in force in the industry, a lump sum payment is made to employees upon retirement. The amount of the payment is based on the length of service of the employees and is conditional upon the employee still being employed by Axalto when retiring.

- Jubilees: after 20, 30 and 40 years of service, active employees receive a lump sum.

The characteristics of these benefits are summarized as follows:

- The expense relating to this plan was $1,315, $1,320 and $2,238 for the years ended December 31, 2002, 2003 and 2004 respectively.

- The Projected Benefit Obligation (PBO) computed by third party actuaries amounts to $13,506 for the years ended December 31, 2003 and $16,085 for the years ended December 31, 2004. The assumptions used for the computation of the 2004 PBO are the following: inflation rate of 2%, discount rate of 4.75% in 2004 (versus 5% in 2003) and salary increases of 3% for exempts and 2.75% for non-exempts.

- The liability recorded in the balance sheet in relation with these benefits amounted to $8.8 million, $10.8 million and $14.6 million for the years ended December 31, 2002, 2003 and 2004 respectively.
The projected payments for the period 2005-2009 are expected to be $1.1 million per year on average. The projected payments for the period 2010-2014 are expected to total $1.4 million.

**Note 15  Stock compensation plan**

Axalto has established a *Global Equity Incentive Plan* ("GEIP") for its employees, approved by the general meeting of shareholders held on March 18, 2004 and April 21, 2004. The GEIP authorizes the company to grant employees over the duration of the plan (ending on April 21, 2014) the right to acquire a total of 7 million ordinary shares of Axalto Holding NV. The Board of Axalto Holding NV, in its meeting of April 2, 2004, approved the main terms and conditions of the 2004 option grant under the GEIP 2004.

As of December 31, 2002 and 2003, Axalto did not operate a stock option plan specific to its stand alone business. Employees of Axalto were part of the Schlumberger Limited Group and certain employees participated in the stock option plan and employee stock purchase plan of Schlumberger. Following the successful completion of the Initial Public Offering of Axalto, Axalto employees are no longer allowed to participate in the Schlumberger employee stock purchase plan and their rights under the Schlumberger stock option plan were terminated in accordance with the provisions applicable to employees leaving the company.

**Stock option plans**

Per the 2004 GEIP, it was decided to authorize the grant of 3,300,000 options to buy ordinary shares with an exercise price equal to the initial price offered to investors, i.e. 14.80 Euros per share. 3,198,000 stock options were granted on May 18, 2004. The vesting schedule differs, depending of the country of employment of the optionee, and varies from a 25% vesting per year over 4 years to a cliff vesting at the end of the 4 year period.

Until 2002, officers and key employees of Axalto were granted stock options under Schlumberger stock option plans. For all of the stock options granted, the exercise price of each option equals the market price of Schlumberger stock on the date of grant; an option’s maximum term is ten years, and options generally vest in 20% increments over five years. There were no grants to Axalto employees in 2003.

As required by SFAS No. 123, the fair value of each grant is estimated on the date of grant using the multiple option Black-Scholes option-pricing model. For 2002, the following weighted-average assumptions were used for the Schlumberger stock option grant: dividend of $0.75; expected volatility of 36%; risk-free interest rates of 4.73% and expected option lives of 5.07 years.

For 2004, the following assumptions were used for the Axalto stock option grant: no dividend, expected volatility of 25%, risk-free interest rate of 2.9%, and expected option life of 4.11 years.

**Employee Stock Purchase plan**

In the period from May 4, 2004 to May 14, 2004, it was proposed to Axalto employees to subscribe to a capital increase reserved to them and so acquire Axalto shares at a price 15% below the initial public offering price, up to a limit of 20,000 Euros per employee. 445,668 new ordinary shares of Axalto were created and acquired by the employees at 12.58 Euros per share.

In 2002 and 2003, under the Schlumberger Discounted Stock Purchase Plan, Schlumberger was authorized to issue up to 22,012,245 shares of common stock to its employees. Under the terms of the Plan, employees can choose each year to have up to 10% of their annual earnings withheld to purchase Schlumberger common stock. The purchase price of the stock is 85% of the lower of its beginning or end of the Plan period market price. Under the Plan, Schlumberger sold 51,513 and 47,739 shares to Axalto employees in 2002 and 2003, respectively. The compensation expense related to this plan has been computed for the fair value of the employees' purchase rights, which was estimated using the Black-Scholes model with the following assumptions for 2002 and 2003: dividend of $0.75; expected life of one year; expected volatility of 34% for 2002 and 28% for 2003; and risk-free interest rates of 1.74% for 2002 and 0.75% for 2003. The weighted-average fair value of those purchase rights granted in 2002 and 2003, was $13.324 and $7.910, respectively.

Axalto uses the intrinsic value method for stock based awards granted to employees. No compensation expense for its stock based awards to employees was recognized for the years 2002, 2003 and 2004.

The table below reflects adjusted net income, had Axalto elected to adopt the fair value approach of Statement of Financial Accounting Standards No. 123, *Accounting for Stock Based Compensation*:
Year ended December 31,

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (loss)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>As reported</td>
<td>(112,578)</td>
<td>25,009</td>
<td>59,099</td>
</tr>
<tr>
<td>Adjusted</td>
<td>(117,968)</td>
<td>21,249</td>
<td>54,117</td>
</tr>
</tbody>
</table>

**Note 16 Financial instruments**

Axalto transacts business globally and is subject to the effects of the fluctuations in foreign exchange rates. Axalto’s objective is to reduce earnings and cash flow variations caused by foreign exchange rate fluctuations.

Axalto enters into various options and forward contracts to protect the value of a certain percentage of its forecasted, but not firmly committed, foreign currency costs for periods generally not exceeding eighteen months. The gains and losses on these contracts offset currency gains or losses on the related forecasted transactions. These hedges mainly relate to Euro denominated costs.

Gains and losses on these contracts are initially recorded under Accumulated Other Comprehensive Income (“AOCI”) in stockholder’s equity, and reclassified to current earnings under cost of revenue when related cost of revenue (for sales to third parties) are recognized, offsetting changes in the value of the foreign currency costs.

As of December 31, 2004, Axalto had pre-tax deferred realized and unrealized gains of $7.8 million recorded under Accumulated Other Comprehensive Income (“AOCI”), which the company expects to recognize as a credit to the cost of revenue over the next 12 months. The impact of cash flow hedging activities on the 2004 operating income was a net gain of $2.2 million, booked as a credit to Cost of revenue.

**Fair Value of Financial Instruments**

As of December 31, 2004, Axalto’s financial instruments included cash, cash equivalents, investments, receivables, accounts payable, borrowings, and foreign exchange risk management contracts.

As of December 31, 2004, the fair values of cash and cash equivalents, receivables, accounts payable, accrued expenses, investments and borrowings approximated the carrying values because of the short-term nature of these instruments.

The estimated fair values of other financial instruments determined based on quoted market prices for the same or similar instruments, and the related carrying amounts are as follows:

<table>
<thead>
<tr>
<th>December 31, 2004</th>
<th>Carrying amount</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency risk management contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange forwards</td>
<td>222</td>
<td>222</td>
</tr>
<tr>
<td>Foreign exchange options</td>
<td>6,883</td>
<td>6,883</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7,105</strong></td>
<td><strong>7,105</strong></td>
</tr>
</tbody>
</table>

**Credit Concentration**

As of December 31, 2004, three major commercial banks are the counterparty to Axalto’s risk management contracts. Axalto’s trade receivables and investments do not represent a significant concentration of credit risk as of December 31, 2004 due to the wide variety of customers and markets into which Axalto’s products are sold, their distribution across many geographic areas, and the diversification of Axalto’s portfolio among instruments and issuers.

**Note 17 Lease and Lease Commitments**

Minimum rental lease commitments under non-cancelable operating leases, primarily real estate and office facilities in effect as of December 31, 2004, are as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>12,780</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>8,944</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>4,634</td>
<td></td>
</tr>
</tbody>
</table>

**Note 18  Related party transactions**

Although Schlumberger sold its remaining shareholding of 12.5% in Axalto on September 17, 2004, Schlumberger has to be considered as a related party for the transactions that occurred in 2004.

The remaining balances of the related party payables and receivables included in the 2002 and 2003 combined balance sheet represent amounts arising from trade transactions entered into by Axalto with other Schlumberger entities and certain local recharges of support services, and have been repaid or collected.

The revenue, cost of revenue, receivables and payables related to transactions with Schlumberger entities are as follows:

<table>
<thead>
<tr>
<th>Year ended December 31</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>13,208</td>
<td>6,909</td>
<td>2,780</td>
</tr>
<tr>
<td>Cost of revenue</td>
<td>7,819</td>
<td>4,341</td>
<td>1,398</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year ended December 31</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>4,913</td>
<td>12,666</td>
<td>1,895</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>24,903</td>
<td>10,263</td>
<td>146</td>
</tr>
</tbody>
</table>

**Note 19  Segment information**

Axalto has adopted SFAS No 131, *(Disclosures about Segments of an Enterprise and Related Information)*. This statement requires enterprises to report information about operating segments in annual financial statements.

Axalto’s operations are organized into two business segments: Cards and Point of Sales Terminals (POS). The Cards segment is organized into four product lines: Mobile Communication, Financial Cards, Public Sector, Access Applications and Other and Prepaid Phone Cards.

The two segments were organized in accordance with how Axalto’s management reviews business performance and allocates resources. To manage the four Cards product lines, management relies on an internal financial management reporting system, which provides revenue and gross profit for each of the product lines.

The accounting policies for the reportable business segments and product lines are the same as those applied in the combined and consolidated financial statements. The following tables present Axalto’s revenues, gross profit, operating expense and net interest expense items by segment, and a reconciliation of the totals reported for each of the two segments to the consolidated amounts:
### Revenue

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cards</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mobile Communication</td>
<td>363,406</td>
<td>443,987</td>
<td>548,799</td>
</tr>
<tr>
<td>Financial Cards</td>
<td>149,446</td>
<td>160,266</td>
<td>196,195</td>
</tr>
<tr>
<td>Public Sector, Network Access and Other Products (1)</td>
<td>95,650</td>
<td>62,525</td>
<td>98,425</td>
</tr>
<tr>
<td>Prepaid Phone Cards</td>
<td>71,463</td>
<td>49,859</td>
<td>39,663</td>
</tr>
<tr>
<td><strong>Total Cards</strong></td>
<td>679,965</td>
<td>716,637</td>
<td>883,082</td>
</tr>
<tr>
<td><strong>Point-of-Sales Terminals</strong></td>
<td>50,246</td>
<td>51,025</td>
<td>77,345</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>730,211</td>
<td>767,662</td>
<td>960,427</td>
</tr>
</tbody>
</table>

(1) Includes the revenue from the licensing of Intellectual Property

### Gross profit

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cards</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mobile Communication</td>
<td>110,521</td>
<td>160,818</td>
<td>214,354</td>
</tr>
<tr>
<td>Financial Cards</td>
<td>9,044</td>
<td>26,545</td>
<td>42,108</td>
</tr>
<tr>
<td>Public Sector, Network Access and Other Products (1)</td>
<td>(49,958)</td>
<td>30,047</td>
<td>37,800</td>
</tr>
<tr>
<td>Prepaid Phone Cards</td>
<td>18,265</td>
<td>9,395</td>
<td>3,057</td>
</tr>
<tr>
<td><strong>Total Cards</strong></td>
<td>87,872</td>
<td>226,805</td>
<td>297,319</td>
</tr>
<tr>
<td><strong>Point-of-Sales Terminals</strong></td>
<td>12,989</td>
<td>11,410</td>
<td>18,081</td>
</tr>
<tr>
<td><strong>Total gross profit</strong></td>
<td>100,861</td>
<td>238,215</td>
<td>315,400</td>
</tr>
</tbody>
</table>

(1) Includes the gross profit from the licensing of Intellectual Property
Cost of revenue includes restructuring and impairment charges as follows:

<table>
<thead>
<tr>
<th>Mobile Communication</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Restructuring charges</td>
<td>(2,201)</td>
<td>(268)</td>
<td>(463)</td>
</tr>
<tr>
<td>Impairment charges</td>
<td>(9,500)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(11,701)</td>
<td>(268)</td>
<td>(463)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial cards</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Restructuring charges</td>
<td>(2,567)</td>
<td>(174)</td>
<td>(164)</td>
</tr>
<tr>
<td>Impairment charges</td>
<td>(1,500)</td>
<td>-</td>
<td>(2,758)</td>
</tr>
<tr>
<td>Total</td>
<td>(4,067)</td>
<td>(174)</td>
<td>(2,922)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Public Sector, Network Access and Other Products</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring charges</td>
<td>(742)</td>
<td>(43)</td>
<td>(60)</td>
</tr>
<tr>
<td>Impairment charges</td>
<td>(82,160)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(82,902)</td>
<td>(43)</td>
<td>(60)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prepaid Phone Cards</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring charges</td>
<td>-</td>
<td>-</td>
<td>(47)</td>
</tr>
<tr>
<td>Impairment charges</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>-</td>
<td>-</td>
<td>(47)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Cards</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Total</td>
<td>(98,670)</td>
<td>(485)</td>
<td>(3,492)</td>
</tr>
</tbody>
</table>

**Point of Sales Terminals**

<table>
<thead>
<tr>
<th>Total Point-of-Sales Terminals</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring charges (1)</td>
<td>(30)</td>
<td>(1,421)</td>
<td>14</td>
</tr>
<tr>
<td>Impairment charges</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(30)</td>
<td>(1,421)</td>
<td>14</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Axalto</th>
<th>Restructuring charges</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(5,540)</td>
<td>(1,906)</td>
<td>(720)</td>
<td></td>
</tr>
<tr>
<td>Impairment charges</td>
<td>(93,160)</td>
<td>-</td>
<td>(2,758)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>(98,700)</td>
<td>(1,906)</td>
<td>(3,478)</td>
<td></td>
</tr>
</tbody>
</table>

(1) Includes in 2003, a $1,289 inventory write-down related to the disposal of the POS manufacturing plant completed that year.

