

# **Axalto**

## **Consolidated financial statements as of December 31, 2005**

## Consolidated balance sheets

*In thousands of US \$*

	Notes	Year ended December 31,	
		2004	2005
<b>ASSETS</b>			
<b>Non current assets</b>			
Property, plant and equipment	7	110,516	102,468
Goodwill	8	311,310	276,252
Intangible assets	8	26,557	21,732
Investments in associates	9	5,220	6,963
Deferred income tax assets	27	53,814	49,256
Available for sale financial assets	10	1,553	628
Other non-current assets		1,202	3,122
Total non-current assets		510,172	460,421
<b>Current assets</b>			
Inventories	11	122,492	93,331
Trade and other receivables	12	250,409	230,959
Derivative financial instruments	18	7,105	-
Cash and cash equivalents	13	223,820	259,284
Total current assets		603,826	583,574
<b>Total assets</b>		1,113,998	1,043,995
<b>EQUITY</b>			
<b>Capital and reserves attributable to the company's equity holders</b>			
Share capital		50,604	50,710
Share premium		551,526	562,746
Treasury shares		-	(4,275)
Fair value and other reserves		6,858	(4,110)
Cumulative translation adjustment		40,490	(16,932)
Retained earnings		52,742	110,620
		702,220	698,759
<b>Minority interest</b>		7,059	2,869
<b>Total equity</b>		709,279	701,628
<b>LIABILITIES</b>			
<b>Non-current liabilities</b>			
Borrowings	14	30,249	6,908
Deferred income tax liabilities	27	7,038	5,755
Retirement benefit obligation	15	17,369	16,225
Provisions and other liabilities	16	16,224	10,128
Total non-current liabilities		70,880	39,016
<b>Current liabilities</b>			
Trade and other payables	17	295,026	270,001
Current income tax liabilities		20,548	15,936
Borrowings	14	8,592	1,835
Derivative financial instruments	18	-	9,151
Provisions and other liabilities	19	9,673	6,428
Total current liabilities		333,839	303,351
<b>Total liabilities</b>		404,719	342,367
<b>Total equity and liabilities</b>		1,113,998	1,043,995

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

## Consolidated income statements

<i>In thousands of US\$</i>	Notes	Year ended December 31,	
		2004	2005
Revenue	20	960,427	992,332
Cost of sales		(644,635)	(671,537)
Gross profit		315,792	320,795
Operating expenses			
Research and engineering		(64,108)	(67,340)
Sales and marketing		(110,823)	(114,226)
General and administrative		(56,257)	(59,000)
Other income, net	24	4,035	(224)
Operating income		88,639	80,005
Finance income (expenses), net	25	(6,044)	1,360
Share of profit (loss) of associates		262	1,145
Profit before income tax		82,857	82,510
Income tax expense	