The 2004 cost of revenue also includes a $2.8 million write-down expense against the carrying value of an industrial site, as mentioned in Note 7.

<table>
<thead>
<tr>
<th>Total Axalto</th>
<th>Restructuring charges</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(5,540)</td>
<td>(1,906)</td>
<td>(720)</td>
<td></td>
</tr>
<tr>
<td>Impairment charges</td>
<td>(93,160)</td>
<td>-</td>
<td>(2,758)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>(98,700)</td>
<td>(1,906)</td>
<td>(3,478)</td>
<td></td>
</tr>
</tbody>
</table>

Operating expenses

<table>
<thead>
<tr>
<th>Total operating expenses</th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>177,243</td>
<td>171,778</td>
<td>212,650</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>15,143</td>
<td>18,546</td>
<td>16,370</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>192,386</td>
<td>190,324</td>
<td>229,020</td>
</tr>
</tbody>
</table>

In 2002, operating expenses for Cards include restructuring expenses of $5,556. For the years ended December 31, 2003 and 2004, restructuring expenses recorded in operating expenses amounted to $75 and $2,821, respectively.
### Interest Expense, net

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>(7,515)</td>
<td>(4,700)</td>
<td>1,045</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>-</td>
<td>(609)</td>
<td>(754)</td>
</tr>
<tr>
<td><strong>Total interest expense, net</strong></td>
<td><strong>(7,515)</strong></td>
<td><strong>(5,309)</strong></td>
<td><strong>291</strong></td>
</tr>
</tbody>
</table>

### Equity in income of investees accounted for by the equity method

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>923</td>
<td>422</td>
<td>262</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total Equity in income of investees accounted for by the equity method</strong></td>
<td><strong>923</strong></td>
<td><strong>422</strong></td>
<td><strong>262</strong></td>
</tr>
</tbody>
</table>

### Income (loss) before Taxes

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>(106,196)</td>
<td>42,060</td>
<td>84,805</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>(2,169)</td>
<td>(7,745)</td>
<td>448</td>
</tr>
<tr>
<td><strong>Total Income (loss) before Taxes</strong></td>
<td><strong>(108,365)</strong></td>
<td><strong>34,315</strong></td>
<td><strong>85,253</strong></td>
</tr>
</tbody>
</table>

### Supplemental segment information

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>741,813</td>
<td>809,875</td>
<td>1,071,898</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>35,995</td>
<td>36,507</td>
<td>41,940</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>777,808</strong></td>
<td><strong>846,382</strong></td>
<td><strong>1,113,838</strong></td>
</tr>
</tbody>
</table>

### Depreciation and amortization expense

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards</td>
<td>51,529</td>
<td>36,516</td>
<td>40,189</td>
</tr>
<tr>
<td>Point-of-Sales Terminals</td>
<td>1,783</td>
<td>805</td>
<td>1,967</td>
</tr>
<tr>
<td><strong>Total depreciation and amortization expense</strong></td>
<td><strong>53,312</strong></td>
<td><strong>37,321</strong></td>
<td><strong>42,156</strong></td>
</tr>
</tbody>
</table>
**Geographic Information**

The table below shows revenue attributed to geographic areas, on the basis of the location of the customer:

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
</tr>
<tr>
<td>North and South America</td>
<td>126,594</td>
</tr>
<tr>
<td>Europe, Middle East and Africa</td>
<td>387,750</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>215,867</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td>730,211</td>
</tr>
<tr>
<td><strong>Long lived assets</strong></td>
<td></td>
</tr>
<tr>
<td>North and South America</td>
<td>42,233</td>
</tr>
<tr>
<td>Europe, Middle East and Africa</td>
<td>336,798</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>17,703</td>
</tr>
<tr>
<td><strong>Total long lived assets</strong></td>
<td>396,734</td>
</tr>
</tbody>
</table>

**Significant Customers (as a percentage of revenue)**

During each of the three years ended December 31, 2002, 2003 and 2004 no customer accounted for 10% or more of the total revenues.

**Note 20 Commitments and contingencies**

Axalto holds a 51% interest in SAIT, a Chinese joint venture. This joint venture has been fully consolidated within Axalto. In 2003, Schlumberger and the joint venture partner amended its articles of association and agreed the following:

- Axalto guarantees the profit of the joint venture will not be less than Chinese renminbi 30 million (approximately $3.6 million) for 2002 and Chinese renminbi 25 million (approximately $3 million) for each fiscal year thereafter until 2006 (inclusive).

- In exchange, Axalto is granted and shall exercise control of the joint venture until December 31, 2006.

This commitment has been accounted for as a FIN 45 guarantee. Therefore it has been fair valued, and the liability will be re-valued at the end of each reporting date. To date, management estimated that the fair value of the guarantee is not material.

Commitments concerning pensions are described in Note 14, those concerning financial instruments in Note 16, and those concerning leasing commitments in Note 17.

Axalto is party to various legal proceedings and claims that arise in the ordinary course of business. As of December 31, 2004, there are no such matters pending that Axalto expects to be material in relation to its business, financial condition, results of operations or cash flows.

Pursuant to the terms of the Master Separation Agreement signed on March 19, 2004, Schlumberger and Axalto have agreed to carry out the complete transfer of the Schlumberger Group’s Cards and POS businesses to Axalto or one of its subsidiaries.

These commitments remain in effect so long as there are contracts, assets or liabilities falling within the scope of Axalto’s business that have not been transferred at the time of the Separation. This also applies to contracts, assets or liabilities falling within the scope of Schlumberger’s business that have not been transferred at that same time.

Until the date of transfer of the such contracts, assets or liabilities to Axalto or to Schlumberger, as the case may be, or in the event that they cannot be transferred or shall not be transferred as agreed by the parties, Schlumberger and Axalto have agreed to cooperate and execute the contracts or manage the assets and liabilities in the name of and for the account of the other party,
pursuant to the instructions of such party, who will receive all profits and bear all losses (including all taxes normally due, other than those due as a result of a tax reassessment, and which are covered by tax indemnification provisions) resulting from these contracts, assets and liabilities.

This Agreement is described in further details in Note 19 to the combined financial statements attached to the Offering Circular.

The activities, assets and liabilities pertaining to Schlumberger activities falling under the provisions of the Separation Agreement are not disclosed in the accompanying financial statements of Axalto.

As of December 31, 2004, the balance of the assets and liabilities belonging to Schlumberger was a net asset of $15.0 million.

**Note 21  Post closing events**

On March 11, 2005, Axalto signed a memorandum of understanding with its Chinese partner in H.S.T.E. (a company located in China, see Note 6) by which the partner has committed to sell to Axalto its interest of 49% in the company. This operation should not have a significant impact on the financial situation of Axalto.

To management’s knowledge, there is no other significant event that occurred since December 31, 2004 which would materially impact the financial statements, as presented in this document.

**5.2.6 Independent Auditors’ report on the audited combined and consolidated financial statements for the years ended December 31, 2002, 2003 and 2004**

We have audited the accompanying consolidated balance sheet of Axalto N.V. and its subsidiaries as of December 31, 2004 and the related consolidated statement of income, shareholders’ equity and cash flows for the year then ended, and the accompanying combined balance sheet of Axalto and its subsidiaries as of December 31, 2003 and 2002 and the related combined statements of income, shareholders’ equity and cash flows for the years then ended (the “financial statements”). The 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 International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Axalto and its subsidiaries as of December 31, 2004, December 31, 2003 and December 31, 2002 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Axalto was historically a fully integrated business of several indirect subsidiaries and joint ventures of Schlumberger Limited. Consequently, as indicated in Note 1, combined financial statements as of December 31, 2003 and December 31, 2002 have been derived from the consolidated financial statements and accounting records of Schlumberger Limited and reflect significant assumptions and allocations. Moreover, as indicated in Note 1, as of December 31, 2003 and December 31, 2002 Axalto relied on Schlumberger Limited and its other businesses for certain administrative, management and other services. Accordingly, combined financial statements as of December 31, 2003 and December 31, 2002 do not necessarily reflect the combined financial position, results of operations, changes in invested equity and comprehensive income/(loss) and cash flows of Axalto had it been a separate, stand-alone entity during the periods presented.

As discussed in Note 2 to the accompanying combined financial statements, in 2002 Axalto changed its method of accounting for goodwill.

**PricewaterhouseCoopers Audit**

**Paris, France**

**April 19, 2005**
5.3 FIRST-TIME ADOPTION OF IFRS


The first financial statements that Axalto will publish under IFRS will be those related to the 2005 financial year. These financial statements will be presented with 2004 comparative data under IFRS, except for the standards IAS 32 and IAS 39, which Axalto has decided to apply, as allowed by the IFRS 1 option, starting January 1, 2005 only.

Since May 17, 2004, when Axalto was listed on the Premier Marché of Euronext Paris, it has carried out work to assess the impact of the first-time adoption of IFRS. This work has been undertaken by a project team reporting to the accounting department, which focused exclusively on the analysis of the differences between US GAAP and IFRS as applicable to Axalto’s business. It has assessed the effects of first-time adoption options and of the application of all IFRS on Axalto’s consolidated financial statements.

At this stage of the project, the main adjustments to the opening IFRS balance sheet at January 1, 2004 and to accounting movements during 2004 have been identified. However, the quantification of these differences are still under finalization, as is the full review of differences between current standards and IFRS.

Therefore, Axalto will release the following information relating to the first-time adoption of IFRS when it reports its interim results for the six months ended June 30, 2005 (by September 30, 2005 at the latest):

- a description of the main differences between the current US GAAP standards and IFRS applicable to the Company,
- the first-time adoption options retained,
- detailed reconciliations of the 2004 opening and closing balance sheets and of the 2004 income statement under US GAAP and IFRS.

As a consequence, Axalto has decided to list and describe below the main differences that may arise from both first-time adoption options and the application of IFRS as of January 1, 2005.

In the notes to the audited combined financial statements for the years ended December 31, 2001, 2002 and 2003 (approved by the AMF under the visa dated May 17, 2004) and in the notes to the consolidated financial statements for the six months ended June 30, 2004, a table setting out the main differences between US GAAP and IFRS in terms of stockholders’ equity and net income was presented for each period. In accordance with the, then, only possible approach at the time, this reconciliation assumed that Axalto had always applied IFRS, and could not therefore take into account any first-time adoption options.

Axalto therefore considered that it was not appropriate to present a reconciliation of net income and stockholders’ equity for the year ended December 31, 2004 using the same form and assumptions used in the reconciliations carried out for 2001, 2002 and 2003 and the first half of 2004, i.e. without taking into account the impact of first-time adoption options.

**Goodwill**

As part of the IFRS transition, when preparing its opening balance sheet at January 1, 2004, Axalto chose the IFRS 1 option, which allows not to restate retrospectively business combinations that occurred prior to that date.

In accordance with US GAAP, Axalto stopped amortizing goodwill on January 1, 2002. In accordance with IAS 36, Axalto will continue to carry out annual impairment tests on goodwill. As regards goodwill recognized at December 31, 2003, the impairment test carried out in accordance with IAS 36 is unlikely to result in any impairment on the opening balance sheet as of January 1, 2004.

**Research and development**

Under US GAAP, Axalto expenses all research and development costs as they are incurred, with the exception of some software development costs when they meet criteria for being capitalized and depreciated, as defined by SFAS 86, in particular when technical feasibility is demonstrated, i.e. upon completion of a working model.

These criteria do not materially differ from those retained for the capitalization of development costs as per IAS 38.
As a result, the application of IAS 38 is unlikely to have a material impact on the opening IFRS balance sheet at January 1, 2004 and on 2004 income statement.

**Property, plant and equipment**

Axalto will not retain the IFRS 1 option, which allows to recognize some fixed assets at fair value on the opening balance sheet.

Work is in progress to assess the impact of adopting IAS 16 relating to property, plant and equipment on the opening balance sheet at January 1, 2004. The main analyses relate to the effect of applying a component approach for buildings and equipment, and the consideration of residual values to determine buildings depreciable amounts. These are the main two differences identified during the assessment of differences between US GAAP (currently applied by Axalto) and IFRS.

Axalto is also reviewing its main fixed assets useful lives at January 1, 2004 in order to ensure that the depreciation rates currently used comply with IFRS.

**Employee benefits**

Liabilities relating to retirement benefits and other post-employment benefits consist mainly of the lump sum payments made to French employees upon retirement, as described in Note 14 to the 2004 consolidated financial statements. These lump sum payments are regarded as defined-benefit plans under SFAS 87 (US GAAP) and IAS 19 (IFRS).

Axalto currently applies SFAS 87, which states that employer obligations under defined-benefit plans must be valued using the projected unit credit method, and that the corresponding provision must be recorded on the balance sheet. To limit the volatility of the annual expense arising from experience-related adjustments (i.e. when variables on which actuarial assumptions have been made have not developed as expected during the period) and the variation over time of parameters used in the calculation of these provisions, SFAS 87 allows a company to recognize only differences that exceed a certain amount. This is known as the corridor method.

The valuation of employer obligations under defined-benefit plans does not differ materially under IAS 19 as compared to the figure obtained using SFAS 87.

IFRS 1 allows, upon first-time adoption, to record in the provisions on the balance sheet unrecognized actuarial gains or losses in application of the corridor method, with a balancing entry to stockholders’ equity. Axalto has decided to opt for this method. As a result, all cumulative actuarial gains or losses on defined-benefit plans as of January 1, 2004 will be accrued with a balancing entry taken directly to equity. As a result, the expense recognized on the 2004 IFRS income statement will not include any amortization of actuarial gains or losses.

Actuarial gains or losses arising from January 1, 2005 onwards will continue to be amortized using the corridor method over the expected average remaining service lives of the employees concerned.

**Remuneration expenses relating to stock options and stock purchase plans**

In accordance with US GAAP, Axalto currently uses the intrinsic value method for accounting for stock options granted to employees (APB 25). As a result, Axalto did not recognize any expenses relating to these stock option grants in its combined financial statements for 2002 or 2003, or in its consolidated financial statements for 2004.

For its stock purchase plan, Axalto did not recognize any compensation expenses relating to the discount which employees were given compared to the prevailing market price, since it was not required to do so under APB 25.

However, if Axalto had continued to apply US GAAP, it would have recognized these expenses in 2005, since this became mandatory for accounting periods starting on January 1, 2005 (SFAS 123).

The application of IFRS 2 will therefore change the method of recognizing stock options and stock purchases granted to employees compared to the method used until December 31, 2004. The value of options, calculated using the Black-Scholes method, and the discount to prevailing market price granted to employees under stock purchase plans, are considered as additional compensation, and will therefore be recognized as expenses on the income statement. Changes in the value of options subsequent to the grant date will have no impact on the initial charge.
This will affect the 2004 earnings restated under IFRS, to the extent of the share attributable to 2004 of the charge relating to the fair value of options granted and the discount to prevailing market price granted to employees under stock purchase plans falling within the IFRS 2 scope.

An estimate of the impact on remuneration expenses of stock option grants and stock purchase plans under SFAS 123 is provided in Note 15 to the combined financial statements for 2002 and 2003 and the consolidated financial statements for 2004. The impact of applying IFRS is unlikely to differ materially from this estimate. The recognition of this charge on the income statement will affect compensation costs, and therefore operating income.

Income statements for subsequent years will recognize this charge as employees acquire rights under existing and new option grants, and as the company arranges stock purchase plans that grant employees a discount to the prevailing market price.

**Impact of other standards**

At this stage of the project, Axalto does not anticipate that the enforcement of other IFRSs – particularly IAS 2 (Inventories), IAS 12 (Income Taxes), IAS 18 (Revenue), IAS 20 (Accounting for Government Grants and Disclosure of Government Assistance) and IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) – will have any major impact on the IFRS balance sheet at January 1, 2004 or the 2004 IFRS income statement.

5.4 **DIFFERENCES BETWEEN US GAAP AND FRENCH GAAP APPLICABLE TO THE COMPANY**

Axalto's combined financial statements have been prepared in accordance with accounting principles generally accepted in the USA of America (US GAAP). If French GAAP had been applied in accordance with regulation 99-02 in force since January 1, 2000, Axalto's combined financial statements would have shown the following main differences with respect to the presentation required under US GAAP.

**Deferred tax**

Taxes on income are recognized in Axalto's combined financial statements according to SFAS 109. In particular, this recommends that provisions be booked as soon as it becomes probable that some or all of the tax saving will not be realized. In addition, discounting is not permitted under US GAAP.

Under French GAAP, deferred tax assets arising from temporary differences or tax loss carryforwards are only taken into account if they are likely to be realized. In addition, deferred tax assets and liabilities must be discounted as soon as the effects are significant and as soon as a reliable schedule of realization can be established.

**Comprehensive income**

Under US GAAP, comprehensive income comprises all changes in equity except those changes resulting from investments by owners and distributions to owners. These changes include unrealized foreign exchange gains and losses.

This concept of comprehensive income does not exist under French GAAP.

**Property, plant and equipment**

Under US GAAP, software is recognized under property, plant and equipment. Under French GAAP, software is recognized under intangible fixed assets. This presentation difference has no impact on equity or income.

**Goodwill**

The changes to US GAAP resulting from SFAS 141 and 142 as of July 1, 2001 did not apply to French GAAP. Under US GAAP, goodwill has not been systematically amortized since January 1, 2002. However, goodwill is subject to an impairment test at least once a year to determine whether an impairment charge has to be booked.

Due to the lack of systematic goodwill amortization in US GAAP financial statements, impairment charges required under US GAAP may be higher than those required under French GAAP.

Under French GAAP, goodwill is still amortized on a straight-line basis over its estimated useful life.
Under US GAAP, transfers of assets or securities between companies belonging to the same group must be stated by the acquirer at historical book value within the group. As a result, assets acquired by Axalto from Schlumberger or transferred by Schlumberger could not be revalued when these transactions took place, since Axalto was at the time 100%-owned by Schlumberger group companies.

Under French GAAP, assets and securities transferred should be recognized by the acquirer at fair value. This may give rise to goodwill, which is determined on the date that control is acquired.

**Additional pension provisions**

Under French GAAP, the additional pension provisions required in some cases by SFAS 87 is recognized with a balancing entry under other long-term assets.

Under US GAAP, additional provisions are booked in the event that provisions are lower than the minimum required by SFAS 87 due to actuarial gains and losses that have not yet been amortized. This results in a balancing charge to equity.

**In-process research and development**

Under US GAAP, in-process research and development work identified at the time of an acquisition, which fails to meet technological viability standards and for which there is no possible alternative use in future, must be immediately recognized and expensed.

Under French GAAP, ongoing research and engineering must be recorded separately as an intangible asset if it meets the criteria for the recognition and recording of intangible assets. Intangible assets must be included within goodwill and amortized under IFRS.

**Subsidiaries and affiliates**

Under US GAAP, certain available-for-sale securities are stated at market value, and unrealized gains or losses are recognized in comprehensive income and taken to equity.

Under French GAAP, available-for-sale securities are stated at cost, and the notion of comprehensive income does not exist.

**Derivative instruments**

Under French GAAP, financial instruments designated as hedging instruments are kept off-balance sheet. The fair value of a financial instrument is recognized when the hedged item is taken to income. Under US GAAP, all financial instruments must be stated on the balance sheet at fair value. Variations in fair value are taken to income, except when the instrument fulfils hedge accounting criteria set by SFAS 133. If this is the case, the effective portion of the cash flow hedge is stated under “Other comprehensive income (loss)”.
### 5.5 FEES PAID BY THE GROUP TO THE AUDITORS AND MEMBERS OF THEIR NETWORKS

<table>
<thead>
<tr>
<th>Service Description</th>
<th>PricewaterhouseCoopers Accountants N.V. The Hague, Netherlands</th>
<th>PricewaterhouseCoopers Audit Countries other The Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent audit, certification, examination of individual and consolidated financial statements...</td>
<td>75 (€ thousands) 4.3%</td>
<td>1,653 (€ thousands) 95.7%</td>
</tr>
<tr>
<td>Ancillary audit work</td>
<td>0 (€ thousands) 0</td>
<td>0 (€ thousands) 0</td>
</tr>
<tr>
<td>Other services</td>
<td>0 (€ thousands) 0</td>
<td>0 (€ thousands) 0</td>
</tr>
<tr>
<td>Total</td>
<td>75 (€ thousands) 4.3%</td>
<td>1,653 (€ thousands) 95.7%</td>
</tr>
</tbody>
</table>
6.1 COMPOSITION AND OPERATION OF THE MANAGEMENT AND CONTROL BODIES

Axalto is managed by a Board of Directors (Bestuur). The General Meeting of shareholders appoints the Chief Executive Officer (CEO), based on the proposal put forward by the Board of Directors. The Board of Directors appoints one of its members as its Chairman (Voorzitter). The CEO handles the day-to-day management of the Company and, along with the Board of Directors as a whole, represents the Company with respect to third parties.

6.1.1 Composition of the Board of Directors and Senior Management

Board of Directors

According to our Articles of Association, the General Meeting of shareholders determines the number of directors of our Board of Directors. Currently, the number of directors is fixed at seven. The General Meeting of shareholders may appoint, suspend or dismiss members of the Board of Directors at any time. Directors are appointed for a maximum term of four years, subject to re-appointment. Directors may only be re-appointed for two additional terms, each with a maximum length of four years. Directors other than the CEO may not be re-appointed for more than two memberships.

At the date of publication, the composition of the Board of Directors was as follows:

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Date of commencement of office</th>
<th>Date of end of term of office (1)</th>
<th>Principal function within the Company</th>
<th>Principal functions and other offices held outside the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>John de Wit</td>
<td>58</td>
<td>2004</td>
<td>2008</td>
<td>Chairman of the Board of Directors</td>
<td>Member of the Advisory Board of Boer &amp; Croon NeXtrategy BV.</td>
</tr>
<tr>
<td>Olivier Piou</td>
<td>46</td>
<td>2004</td>
<td>2008</td>
<td>CEO</td>
<td>Director, Mergers and Acquisitions at Schlumberger</td>
</tr>
<tr>
<td>Maarten Scholten</td>
<td>50</td>
<td>2004</td>
<td>2007</td>
<td>Director</td>
<td></td>
</tr>
<tr>
<td>Michel Soublin</td>
<td>59</td>
<td>2004</td>
<td>2007</td>
<td>Director</td>
<td>Member of Atos Origin's supervisory board</td>
</tr>
<tr>
<td>Willem Stolwijk</td>
<td>59</td>
<td>2004</td>
<td>2006</td>
<td>Director</td>
<td>Chairman of the Board of Directors of MEDEA+, member of the supervisory board of ASML, DHV and PSV Eindhoven</td>
</tr>
<tr>
<td>Arthur Van der Poel</td>
<td>56</td>
<td>2004</td>
<td>2008</td>
<td>Director</td>
<td></td>
</tr>
<tr>
<td>Robert Singer (2)</td>
<td>56</td>
<td>2004</td>
<td>2004</td>
<td>Director</td>
<td></td>
</tr>
</tbody>
</table>

(1) Directors are appointed for a maximum term of four years. In accordance with the Articles of Association, and in order to ensure periodic renewal of terms of office, the Board of Directors in its April 2, 2004 meeting drew up a timetable for renewing terms of office corresponding with the end of directors' current terms.

(2) Robert Singer has resigned on December 13, 2004 for personal reasons.

John de Wit is the Chairman of our Board of Directors. He has the Dutch nationality. He is a graduate of NOIB Business School in The Netherlands. He has held a variety of posts in the technology and information sector with Burroughs, Royal Philips Electronics in The Netherlands, Mexico and Spain; Motorola Systems, where he was Vice-President and European Chief Executive Officer in Brussels; and Tandem Computers. In 1995, he assisted in the creation of Libertel, the Netherlands’ second largest mobile telephone operator, which is now part of the Vodafone group. In 1999, he was Chief Executive Officer when Libertel NV was listed in Amsterdam. From 2001 until his departure in 2003, he was Chief Executive Officer of Airtel S.A., which subsequently became Vodafone Spain, the Spanish subsidiary of Vodafone.

Olivier Piou has been a director and the Chief Executive Officer of our company since February 17, 2004. He has the French nationality. He began his career with Schlumberger in 1981 and has held different management posts in the technology, marketing and operations divisions of Schlumberger in France and the USA. From 1994 to 1997, he was Vice-President Marketing and Technology of the Electronic Transactions business and from 1998 to 2000 he was Vice-President and General Manager of the Smart Cards business. From 2001 to 2004, he was chairman of Schlumberger's Volume Products and Global Markets Segments activities. He is a graduate of the Ecole Centrale de Lyon. He is also the chairman of Eurosmart, the
international non-profit association based in Brussels which represents the chip card industry globally and member of the supervisory board of INRIA, the French National Institute for Computer Science and Control. Olivier Piou is Chairman of Axalto International S.A.S.

Maarten Scholten is a non-executive director. He has the Dutch nationality. He is a law graduate of the University of Amsterdam in The Netherlands and has a Masters in Political Sciences from the University of Paris-Sorbonne. Before joining Schlumberger in 1986, he practiced as a lawyer in Amsterdam and New York. Since joining Schlumberger, he has held different legal positions within the company in London and Paris. In 1996, he became the assistant General Counsel in charge of the intellectual property department in New York, and, in 1998, he became corporate General Counsel. In 2000 he became CFO of Schlumberger Oilfield Services, and, in 2002, he became President of Schlumberger Oilfield Services Europe, Africa and the CIS region based in Paris. Since March 2003, he has been Schlumberger’s director of Mergers and Acquisitions. He is also Chairman of the Schlumberger Foundation.

Michel Soublin is a non-executive director. He has the French nationality. He is a graduate of the Institute of Political Studies in Paris (Sciences-Po Paris) and of the Faculty of Law and Economics. He joined Schlumberger in 1973 and has held several positions in the financial sector. He has, most notably, been CFO of Oilfield Services from 1996 to 1998, seconded as CFO to OAO NK Yukos in Moscow from 1999 to 2001 and has been Treasurer of the group from 2001 to February 2005. From 1983 to 1990, he was Chief Executive Officer of Schlumberger’s Electronic Transactions, comprising the smart cards, POS terminals, service station equipment and parking divisions. He currently works for Schlumberger as a Financial Advisor. He is a member of the supervisory board of Atos Origin. He is a founding member of the Association Française des Trésoriers d’Entreprises (French association of company treasurers) and a director of the Comité de la Charte (French charity governance organization).

Willem Stolwijk is a non-executive director. He has the Dutch nationality. He holds a degree in business administration from Erasmus University, Rotterdam and is a Registered Accountant. Between 1972 and 1977, Willem Stolwijk held various posts at Algemene Bank Nederland in the Netherlands, before becoming IT officer for foreign subsidiaries at Nederlandsche Middenstandsbank between 1977 and 1984. From 1984 to 1986, he worked for Publishing Company Succes, and, Alpha Compu Service, he was also Chairman of Datatraffic, BeaNet, and Eurocard Netherlands between 1986 and 2003. He was CEO of the Dutch Payments company “Interpay” between 1994 and 2004.

Arthur Van der Poel is a non-executive director. He has the Dutch nationality. He is a graduate of Eindhoven Technical University. He started his career in the research and development department of the Dutch postal and telecoms service. He then joined International Telecommunications Union in Indonesia, before returning to the Netherlands to work for Royal Philips Electronics NV in 1984. He held various marketing and management positions in the Philips Semiconductors division. In March 1986, he became CEO and Chairman of the Board of Directors of Philips Semiconductors, and a member of Royal Philips Electronics NV’s Group Management Committee. In May 1998, he was made a member of Royal Philips Electronics NV’s executive board. Arthur Van der Poel was a member of the Group Management Committee until April 1 2004. He is currently Chairman of the Board of Directors of the European research and development consortium MEDEA+ and is a member of the supervisory boards of ASML, DHV and Philips Sport Vereeniging (PSV Eindhoven).

Robert Singer was a non-executive director until December 13, 2004, when he resigned for professional reasons.

Shareholders will be invited to vote on the appointment of a new director to replace Robert Singer in the next General Meeting of shareholders.

The company had six independent directors in 2004: John de Wit, Maarten Scholten (since September 2004), Michel Soublin (since September 2004), Willem Stolwijk, Arthur Van der Poel and Robert Singer (until his resignation on December 13, 2004).

Currently all non-executive directors are independent as referred to in best practice provision III.2.2. of the Dutch corporate governance code, Michel Soublin and Maarten Scholten are Schlumberger employees, and have been independent since the date on which Schlumberger’s stake in Axalto fell to less than 10% in September 2004.

Senior Executives

The following departments provide support to the Board of Directors and its Chief Executive Officer in managing the Company:

- a financial services department, including consolidation, internal audit, cash management, tax, investor relations and the regional controller functions;
- a human resources department, including recruiting strategy, performance and career management, and integrating the regional staff management and structures;

- a legal department, including Corporate Secretary functions, administrative management of group companies, commercial and contractual affairs risk management, benefits plans and insurance.

The Company's three regional departments - North, Central and South America (NSA), Europe, Middle East and Africa (EMEA) and Asia (ASA), and its two product segments POS terminals and Cards, give it direct contact with its markets and customers.

The Company's senior executives are as follows:

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paul Beverly .............</td>
<td>43</td>
<td>Vice-President, North, Central and South America (NSA)</td>
</tr>
<tr>
<td>Philippe Cabanettes .....</td>
<td>50</td>
<td>Vice-President, human resources</td>
</tr>
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<td>Philippe Cambriel .......</td>
<td>46</td>
<td>Vice-President, Europe, Middle East and Africa (EMEA)</td>
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<tr>
<td>Claude Dahan .............</td>
<td>57</td>
<td>Vice-President, Cards</td>
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<td>Charles Desmartis .......</td>
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<td>Vice-President, Finance</td>
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<td>Christophe Pagezy .......</td>
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<td>Vice-President, strategic development and POS Terminals</td>
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<tr>
<td>Miriam Fedida ............</td>
<td>36</td>
<td>General Counsel and Corporate Secretary</td>
</tr>
<tr>
<td>Teck Lee Tan .............</td>
<td>44</td>
<td>Vice-President, Asia</td>
</tr>
</tbody>
</table>

**Paul Beverly** manages our operations in North America, Central America and South America. He joined Schlumberger in 1985 as a project engineer and during the course of his 19-year career with the company has held a number of different management posts in its operations, marketing and business divisions both in North America and in France. From 1999 to 2003, he was Vice-President of Schlumberger’s Volume Products business for North America. He became Vice-President of North America, Central America and South America in April 2003. He is a graduate of Auburn University in the USA.

**Philippe Cabanettes** is Vice-President of Human Resources. He has been with Schlumberger for 23 years and has held different posts of global responsibility for human resources in the petroleum, industrial and services sectors in France, Italy and the USA. From 1997 to 2001, he was Director of Personnel of the Resources Management Services division of Schlumberger. In May 2001, he became the Director of Personnel of Schlumberger’s Volume Products business. He is a graduate of the Institute of Political Science in Paris (Sciences-Po Paris) and has a Masters in Economics.

**Philippe Cambriel** manages our operations in Europe, the Middle East and Africa. He began his career at Aerospatiale in 1983. From 1989 to 1996, he held various sales and marketing posts at Compaq in France and in Germany. From 1996 to 1997, he was General Manager for IPC in France before holding various posts at Bull CP8 from 1997 to 1998. From 2001 to 2003, he was Vice-President of Schlumberger's e-Transaction Cards business. In April 2003, he was made Vice-President of Schlumberger's Smart Cards business for Europe, the Middle East and Africa. He is a graduate of Ecole Nationale Supérieure de l’Aéronautique et de l’Espace (Sup’Aéro) and has an MBA from INSEAD. He is also a director of Axalto SP SA.

**Claude Dahan** is Chief Operating Officer. He started his career with Office National d'Etudes et de Recherches Aérospatiales (ONERA) in 1977, and was working as Vice-President of a research center when he left in 1982. Between 1982 and 2001, he held various management posts in Schlumberger’s many different businesses, including research and engineering, marketing and production in both France and the USA. From 2001 to 2002, he was the Vice-President in charge of marketing and product development for Schlumberger. In January 2003, he became Vice-President of Schlumberger’s Smart Cards business. He is a graduate of the Ecole des Mines in Paris and has a Doctorate in fluid mechanics and physics. He is also currently Chairman of the Board of Directors of Axalto SP SA and is a director of Axalto SA.

**Charles Desmartis** is Chief Financial Officer. Between 1992 and 2001, he worked as financial controller within various Schlumberger entities in several European countries. From 2001 to 2002, he was the Director of Internal Audit for Schlumberger Limited. In January 2003, he became the Financial Director for Schlumberger’s Volume Products business. He is a graduate of the Ecole des Hautes Etudes Commerciales (HEC) and Stanford University where he obtained a Masters of Science in Management.
Christophe Pagezy is a Director in charge of Strategic Development and the POS Terminal division. Having joined Schlumberger in 1983 as a project engineer, he held various operational, technical and business positions in France and Italy within the company until 2001. Between 2001 and 2002, he was business development manager for Schlumberger's Volume Products and Global Market Segments business. In June 2002, he became Vice-President of Schlumberger’s Terminals division. He is a graduate of the École Supérieure d’Electricité (Supelec) and of the Massachusetts Institute of Technology (MIT). He is also a director of Axalto SA.

Miriam Fedida is General Counsel and Company Secretary. She started her career in 1990, working in various law firms in London and Paris, where she was admitted to the Bar. Between 1994 and 2001, she held a variety of legal and business development positions within the Schlumberger group. From 2001 to 2003, she was Market Development Manager for Schlumberger’s finance segment, and, in March 2003 became General Counsel of Schlumberger’s Volume Products division. She has a DESS in Pharmaceutical law from Scœaux University and a DEA in International Public law from Nanterre University. She is also Central Officer, Chairman of Axalto SA and CP8 Technologies and a director of ETIS.

Teck Lee Tan manages our operations in Asia. He started his career as a software engineer for Singapore Electronic & Engineering (Pte) Ltd. He joined Schlumberger in 1986 and between then and 2002 has held a variety of marketing, technology and general management posts in different Schlumberger group entities in several countries in Asia. From 2001 to 2002, he was Vice-President of Schlumberger’s Mobile Communications Cards business for Asia. In September 2002, he became Vice-President of Schlumberger’s Volume Products business for Asia. He has a Bachelor of Engineering degree from the National University of Singapore. He is also Chairman of Axalto Eastern Holding Inc, Commissioner of PT Axalto Indonesia, Chairman of Axalto Beijing Smart Cards Technology Co. Ltd, director of Axalto KK, CEO of Axalto Technology Asia Ltd — Beijing Representative Office, CEO of Axalto Technology Asia Ltd — Shanghai Representative Office and CEO of Axalto Technology Asia Ltd — Guangzhou Representative Office.

6.1.2 Board of Directors: appointment, role of members, functioning and organization

Appointments

According to our Articles of Association, the General Meeting of shareholders determines the number of directors on our Board of Directors in the General Meeting of shareholders, based on the proposal of the Board of Directors. Currently, the number of directors is seven. The General Meeting of shareholders may appoint, suspend or dismiss Board members at any time.

When a director is appointed, the Board of Directors may initially propose at least two candidates recommended by the Selection and Appointment Committee (see section 6.1.3.3 - Selection and Appointment Committee).

Under the Board's charter governing its internal proceedings, the issues looked at by the Selection and Appointment Committee are as follows:

- Independence: the majority of non-executive directors must be people who have no significant direct or indirect link with the Company and who meet the independence criteria set out in the Dutch corporate governance code (“Tabaksblat”), official regulations and the Bouton report entitled "Pour un meilleur gouvernement des entreprises cotées" ("Towards a better governance of listed companies").

- Retirement policy: The CEO must normally retire at the age of 65. The Board of Directors in its April 2, 2004 meeting drew up a timetable for the renewal of directors' terms of office, with dates corresponding to the end of directors' current terms.

- Changes to main functions: candidates for the post of director must agree to offer their resignation of this post to the Selection and Appointment Committee in the event of any change in their main functions that creates a conflict of interest with the obligations of the Company's directors or that makes them unable to carry out their functions in accordance with the law and the Company's charters governing internal proceedings. The Selection and Appointment Committee gives its opinion on whether or not this resignation should be accepted by the Board of Directors.

- Director availability and commitment: directors must regularly attend meetings of the Board of Directors and meetings of any Committees of which they are members. They must also carry out all tasks given to them by the Board of Directors following recommendations by the Selection and Appointment Committee. Any exceptional circumstance that would prevent a director from attending at least 75% of meetings of the Board of Directors must be discussed with the Chairman of the Board of Directors and the Chairman of the Selection and Appointment Committee. Directors must read documents given to them before meetings of the Board of Directors and allocate sufficient time to prepare for these meetings. The
Chairman of the Board of Directors and the Corporate Secretary must be able to contact directors quickly, and directors must make themselves available for extraordinary meetings of the Board of Directors when necessary.

The proposal of the Board of Directors to appoint a director has mandatory force for the General Meeting of shareholders, although the General Meeting of shareholders can reject the proposal by adopting a resolution to this effect, passed with an absolute majority of votes representing at least a third of the Company's issued capital. If, in the absence of such a quorum, the majority of votes is in favor of a resolution to reject the proposal of the Board of Directors, a second General Meeting of shareholders must be convened. In this event, resolutions will be passed based on an absolute majority of votes, without any quorum conditions.

If no proposal has been made, has been made too late or has been rejected by the General Meeting of shareholders, the General Meeting of shareholders may elect the director of its choice.

The appointment of a director proposed by the Board of Directors is made through a resolution passed on the basis of an absolute majority of votes, with no quorum needed. The appointment of a director not proposed by the Board of Directors is made through a resolution passed on the basis of an absolute majority of votes representing at least a third of the Company's issued capital.

A candidate obtaining an absolute majority of votes in the first round of voting will be elected. If no candidate gains this absolute majority, a second round is organized between the two candidates that obtained the largest number of votes, possibly following an intermediate round of voting if several candidates obtain the same number of votes. If, in the event of a second round of voting, both candidates obtain the same number of votes, the winner will be chosen by drawing lots.

The General Meeting of shareholders may suspend or dismiss directors on the basis of an absolute majority of votes representing at least a third of the Company's issued capital. This quorum is not required if the suspension or dismissal has been proposed by the Board of Directors, except for the dismissal of the CEO. If, in the absence of a quorum, the majority of votes is in favor of a resolution to suspend or dismiss a director, a second General Meeting of shareholders must be convened. In this event, resolutions will be passed based on an absolute majority of votes, without any quorum conditions.

Directors are, in principle, appointed for a minimum term of four years. A director's term ends, at the latest, at the first annual General Meeting of shareholders taking place after the fourth anniversary of the day the director was appointed. Directors other than the CEO may be re-appointed for two additional terms, each with a maximum length of four years. In accordance with Dutch corporate legislation, directors are not obliged to own shares in the Company.

The General Meeting of shareholders designates the Company's CEO on the proposal of the Board of Directors. The Board of Directors appoints one of its independent members as its Chairman. The Board of Directors may dismiss the Chairman at will. The same person may not be the Company's CEO and Chairman of the Board of Directors.

The Articles of Association state that the Company shall indemnify any person who, because of his/her status as a director, manager, employee or representative of the Company, or of another entity on the Company's request, is party to any completed, current or future legal procedure of a civil, criminal or administrative nature.

Powers of the Board of Directors, the CEO and the Chairman of the Board.

The Company is managed by a Board of Directors. The Board is responsible for making the decisions in the following areas:

- in so far as and as long as the Board of Directors has been designated by the General Meeting of shareholders as authorized to resolve upon the issue of shares and to limit or exclude pre-emptive rights - issuing shares in the Company as well as granting rights to subscribe for shares, limiting or excluding pre-emptive rights with respect to an issue of shares, acquiring shares by the Company in its own share capital as well as disposing of such shares;
- issuing bonds or other debt instruments as well as entering into medium- and long-term indebtedness;
- applying for quotation or for withdrawal of the quotation of the aforementioned securities in the price list of any stock exchange;
- concluding or canceling any long-lasting cooperation by the Company or a subsidiary of the Company (dochtermaatschappij) with any other legal person or company or as a fully liable general partner of a limited partnership or a general partnership provided that such cooperation or the cancellation thereof is of essential importance to the Company;
making any investment or disposing of any assets involving an expenditure equal to at least €10 million;

filing a request for bankruptcy (faillissement) or a request for suspension of payment of debts (surséance van betaling);

acquiring or disposing of any participating interest by the Company or a subsidiary of the Company in the capital of a company;

making capital contributions of any kind, whether in the form of cash, personal property or real property, to a corporation or other business entity (including newly formed entities);

adopting and approving capital expenditure budgets, the Company's annual budget, any annual business plan and any multi-year strategic plan;

entering into leases which are capitalized on the books of the Company;

extending guarantees or indemnities to third parties other than those relating to the obligations of subsidiaries (dochtermaatschappijen) and group companies (groepsmaatschappijen) of the Company;

entering into any contract for the purchase or sale of real property for a material amount (i.e. equal to more than 2% of the Company's annual revenues) or entering into a lease, as lessor or lessee, with a value of at least €10 million or with a term of 5 years or more;

entering into any shareholders agreements or joint venture agreements;

entering into a contract for the supply of goods or services for a material amount (i.e. equal to more than 5% of the Company's annual revenues) or with a term of more than 5 years;

transferring the enterprise of the Company or almost the entire enterprise of the Company to a third party;

making any proposal to the General Meeting of shareholders.

In addition, the Board's charter governing internal proceedings state that the Board carries out the following functions:

reviewing and approving the Company's strategies, long-term plans and major corporate actions, as well as monitoring their progress;

reviewing, with the assistance of the Audit Committee, the financial, legal and ethical controls of the Company and ensuring that appropriate compliance processes are in place;

reviewing the Chief Executive Officer’s objectives and performance evaluation as prepared by the Remuneration Committee;

reviewing major allocations of capital and approving significant business acquisitions and divestitures;

nominating candidates for election by the General Meeting of shareholders to membership on the Board of Directors based upon the recommendations of the Selection and Appointment Committee;

resolving upon the remuneration of the Chief Executive Officer, based upon the recommendations of the Remuneration Committee and with due observance of the Company's remuneration policy for the Chief Executive Officer as adopted by the General Meeting of shareholders.

With respect to third parties, the Company is represented either by its directors acting jointly or by the CEO. The Board may also delegate its role as regards representing the Company to third parties within or outside the Company, subject to determining the extent of their powers.

The Board of Directors has delegated its role, as regards to representing the Company, to Olivier Piou, in his capacity as CEO, for the following purposes:

buying back shares in the Company, in accordance with the terms stated in the information memorandum drawn up by the
Company and which is currently under review by the AMF and which will be published on the Company’s website and on the AMF website upon the AMF granting its visa;

- signing all types of comfort letters required by auditors, financial organizations or any other individual or legal entity, in order to guarantee actions taken or financial results achieved by the Company and/or its subsidiaries;
- signing any type of document and/or agreement with a view to setting up a joint venture in Egypt, as described in Chapter VII - Recent Events and Outlook;
- signing any type of document and/or agreement with a view to setting up a company 100%-owned by the Company in South Africa, as described in Chapter VII - Recent Events and Outlook;
- signing any type of document and/or agreement with a view to relocating the Company’s French operations in the Paris region, as this situation is described in Chapter VII - Recent Events and Outlook.

The CEO is responsible for the Company's day-to-day management. He has the task of preparing questions submitted to the Board of Directors for discussion.

At least once a year, the Board of Directors meets without of the CEO in order to examine his/her performance and to examine a succession plan. This plan details the criteria and principles governing the selection of the CEO and succession policies in the event of an emergency or the CEO's retirement. The Board's assessment is reported to the CEO.

Documents and information needed to understand the agenda and to promote discussion are in general provided to the members of the Board of Directors a week before the meetings of the Board of Directors.
In 2004, the Board of Directors met five times. The average attendance rate in these meetings was 83.3%. The absence of Robert Singer for professional reasons adversely affected the average Board of Directors meeting attendance rate. Having accepted a post as company senior executive in the USA, Robert Singer no longer had the time available to attend meetings of the Board of Directors and of the Committees. Robert Singer resigned from the Board of Directors on December 13, 2004.

Corporate governance

When setting up its corporate bodies, the Company took into account a large number of recommendations contained in the Bouton report entitled "Pour un meilleur gouvernement des entreprises cotées" ("Towards better governance of listed companies") and the proposals made in the Dutch corporate governance code. The Company carefully monitors changes in these recommendations and strives to ensure the transparency and the coordinated functioning of its corporate bodies.

In accordance with the Dutch corporate governance code, the Company intends to comply with the "apply or explain" rule with respect to any past or future divergences from the Dutch corporate governance code.

The Company noted the following divergences in 2004:

- Under the Dutch corporate governance code, the CEO's severance package must not exceed 12 months of gross salary. On May 3, 2004, the Company's Board of Directors decided that the CEO is entitled to a severance package equal to two years of gross salary (excluding the 6-month notice period). This decision is in line with normal remuneration practices in France, which take into account the person's seniority and level of responsibility.

- Under the Dutch corporate governance code, the Company is required to appoint a Confidential Adviser so that all information may be reported in full confidence and with no fear of reprisals. The Company plans to appoint a Confidential Adviser in 2005.

- Under the Dutch corporate governance code, the Company is required to make all its corporate governance documents available to the public through its website. The Company was not able to provide all required documents on its website in 2004. The situation has now been rectified.

The Board of Directors has adopted a Code of Practice, which includes certain corporate governance principles. In addition, Axalto has introduced charters governing internal proceedings within the Board of Directors and its Committees.

Axalto’s corporate governance principles and charters are described in detail in an information document for our stockholders. A copy of this document may be obtained free of charge on Axalto’s website (http://www.axalto.com).

Corporate governance principles specify that non-executive directors must draw up a report on the Board of Directors’ work organization as part of the information submitted for the annual report. This report is featured in section 6.5 - Report of the Non-Executive Directors.

For information about the Articles of Association with respect to public offers, see section 3.1.12 – Public Offers.

Charters governing internal proceedings within the Board of Directors

Charters governing internal proceedings within the Board of Directors were adopted by the Board of Directors on February 25, 2005 and implemented as of March 21, 2005.

This charter states that a director may not accept more than five memberships of a board of directors, executive board or supervisory board of any companies other than the Company or its subsidiaries, unless the Board has approved such memberships. The Chief Executive Officer may not be a member of any board of directors, executive board or supervisory board of any companies other than the Company or its subsidiaries, unless otherwise approved by the Board. Directors may not hold any office within a board of directors, executive board or supervisory board of a company that is, or is liable to be, a significant competitor or client of the Axalto group. The Chairman of the Board of Directors may only be chairman of one other company whose shares are authorized for trading on a regulated market.
A director may, however, continue to hold such positions with other companies that he/she holds at the time of his/her appointment.

Non-executive directors must inform the Selection and Appointment Committee and/or the Board of Directors if they are nominated for election to the board of directors, executive board or supervisory board of another company, and if there is any change to their status as director on any other board.

The CEO must consult the Board of Directors before any senior manager of the Company accepts the appointment to the board of directors, executive board or supervisory board of a company that is, or is liable to be, a major supplier, contractor or consultant of the Company, and must inform the Board of Directors of any outside board memberships accepted by a senior manager of the Company.

The Board of Directors and each of its Committees will carry out an annual self-assessment in 2005. At least once a year, the Board of Directors meets without the CEO to assess the performance of non-executive directors as a group and individually.

In accordance with the Board's charter governing internal proceedings, the directors and members of each Committee may meet with the Axalto Group’s senior management and employees at any time. In order to prepare the agenda for meetings of the Board of Directors and Committee meetings, the Chairman of the Board of Directors and the chairmen of the Committees seek suggestions from directors in order that senior executives may make appropriate presentations in these meetings. The Board of Directors may, at the Company's expense, make use of external advisors, particularly lawyers, auditors and other consultants, when it deems this necessary to the fulfillment of its duties. The Board of Directors and the various Committees are assessed by the Selection and Appointment Committee as described in section 6.1.3.3 - Selection and Appointment Committee.

The Board of Directors provides the General Meeting of shareholders with all information requested, provided that this is not contrary to an overriding interest of the Company. If the Board of Directors invokes an overriding interest, it must give reasons.

Confidentiality and insider trading policy

Axalto’s corporate governance principles provide that Axalto and its affiliates may not make any loans to directors or their immediate family members. In accordance with Dutch legislation with respect to insider trading (Wet toezicht effectenverkeer 1995), the Company has a confidentiality and insider trading policy.

In accordance with Dutch legislation and the rules set forth in this policy, our directors must, within two weeks of their appointment, notify the Dutch Financial Markets Authority (Autoriteit Financiële Markten) of the number of securities of Axalto and its affiliated companies that they hold. Directors must also promptly notify the Dutch Financial Markets Authority of any change in the number of these securities that they hold.

Directors are required to report to Axalto any transactions relating to Axalto common stock entered into by them. Any such transactions must then be reported by Axalto to the AMF within five trading days from the time when the Company receives this declaration, and announced in a press release. This obligation to report information to the Company also applies to persons closely related to directors, in accordance with the definition of close relations in directive 2007/72 dated April 29, 2004 in application of the "market abuse" directive.

The Company's confidentiality and insider trading policy also states that directors are prohibited from participating in transactions concerning Axalto securities for a period of two months prior to the date on which annual or consolidated financial statements are made public, and for a period of three weeks prior to the date on which quarterly and half-year figures are made public. Directors may not participate in transactions concerning Axalto securities if they hold privileged information that has not yet been made public.

Code of Ethics

The Board of Directors has adopted a document entitled "Corporate values and principles", which has subsequently been developed into a Code of Ethics. The Board of Directors expects the directors to act in accordance with ethical principles at all times, and to state their acceptance of the principles described in the Code of Ethics. The Company will not tolerate any infringement of ethical principles by its directors. In the event of a conflict of interest, even potential, the director concerned must inform the Chairman of the Board of Directors and the other directors as quickly as possible. If the conflict of interest has occurred or cannot be resolved, the director must temporarily cease attending meetings of the Board of Directors or resign.
This Code of Ethics will be communicated to all Axalto employees through various means, i.e. through individual training, collective training, via the intranet and through its inclusion in rules governing internal proceedings.

6.1.3 Committees

In accordance with the Articles of Association, the Board of Directors has set up Committees made up exclusively of non-executive members of the Board of Directors, and has defined their powers, functions and charters governing their internal proceedings.

An Audit Committee, a Remuneration Committee and a Selection and Appointment Committee have been set up. The charters governing internal proceedings for each of these Committees were adopted by the Board of Directors on February 25, 2005, and were implemented as of March 21, 2005.

The CEO may not be a member of these Committees.

The Board of Directors remains responsible for its decisions, even if they have been prepared by one of the aforementioned Committees.

The Audit Committee, Remuneration Committee and Selection and Appointment Committee are all authorized to use the services of legal, accounting or other advisors at the Company's expense.

6.1.3.1 Audit Committee

The Audit Committee comprises at least three non-executive directors. The Audit Committee's members are appointed by the Board of Directors. The majority of its members must have no material links, either direct or indirect, with the Company and/or the Axalto group, and must meet the independence criteria set out in the Dutch corporate governance code. At least one member of the Audit Committee must be a financial expert with knowledge or experience in financial management or accounting within a listed company or large corporation.

The Audit Committee may not be chaired by the Chairman of the Board of Directors or by a former executive member of the Board of Directors.

The Audit Committee's members in 2004 were as follows:

- Robert Singer, chairman of the Committee until his resignation on December 13, 2004;
- Willem Stolwijk (independent director), acting chairman since the resignation of Robert Singer;
- Michel Soublin (independent director as of September 2004).

In accordance with the Audit Committee's charter governing internal proceedings, the Committee meets at least three times per year. The CFO, the Internal Audit Officer and a representative of the independent auditors are invited to attend Audit Committee meetings. The Audit Committee must also meet internal auditors and independent auditors at least once per year in the absence of the Axalto Group’s executive directors and senior members of the management. The Corporate Secretary and any member of the Audit Committee may request that an Audit Committee meeting be held.

The Audit Committee's meetings are only legitimate if at least an absolute majority of its members is present or represented. Its decisions are taken on an absolute majority basis. In the event that a vote is tied, the chairman of the Audit Committee has the casting vote.

The Audit Committee met five times in 2004. The average attendance rate in these meetings was 75%. The absence of Robert Singer for professional reasons adversely affected the average Audit Committee meeting attendance rate. Having accepted a post as company director in the USA, Robert Singer no longer had the time available to attend meetings. Robert Singer resigned from the Board of Directors on December 13, 2004.

The Board of Directors, in accordance with article 16 of the Articles of Association, will make a proposal to the next General Meeting of shareholders to appoint a replacement for Robert Singer. This replacement will meet the corporate governance criteria required of the chairman of the Audit Committee.
Under the charter governing internal proceedings, the Audit Committee has the following duties:

- considering the appointment, re-appointment, dismissal and resignation of the independent auditors used by the Company and any group company, and making recommendations to the Board of Directors in this respect;
- controlling and handling the Company's relations with the independent auditors in order to define the extent and the terms of their audit;
- controlling at least once a year financial reporting procedures and the efficiency of the internal control system within the Axalto group;
- supervising the Company's compliance with regulatory requirements applying to companies whose shares are tradable on a regulated market in France and all regulations applicable to the Company;
- supervising the financial information provided by the Company, the accounting decisions made and the application and impact of new accounting standards;
- supervising the Internal Audit department and the implementation of an appropriate tax and financial policy;
- supervising the Company's implementation of recommendations made by the independent auditors and internal auditors;
- granting specific responsibilities to one or more Committee members within the limits authorized by laws, regulations, the AMF's general regulation and the Company's Articles of Association;
- supervising the Company's use of information and communication technologies;
- preparing an annual report on its discussions and conclusions for the Board of Directors.

6.1.3.2 Remuneration Committee

The Remuneration Committee comprises at least three non-executive directors. The Remuneration Committee's members are appointed by the Board of Directors. The majority of its members must have no material links, either direct or indirect, with the Company and/or the Axalto group, and must meet the independence criteria set out in the Dutch corporate governance code. The chairman of the Remuneration Committee may not be the Chairman of the Board of Directors or a former executive member of the Board of Directors, and is appointed by the Board of Directors.

The Remuneration Committee's members in 2004 were as follows:
- Arthur Van der Poel (independent director), chairman;
- John de Wit (independent director);
- Maarten Scholten (independent director as of September 2004).

In accordance with the Remuneration Committee's charter governing internal proceedings, the Committee meets at least three times per year, and more frequently if necessary. The Vice-President Human Resources is invited to attend Remuneration Committee meetings. The Committee regularly reports its activities to the Board of Directors.

The Remuneration Committee's meetings are only legitimate if at least an absolute majority of its members is present or represented. Its decisions are taken on an absolute majority basis. In the event that a vote is tied, the chairman has the casting vote.

The Remuneration Committee met five times in 2004. The average attendance rate in these meetings was 87%.

In accordance with its charter governing internal proceedings, the Remuneration Committee's duties include the following:
- supervising the Company's general remuneration policy;
- preparing proposals to the Board of Directors relating to changes in the policy for remunerating the CEO, to be adopted by the General Meeting of shareholders;
- preparing proposals relating to the remuneration of the CEO, which must include (i) the remuneration structure and (ii) the amount of fixed remuneration, shares and/or options and/or other variable remuneration, pension benefits, severance
packages and other forms of remuneration to be granted, along with performance criteria and their application;

- supervising and assessing targets assigned to the CEO;

- supervising the remuneration of senior executives and non-executive directors of the Axalto Group;

- preparing the Board of Directors' report on the policy for remunerating the CEO and senior executives that is to be adopted by the Board of Directors. This remuneration report includes developments concerning the way in which the policy for remunerating the CEO and senior executives has been implemented in the last year, and sets out the remuneration policy to be adopted in the next year and subsequent years;

- preparing employee profit-sharing and incentive plans (including the GEIP - see section 6.3.3 - Selection and Appointment Committee), plans for share issues to Axalto employees and any changes to existing profit-sharing plans, and proposing them to the Board of Directors;

- presenting an annual report on its discussions and conclusions to the Board of Directors.

In accordance with the Board of Directors' charter governing internal proceedings, the Remuneration Committee examines director remuneration annually, and makes recommendations on this matter to the Board. To do this, the Remuneration Committee takes into account the fact that (i) directors must be fairly compensated for the work involved in supervising the management of a company of Axalto's scale and activity and (ii) remuneration offered must be competitive with that offered by other European companies of similar scale and activity.

**Selection and Appointment Committee**

The Selection and Appointment Committee comprises at least three non-executive directors. The Selection and Appointment Committee's members are appointed by the Board of Directors. The majority of its members must have no material links, either direct or indirect, with the Company and/or the Axalto group, and must meet the independence criteria set out in the Dutch corporate governance code. The Selection and Appointment Committee's chairman is appointed by the Board of Directors.

The Selection and Appointment Committee's members in 2004 were as follows:

- Arthur Van der Poel (independent director), chairman;
- John de Wit (independent director);
- Maarten Scholten (independent director as of September 2004).

In accordance with the Selection and Appointment Committee's charter governing internal proceedings, the Committee meets at least three times per year, and more frequently if necessary. The Vice-President Human Resources is invited to attend Selection and Appointment Committee meetings. The Committee regularly reports its activities to the Board of Directors.

The Selection and Appointment Committee's meetings are only legitimate if at least an absolute majority of its members are present or represented. Its decisions are taken on an absolute majority basis. In the event that a vote is tied, the chairman has the casting vote.

The Selection and Appointment Committee met five times in 2004. The average attendance rate in these meetings was 87%.

As regards its charter governing internal proceedings, the Selection and Appointment Committee has the following duties:

- defining procedures for selecting and appointing candidates for the post of director. This involves pre-selecting candidates and in particular assessing their skills and integrity;

- carrying out periodic assessments of the scale and composition of the Board of Directors and proposing changes to the Board's configuration based on these assessments;

- carrying out periodic assessments of the Board's activities and the management provided by its members and senior executives, and presenting a report to the Board;

- making proposals regarding the re-appointment of directors;
• considering the resignation of a director whose main activity or functions outside of Axalto have changed, and recommending or otherwise the resignation of this director to the Board of Directors;

• considering the existence of direct or indirect links between members of the Board and the Company or its executives, and helping the Board to determine the independence of directors;

• supervising the development program adopted by the CEO and senior executives of the Axalto Group;

• supervising the policy regarding selection criteria and procedures for appointing senior executives of the Axalto Group;

• preparing an annual report on its discussions and conclusions for the Board of Directors.

6.2 REMUNERATION OF THE MANAGEMENT AND OFFICERS

6.2.1 Remuneration of the Directors and senior managers

The General Meeting of shareholders determines the remuneration of non-executive directors based on a proposal by the Board of Directors. The CEO's remuneration is set by the Board of Directors within the limits of the remuneration policy as adopted by the General Meeting of shareholders. Any substantial alteration to the remuneration policy must be adopted by the General Meeting of shareholders. The Remuneration Committee makes proposals regarding remuneration.

The gross remuneration paid by the Company to Board members for the 2004 financial year broke down as follows:

<table>
<thead>
<tr>
<th>Name</th>
<th>Function</th>
<th>Amount (1)</th>
<th>Prorated amount actually paid, including Committee payment</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>John de Wit</td>
<td>Chairman of the Board of Directors</td>
<td>45,000(2)</td>
<td>43,279(2)</td>
<td>March 19, 2004</td>
</tr>
<tr>
<td>Olivier Piou (3)</td>
<td>CEO</td>
<td>35,000</td>
<td>26,202</td>
<td>April 2, 2004</td>
</tr>
<tr>
<td>Maarten Scholten</td>
<td>Director</td>
<td>35,000</td>
<td>35,410</td>
<td>March 19, 2004</td>
</tr>
<tr>
<td>Robert Singer (4)</td>
<td>Director</td>
<td>35,000</td>
<td>0</td>
<td>April 1, 2004</td>
</tr>
<tr>
<td>Michel Soublin</td>
<td>Director</td>
<td>35,000</td>
<td>31,475</td>
<td>March 19, 2004</td>
</tr>
<tr>
<td>Willem Stolwijk</td>
<td>Director</td>
<td>35,000</td>
<td>29,611</td>
<td>April 21, 2004</td>
</tr>
<tr>
<td>Arthur Van der Poel</td>
<td>Director</td>
<td>35,000</td>
<td>31,352</td>
<td>April 21, 2004</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>255,000</strong></td>
<td><strong>197,329</strong></td>
<td></td>
</tr>
</tbody>
</table>

(1) Plus €7,500 due to the chairman of the Audit Committee and €5,000 due to each director for his/her activity within Board Committees. The Company also paid the travel expenses of members of the Board of Directors in 2004.

(2) The Chairman of the Board of Directors received an additional €32,500 in 2004 for setting up the Board of Directors and its governing bodies.

(3) The CEO also has an employment contract governed by French law with Axalto International SAS, an Axalto subsidiary. In respect of this, he received an annual gross salary of €465,000, in addition to his remuneration as a corporate officer of Axalto, taking his total reference compensation for 2004 to €500,000. The prorated gross amount paid in 2004 was €488,702. Following a decision by the Board of Directors on February 25, 2005, his annual gross salary was increased to €515,000 as of March 1, 2005, in addition to his remuneration as a corporate officer of Axalto, taking his total reference compensation to €550,000. The effective granting of this remuneration is subject to shareholders accepting the policy for remunerating the CEO in the next General Meeting of shareholders.

In addition to this amount, the CEO receives variable compensation equal to 0-75% of his Total Reference Compensation. Part of this variable compensation, typically half, is related to the Company's financial results, and the remainder depends on his success in hitting a limited number (typically 4-6) of specific strategic, tactical or individual objectives. The proportion related to financial results may be increased, and may be as much as doubled, if exceptional financial results are achieved. As a result, total variable remuneration may equal up to 112.5% of Total Reference Compensation.
Based on the Company's financial results for 2004, reported on March 3, 2005, along with his success in hitting specific objectives for 2004, the CEO received gross variable remuneration of €549,790 for the 2004 financial year.

Due to the excellent outcome of the IPO and the Company's development in 2004, the Board of Directors decided in its February 25, 2005 meeting to grant the CEO an exceptional bonus of €73,305, and will put a proposal to the General Meeting of shareholders in the next annual General Meeting of shareholders to grant him 150,000 stock options. The effective granting of these stock options is subject to shareholders accepting the policy for remunerating the CEO in the next General Meeting of shareholders.

The CEO does not benefit from any special pension plan provided by the Company. As part of the 2004 GEIP (as defined below), the CEO was granted 600,000 stock options, the main terms of which are described below. The CEO's length of service with Schlumberger is taken into account in determining his Axalto seniority. On this basis, he is entitled to a severance package equal to two years of gross salary (excluding the 6-month notice period).

(4) Robert Singer resigned from the Board of Directors in December 2004 for professional reasons, and relinquished his remuneration of €35,000.

The total gross remuneration (including fixed salary and variable remuneration) paid by the Company or its subsidiaries to members of the Company's Board of Directors that have an employment contract and to senior executives of the Company for 2004 was around €3.6 million. Part of the variable compensation of senior executives, typically half, is related to the Company's financial results, and the remainder depends on their success in hitting a limited number (typically 4-6) of specific strategic, tactical or individual objectives. Since the Axalto group was created, the only member of the Board of Directors to have an employment contract has been the CEO.

The Company has not provisioned and does not plan to provision any other amount with respect to remuneration, pension benefits or other benefits granted to corporate officers for 2004.

The Board of Directors will make a proposal to the General Meeting of shareholders in the next annual General Meeting of shareholders to set the annual remuneration of Audit Committee members at €10,000.

6.2.2 Stock options granted to and exercised by each executive director

Stock options granted to executive directors

<table>
<thead>
<tr>
<th>Stock options:</th>
<th>Grant date</th>
<th>Number of options granted</th>
<th>Strike price (€)</th>
<th>Expiry</th>
<th>Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>granted during the year to each executive director</td>
<td>May 17, 2004</td>
<td>600,000</td>
<td>14.80</td>
<td>Nine years and six months after the grant date</td>
<td>2004 GEIP</td>
</tr>
<tr>
<td>• Olivier Piou</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Stock options exercised by executive directors in 2004

None.

6.2.3 Information on agreements with members of governing bodies

No agreements have been made between the Company and any member of its Board of Directors or management.

6.2.4 Shares owned by members of the Board of Directors and senior executives

The number of Axalto shares bought directly and owned by members of the Board of Directors currently breaks down as follows. Olivier Piou owns 70,000 shares, Maarten Scholten 2,000 and Michel Soublin 1,500. Eligible senior executives and members of the Board of Directors who have employment contracts were able to take part in the stock issue reserved for employees as part of the IPO.

6.2.5 Loans and guarantees granted to members of the Company's Board of Directors or management.

None.
6.3 EMPLOYEE PROFIT-SHARING AND INCENTIVE PLANS

6.3.1 Employee profit-sharing and incentive plans

In some countries, the policy for remunerating employees is dependent on hitting targets.

Many Axalto employees receive remuneration under a plan for sharing in the Company's results. These plans, in accordance with local legislation, offer either a share of the company's profits or the matching of voluntary contributions paid into a Company savings plan.

Axalto has also set up a Group Savings Plan, enabling employees of its French subsidiaries to invest in various mutual funds, of which one invests exclusively in Axalto shares.

In the USA, employees can pay voluntary contributions into a savings plan, which are matched by the company, depending on the Company's results, an additional payment can be served.

6.3.2 Issues of stock to employees

As part of its May 2004 IPO, the Company offered eligible employees the opportunity to buy shares in the Company as part of a capital increase reserved for employees.

In accordance with the shareholders resolutions adopted on March 18 and April 21, 2004, it was decided to approve the creation of a Global Employee Share Purchase Plan (GESPP).

The GESPP has been implemented in eight countries (United Arab Emirates, Spain, USA France, Hong Kong, Mexico, UK and Singapore). In some countries, it includes specific arrangements intended to enable employees to benefit from preferential tax treatment. It is available to expatriate employees.

In France, the Company has set up a Group Savings Plan (GSP), under which a mutual fund invests exclusively in Axalto shares.

The price of these shares, offering dividend rights as of January 1, 2004, sold as part of the IPO and reserved for employees of the company was set on May 17, 2004 at €12.58, representing a discount of 15% to the IPO price of €14.80.

The offer reserved for employees led to the creation of 445,668 new shares, representing around 1% of the Company's capital.

In accordance with the resolution of the Board of Directors adopted on December 13, 2004, the principles of which were confirmed by the resolution of the Board of Directors adopted on February 25, 2005, the Company plans to launch a new offer reserved for employees in 2005, to enable employees to increase their interest in the Company's capital.

The terms and conditions of this capital increase will be set out in the transaction memo to be filed with the AMF in 2005. The price of the new shares offered to employees via this offer will be set in accordance with applicable regulations.

6.3.3 Employee stock option plans

In accordance with shareholders resolutions adopted on March 18 and April 21, 2004, it was decided to approve the creation of a Global Equity Incentive Plan (GEIP) for Axalto group employees. In its April 2, 2004 meeting the Board of Directors resolved that the 2004 GEIP would apply to employees in the following 18 countries: Germany, Brazil, Canada, China, United Arab Emirates, Spain, USA, France, Hong Kong, India, Italy, Malaysia, Mexico, Netherlands, UK, Singapore, Taiwan and Turkey.

The GEIP, which will end on April 21, 2014, allows different types of arrangements depending on the country concerned and the type of options offered, i.e.

- stock options
- restricted share units, intended for certain employees, which give employees the right to acquire shares at the end of a given period of time and under certain conditions. Restricted share units do not give holders any of the rights conferred by common stock.
Share appreciation rights, intended for certain employees, which enable employees to receive, in either cash or shares, the difference between the share price on the share appreciation right exercise date and the strike price of the share appreciation right determined on the grant date.

The number of options granted under the GEIP as part of the IPO will potentially enable employees to buy around 3.2 million new or existing shares, i.e. around 8% of the Company's fully paid-up share capital after the IPO.

The total number of options that may be granted under the GEIP will potentially enable employees to acquire up to 7 million new or existing Company shares during the life of the plan.

In accordance with the resolution of the Board of Directors adopted on December 13, 2004 and February 25, 2005, the Company could grant around 700,000 stock options during 2005.

6.3.4 Stock options granted to the top ten senior management (excluding executive directors) and stock options exercised by the top ten senior management (excluding executive directors)

Stock options granted to the top ten recipients of stock options (excluding executive directors)

<table>
<thead>
<tr>
<th>Stock options:</th>
<th>Grant date</th>
<th>Number of options granted</th>
<th>Strike price (€)</th>
<th>Expiry</th>
<th>Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>granted during the year to the top ten recipients of stock options excluding executive directors</td>
<td>May 17, 2004</td>
<td>880,000</td>
<td>14.80</td>
<td>Tenth anniversary of the grant date, except in France (1)</td>
<td>2004 GEIP</td>
</tr>
</tbody>
</table>

(1) Nine years and six months for employees of the Axalto group's French companies.

Stock options exercised by top ten senior management (excluding executive directors)

None.

6.4 INTERNAL CONTROL

In accordance with the requirements of Article L. 225-37 of the French commercial code and article L. 621-18-3 of the French monetary and financial code, and in accordance with the Dutch corporate governance code, the Chairman of the Board of Directors and the CEO report on the way in which the Board's activities are prepared and organized, and on the Axalto Group's internal control procedures during 2004.

Axalto has based its corporate governance on international best practice, and took into account French and Dutch recommendations when setting up its corporate bodies. The Company took the same approach when setting up and deploying its internal control procedures. In this respect, Axalto intends to remain at the forefront of developments as regards corporate governance and internal control practices, and will take all measures it deems necessary to comply with new recommendations or regulatory requirements. Axalto is not currently planning to make any significant changes that would adversely change its internal control procedures.

The Chairman of the Board of Directors gave the chairman of the Audit Committee, the General Counsel and the head of Internal Audit the task of carrying out the preparatory work and investigations needed to draw up this report. The Audit Committee and the independent auditors were informed of this work and these investigations.

The strategy and risk of Axalto’s business and the CEO’s assessment of the structure and operation of the internal risk management and control procedures implemented within the Axalto Group during 2004 were discussed with Axalto's non-executive directors and the members of the Audit Committee.

To guarantee the quality and reliability of the financial information produced, the Axalto group has adopted a permanent process to ensure constant improvements in internal control.
6.4.1 Preparation, organization and work done by the Board of Directors

6.4.1.1 Preparation and organization of work done by the Board of Directors

Axalto is managed by the Board of Directors, which makes decisions on major strategic, economic, employee-related, financial and technological issues and ensures that they are implemented by the senior executives.

In particular, Axalto's CEO must obtain the Board of Directors' authorization to sign any contract relating to the acquisition or sale of an asset in an amount of €10 million euros or over.

The Board of Directors consists of seven directors, the majority of whom are independent. Michel Soublin and Maarten Scholten are Schlumberger employees, and have been independent since the date on which Schlumberger's stake in Axalto fell to less than 10% in September 2004. Details on the members of the Board of Directors are provided in section 6.1.1 - Composition of the Board of Directors and the Senior Executives.

In 2004, the Board of Directors met five times, and meetings were attended by 6 out of 7 directors on average. Each meeting was preceded by a meeting of one or more Committees, in order to prepare for the meeting of the Board of Directors.

6.4.1.2 Duties and operation of the Board's Committees

Audit Committee

The Audit Committee was made up of three directors in 2004, two of whom were independent: Michel Soublin, Robert Singer - chairman of the Committee until his resignation on December 13, 2004 for professional reasons - and Willem Stolwijk, who has been acting chairman since the resignation of Robert Singer.

The Board of Directors, in accordance with article 16 of the Articles of Association, will make a proposal to the General Meeting of shareholders in the next annual General Meeting of shareholders to appoint a replacement for Robert Singer. This replacement will meet the corporate governance criteria required of the chairman of the Audit Committee.

The Audit Committee met five times in 2004 in the Netherlands.

The Committee regularly met with Axalto executives, the head of Internal Audit and the independent auditors in order to examine with them their planned activities and the results thereof.

Remuneration Committee

The Remuneration Committee is made up of three directors, all of whom are independent: John de Wit, Maarten Scholten and Arthur Van der Poel, chairman.

The Remuneration Committee met five times in 2004 in the Netherlands.

Selection and Appointment Committee

The Selection and Appointment Committee is made up of three directors, all of whom are now independent: John de Wit, Maarten Scholten and Arthur Van der Poel, chairman.

The Selection and Appointment Committee met five times in 2004 in the Netherlands.

The charter governing internal proceedings of each of the Board's three Committees were adopted by the Board on February 25, 2005, and are summarized in section 6.1.3 - Committees.

6.4.2 Internal control within the Axalto group

6.4.2.1 Internal control environment

Axalto's management regards internal control as a responsibility that is shared by all managers and that is met by implementing within the company a set of processes and procedures intended to provide reasonable assurance that the Board of Directors objectives will be attained. These objectives concern:
The conduct of business in compliance with internal policies and rules, and operational effectiveness
the reliability of financial information, both published and used internally to assess performance and allocate resources
compliance with laws and regulations in force in the countries in which the Company operates

The Company has defined corporate governance rules with which it intends to comply.

It has also defined internal control principles and procedures applicable to its main transaction cycles and to its central functions. These principles and rules are codified in financial procedures, and include:

- ethical rules that apply to the conduct of business
- authorizations to bind the Company (contracts, purchases, various commitments)
- controls and authorizations required in procedures relating to sales, purchases, cash inflows and outflows, payroll and so forth;
- the accounting policies defined by the Company
- the rules applicable to the production of financial reports
- cash management and exchange rate risk management
- the arrangement of external and internal financing for subsidiaries
- the creation and liquidation of legal entities within the Axalto group
- acquisitions of assets or shares in companies
- capital expenditure

Internal control is based on granting extended responsibilities and powers to the managers of subsidiaries, to management entities and to their functional teams (operational audit, legal, HR), which are in charge of applying the policies, standards, guidelines and procedures defined by the Axalto group's Management Board.

6.4.2.2 Corporate Governance

When setting up its corporate bodies, the Company took into account the French financial security act (Loi sur la sécurité financière) along with a large number of recommendations contained in the Bouton report entitled "Pour un meilleur gouvernement des entreprises cotées" ("Better governance of listed companies") and in the Dutch corporate governance code (Code Tabaksblat). The Company intends to ensure the transparency and the co-ordinated functioning of its corporate bodies, and pays close attention to changes in these recommendations and proposals.

As a result, the Board of Directors has adopted a Code of Practice, in order to apply the most effective corporate governance principles to the entire Axalto group. In addition, Axalto has introduced rules governing internal proceedings within the Board of Directors and its Committees.

Axalto’s corporate governance principles are described in detail in an information document for our stockholders. A copy of this document may be obtained free of charge on our internet site (http://www.axalto.com).

6.4.2.3 Internal Audit

Axalto started to set up its dedicated Internal Audit department in 2004, as part of preparations for the Company's IPO on the Premier Marché of Euronext Paris in May 2004. Previously, Axalto's activities were part of the Schlumberger group, and internal audit tasks were carried out by Schlumberger Limited's internal audit department.
Internal Audit's main duty is to audit Axalto group entities with the aim of:

- assessing and evaluating the effective implementation of policies and rules drawn up by the Axalto group's management regarding the conduct of business and the protection of Axalto's assets
- ensuring compliance with laws and regulations in force in the countries in which the Axalto group entities operate
- ensuring the reliability and integrity of financial information produced
- ensuring that the Axalto group's values are understood and complied with at all the various organizational levels

This work is co-ordinated with the work done by the external auditors.

Internal Audit's other duties consist of:

- providing advice in various areas to Axalto's operational subsidiaries and central functions, with the aim of increasing the efficiency of operations
- recruiting young professionals who show a high level of potential and have the ability to become senior executives within the Axalto group

The Internal Audit department has direct and unlimited access to the Audit Committee, and to Axalto group's operations, documents and employees.

The head of Internal Audit's hierarchical superior is Axalto's CFO and reports directly to the chairman of the Audit Committee.

At the time of writing, Internal Audit consisted of two people. The aim is to have three permanent internal auditors.

6.4.2.4 Self-assessment of internal control

The implementation of internal control within Axalto is based on annual self-assessment carried out by each subsidiary and management entity. The aim of self-assessment is to identify any weaknesses in the implementation of the Axalto group's policies and procedures, and to rectify them as quickly as possible.

The main self-assessment tool is the internal control questionnaire, which was drawn up and is regularly updated by Axalto's Internal Audit department. This Internal Control Questionnaire covers the key aspects of the control environment and the management of entities' operational and financial risks.

The results of this self-assessment are systematically reviewed by Axalto's Internal Audit and management, which also ensure that any required corrective action is carried out.

In 2004 and the first quarter of 2005, Axalto's main entities applied internal control self-assessment procedures under the supervision of Internal Audit.

6.4.2.5 Control of financial information

The production and control of financial information are organized so as to be consistent with Axalto's operational organization. To ensure the quality and exhaustiveness of the financial data produced and reported, the Axalto group has set up a system for co-ordinating and controlling results and activity.

**Budget and permanent forecast updating process**

The budget process covers all operational entities and central departments, including the Treasury. The main phases of the process are as follows:

- In November, each segment and functional department draws up a budget for the following year; these budgets are combined into an annual plan for the Axalto group and presented to the Board of Directors in December;
Whenever changes in activity justify it, current-quarter and current-year forecasts for the two segments are reviewed and updated.

**Monthly report**

The monthly report is a major component of Axalto’s system for producing and controlling financial information that is used internally and published. It is the main tool used by the Axalto group's senior executives for controlling and co-ordinating activity.

It is made up of several documents prepared by the managers of operational entities and central departments on the basis of statements and key financial indicators (revenue, standard margin and gross profit, operating expenses, net financial items, net cash position, inventory levels, accounts receivable etc.). As well as figures, it includes comparisons with forecasts and previous-year results, along with explanatory comments and updated forecasts if necessary.

Monthly and quarterly results are reviewed and discussed in meetings held in the first few days of the following month by Axalto's Chief Executive Officer, to which the Chief Financial Officer of the Axalto group participate. These meetings are attended by the heads of the Cards and POS Terminals segments and their operational auditors, the head of accounting and the head of Internal Audit, along with regional and product line managers.

This rigorous and systematic process involves the combined review and analysis of results, activity and forecasts at the end of every month and quarter, covering all main levels of the Axalto group's operational organization. It is fundamental to the quality and reliability of the financial information produced.

A specific report for the Board of Directors is prepared every month by the Chief Financial Officer. It covers the activity of the month, the updated income statement forecast for the current quarter and year for the two activity segments and the group, a review of the net cash and debt positions and of the evolution of the receivable collection performance and of the level of the inventory relative to the activity forecast.

**Business reviews**

The main aim of business reviews is to ensure that actions undertaken are appropriate to the Axalto group's ambitions. They form a key part of the activity co-ordination and monitoring system. These reviews are carried out every quarter by regional, segment and product line managers.

A review of the activity of the last months and of the expected evolution is presented by the CEO and the CFO at each meeting of the Board of Directors.

**Common group accounting standards and policies**

All Axalto entities draw up the financial statements used to produce consolidated group financial statements using the same accounting standards: US GAAP up to December 31, 2004 and IFRS since January 1, 2005. The content and form of these financial statements and the accounting policies used to produce them are subject to periodic review, as stated in section 6.4.2.1 - Internal Control Environment.

The standardized financial statements drawn up by all operational entities according to these procedures are processed using a single system for consolidating and analyzing data, specific to the Axalto group.

**6.4.3 Enhancing risk management**

**6.4.3.1 Prevention and management of risks relating to order acceptance and contract execution**

In order to address local differences in its activities while maintaining overall control over risks that may have an impact on results or compromise customer satisfaction, the Axalto group has adopted a system of permanently enhancing the way it handles tenders and commercial contracts.

In 2004, this process led to the following initiatives:

- "Standard" commercial and legal conditions were reviewed to adjust them to general changes in activity and to make them more consistent with specific regional situations.
• The roles and responsibilities of operational and functional departments as part of the risk identification and assessment process were aligned with the structure of Axalto's organization.

• Subsidiaries and local management entities were given greater responsibility in the tendering and contract approval process, within clearly defined authorization limits. Axalto's head management retains responsibility for "strategic" projects or projects that exceed a predefined monetary limit.

In addition, to accompany this effort to bring tendering and contract management into line with Axalto's operational organization and to ensure compliance with the Axalto group's rules, the Company uses contract management software that was initially piloted in the EMEA region. In 2005, Axalto plans to develop this software to cover tender management, and roll it out in the Asia and NSA regions.

6.4.3.2 Health, safety and environmental risk management

As part of its health, safety and environmental risk management policy, Axalto has set up a system for reporting accidents and monitoring risks identified in production units, known as "Omnisafe". The system will also allow Axalto to carry out statistical analyses of the causes of accidents. This will lead to greater understanding of risks and allow the resulting insurance programs to be optimized.

6.4.4 Statement by the CEO

Given the above information, the CEO believes that he has implemented a risk management and internal control system that is appropriate to the Company's activity and compliant with the requirements of best practice provision II.1.4 of the Dutch corporate governance code. However, the rapid changes in the operating environment and the constant appearance of new challenges and requirements will lead to additional requirements and new standards relating to risk management and internal control. As a result, permanent efforts must be made to enhance Axalto’s risk management and control system.

6.5 Report of the non-executive directors

Axalto’s first year as an independent company has been very busy and successful. In addition to the company’s introduction on the stock market in May and the creation of its corporate governance processes, Axalto achieved excellent results in terms of growth and profitability. These results testify to the company’s sharp focus on its business values and its ability to seize market opportunities quickly and effectively. The Board of Directors wishes to deeply thank all the stakeholders, and in particular the new shareholders that joined Axalto this year, for their trust in the company.

As a corporation established under Dutch law that is also publicly traded on the Euronext Paris stock exchange, Axalto must comply with a wide range of international governance requirements. Fortunately, thanks to our history, most of the processes were already in place prior to the initial public offering.

Together with the Dutch corporate governance code (known as the “Tabaksblat” code), Axalto has used international benchmarks to implement as many best practices as possible. These concern areas such as the independence of Board members, management remuneration, Board members’ understanding of the company, its business and its strategy, the processes implemented to avoid or manage risks, employees’ development, and others. These practices, the deviations, together with the Board and committees meetings and actions are described in more detail in the chapter 6 of this annual report.

Corporate governance is not a set of technocratic regulations at Axalto. Rather, Axalto corporate governance helps ensure that the company’s values infuse and inspire ongoing operations and activities. Axalto corporate governance is “walking the talk” in terms of what stakeholders expect from the company.

Axalto is built around five key values: customers, people, speed, technology and profit. It has the ability to recognize customer needs, and the strong desire to serve them best. Axalto combines this with a good understanding of the required technologies, with operations on a truly global scale, with an exceptional diversity of nationalities well integrated within the company, and excellent speed with which all these processes are linked together and executed. Altogether, these values and the clear dedication of the Axalto management towards them, provides the Board with a strong belief that Axalto will be successful in the future.

All of Axalto’s markets are growth markets. The mobile communications sector is likely to continue to expand as mobile telephony continues to develop in the high population countries, as demand grows for increasingly sophisticated and diverse applications and as third generation services spread. In the financial services sector, the migration from magnetic stripe to chip
cards (so-called EMV migration) is likely to continue to stimulate significant business in the years to come. Further, the increased demand for security, protecting personal identity and open systems networks, is creating a complete new range of opportunity. These same needs are driving public sector markets, such as those for electronic passports. With the right technology, combined with the ability to identify and seize opportunities very quickly, Axalto is uniquely positioned to benefit from these expanding markets.

As Axalto continues to focus on its five key values in 2005, the Board of Directors will concentrate on three areas in particular to support the company’s mid- and long-term development. We will continue our ongoing review of the company strategy, and will also focus on the continuous evaluation of the company’s management and internal control systems. The third area for our efforts will concern personnel development, to ensure that Axalto has the necessary people and programs to ensure a continuous supply of talent.

Good corporate governance is important to all stakeholders. The best way to fulfill our responsibility to defend all of their interests is by enhancing the strength of the company through growth and profitability. We are confident that this initial year success is only the first in a sustained series of achievements built upon excellence and market leadership.

On behalf of the non-executive directors
John de Wit
Chairman of the Board
CHAPTER VII   RECENT EVENTS AND OUTLOOK

• **Egypt**

Makxalto Advanced Card Technology Co., a joint-venture between the Company, on one hand, and Egyptian law-based companies EMAK Computer Manufacturing Co. and EMAK International Academy Co., on the other hand, has begun the registration process. The required notarized and conformed documents have been received by EMAK. The Company will hold a 34% interest of the Makxalto Advanced Card Technology Co. joint venture. The transaction is expected to close in the coming weeks.

• **Simbit**

On March 31, 2004, Axalto S.A. commenced its acquisition of the business of Simbit Corporation, a company governed by the laws of Canada, for US$2,072,820, US$1,422,820 of which was to be paid at the time of the acquisition, with the remaining US$650,000 to be held in escrow for one year for purposes of the guarantee. The purpose of this transaction is to acquire Simbit Corporation’s licensing and software portfolio and, in particular, its Simsave software, which allows for extended batteryless mobile telephone use and for the synchronisation of its SIM card.

• **South Africa**

The Company upon a Board of Directors resolution dated February 25, 2005 has initiated the process of setting up a subsidiary of the Company in the Republic of South Africa. The registration is in process and the scope of the subsidiary is sufficiently large to enable the Axalto group to extend its current and future activities in the area.

• **Montrouge Site**

Under the Separation Agreement, Schlumberger has agreed to keep the French subsidiary of the Axalto as a lessee on its Montrouge site until April 2006. Schlumberger has sold to a Buyer the Montrouge site on March 29th, 2005. As per the Separation Agreement, Axalto has entered into negotiation with the Buyer in order to obtain a fair lease to be maintained on the Montrouge site. Unfortunately, Axalto has not obtained from the Buyer the fair conditions to remain on the site, which will force Axalto to find a new location. Under the Separation Agreement, Schlumberger had agreed that in such a case-it will bear part of the relocations costs of Axalto. Axalto will ask Schlumberger to execute their commitment. Axalto will bear the balance of costs not covered by Schlumberger.
GLOSSARY

Applet
A small software program that runs on a microprocessor chip and interacts exclusively with external applications such as designated server-based applications. Applets differ from applications in that they cannot access certain resources on the local server or microprocessor card, such as files and serial devices, nor communicate or interact with any software other than their designated applications that run on the card issuer’s server.

Authentication
The process of ensuring the identity of the connecting user or participants exchanging electronic data. It is a fundamental part of many cryptography systems. It ensures that the person, card or server at either end of a connection is who it claims to be and not an impostor.

Biometrics
Security techniques using a person’s biological or physiological characteristics to identify or verify an individual (for example, retina scans, finger scans, voice verification or dynamic signature verification).

CEPS (Common Electronic Purse Specifications)
These specifications provide for interoperability of electronic purse schemes worldwide. They define requirements for all components needed by an organization to implement a globally interoperable electronic purse program.

Certification authority
A trusted third party that takes responsibility for issuing public/private keys, signing certificates and vouching for the binding of a particular key to a particular user.

Chip card
A card formed of a plastic body with a module embedded in a special cavity.

Contactless card
Chip card with an internal antenna that enables a transaction to be executed through electronic waves without having physical contact between the card and a reader.

Cryptography
The science of ensuring that messages are secure. Cryptographic systems are based on concepts of authentication, integrity and confidentiality.

Digital Certificate
A digital certificate is an electronic sequence that establishes the user’s credentials when doing business or other transactions on the Internet. It is issued by a certification authority and contains the user’s name, a serial number, expiration dates, a copy of the certificate holder’s public key and the digital signature of the certificate-issuing authority so that a recipient can verify that the certificate is real.

Digital Signature
An electronic signature created using a public-key algorithm. A digital signature can be used by the recipient to authenticate the identity of the sender and to ensure the integrity of the message.

Double Interface Card
A card which has both contact and contactless functions but which is considered as a contactless card.

e-business
Electronic commerce, or commerce on the Internet.
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<tr>
<th>Term</th>
<th>Description</th>
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<tr>
<td>e-purse (electronic purse)</td>
<td>A chip card that allows users to download cash in electronic form onto the card and debit an appropriate amount at each transaction.</td>
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<tr>
<td>EMV (Europay Mastercard Visa) Standard</td>
<td>Set of specifications adopted by Europay, MasterCard and Visa for an international debit/credit microprocessor card.</td>
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<tr>
<td>Encryption</td>
<td>A cryptographic procedure through which a legible message is encrypted and made illegible to all but the holder of the appropriate cryptographic key.</td>
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<tr>
<td>FIPS (Federal Information Processing Standards)</td>
<td>Standards and guidelines issued by the National Institute of Standards and Technology for computer systems used throughout the U.S. federal government.</td>
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<td>GAIT (GSM/ANSI Interoperability Team)</td>
<td>Panel of operators and equipment manufacturers that is developing GSM/TDMA interoperability.</td>
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<td>GSM Association’s Security Accreditation Scheme</td>
<td>A status conferred upon microprocessor card manufacturers for meeting stringent security standards in microprocessor card manufacturing.</td>
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<td>Interoperability</td>
<td>Depending on the context, (i) the ability of products manufactured by different companies to operate seamlessly with one another or (ii) the ability for a mobile phone subscriber to access and use the wireless network of another operator, including those using another mobile communications standard, such as GSM, CDMA, TDMA or 3G.</td>
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<tr>
<td>Intranet</td>
<td>A private IP network used exclusively by the employees or members of a company or organization to communicate, exchange information, share files and perform other internal transactions.</td>
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<td>Java</td>
<td>Computer language that makes it possible to develop a single software program that is capable of running on or operating in different technical platforms.</td>
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<td>Key</td>
<td>A value that is used with an algorithm to encrypt data.</td>
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<td>LAN (Local Area Network)</td>
<td>A geographically limited network (generally within a building or small group of buildings) that is managed and owned by a single company.</td>
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<tr>
<td>Magnetic stripe card</td>
<td>A plastic card with a magnetic stripe stuck on one side of the card and which can store data. The format of tracks on the stripe is defined by ISO standards. The stored data cannot be modified.</td>
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<tr>
<td>M-Commerce (Mobile Commerce)</td>
<td>Mobile Commerce or commerce on the Internet from a mobile device such as a mobile phone or smartphone.</td>
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as a mobile phone or a Personal Digital Assistant (“PDA”).

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tr>
<td><strong>Memory card</strong></td>
<td>Chip card that enables secure storage of data or monetary amounts that may be modified by a reading terminal.</td>
</tr>
<tr>
<td><strong>Microprocessor card</strong></td>
<td>Chip card equipped with a microprocessor chip that enables the transfer, processing and storage of data with a very high level of security.</td>
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<td><strong>MMS (Multimedia Message Services)</strong></td>
<td>A GSM service allowing messages, images and even small video clips to be sent and received.</td>
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<tr>
<td><strong>Module (also called micromodule)</strong></td>
<td>The unit formed by a chip and a printed circuit board, with fine connecting wires that is encapsulated in a drop of epoxy resin. The module is embedded in a cavity in the card body. It is the core hardware component of a microprocessor card.</td>
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<tr>
<td><strong>Multi-application card</strong></td>
<td>Microprocessor card capable of running more than one software program for different services or applications.</td>
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<td><strong>OTA (Over The Air)</strong></td>
<td>Transmission of data between a chip card and a remote server using microwave channels.</td>
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<tr>
<td><strong>PKI (Public Key Infrastructure)</strong></td>
<td>Enables users of an open network, such as the Internet, to securely and privately exchange data through the use of digital certificates and keys obtained from a trusted authority.</td>
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<td><strong>RSA</strong></td>
<td>A public-key cryptographic system for both encryption and authentication invented in 1977 by Ron Rivest, Adi Shamir, and Leonard Adleman. The RSA algorithm has become the de facto standard for industrial-strength encryption, especially for data sent over the internet. The RSA algorithm has become an encryption standard for many e-commerce security applications.</td>
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<tr>
<td><strong>S@T</strong></td>
<td>An Internet browser defined by SIM Alliance to access internet-based content through a mobile device.</td>
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<td><strong>SIM (Subscriber Identification Module) card</strong></td>
<td>Microprocessor card inserted in a GSM mobile phone or device that enables secure and unique authentication of a network subscriber and access to certain services and applications throughout interactive menus posted on the mobile phones server.</td>
</tr>
<tr>
<td><strong>SIM Toolkit (STK)</strong></td>
<td>Standard developed in 1996 by the ETSI that defines how the SIM card interacts with the mobile phone through a series of interactive menus. It enables wireless operators to install and provide a wide range of value-added services to network subscribers through the SIM card.</td>
</tr>
<tr>
<td><strong>SMS (Short Message Services)</strong></td>
<td>A GSM service that sends and receives messages of up to 160 characters to</td>
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USB (Universal Serial Bus)  
An external bus standard which can support up to 127 peripheral devices in a daisy chain configuration, can support plug-and-play, and has a total bandwidth of 1.5 megabits per second. An external bus is a collection of wires through which data is transmitted from a computer to its peripheral devices.

USIM (Universal Subscriber Identity Module)  
A microprocessor card that is inserted into 3G-compliant mobile phones or terminals to provide user authentication, transaction security, use of an Internet mini-navigator, as well as access to additional capabilities.

VPN (Virtual Private Networking)  
Private network established using public networks, such as the Internet. The integrity of the network and the confidentiality of information is maintained using encryption and authentication techniques.

WAP (Wireless Application Protocol)  
A communication protocol enabling mobile phones to access electronic messages and Internet content.

WIB  
A wireless Internet browser that is contained in a microprocessor card which was defined by SmarTrust to compete with S@T.

Wi-Fi (Wireless Fidelity)  
A high-frequency wireless local area network (“WLAN”) based on an 802.11b wireless standard.

WIG (Wireless Internet Gateway)  
A module contained in the platform which was developed by SmarTrust to enable WAP and SIM Toolkit-based mobile terminals to access WAP Wireless Markup Language Specification (“WML”)-based applications.

XML (Extensive Markup Language)  
A pared-down version of the Standard Generalized Markup Language, which is a system for personalizing the structure of data to be presented. XML is designed especially for Internet documents. It allows designers to create their own customized tags, enabling the definition, transmission, validation, and interpretation of data between applications and between organizations.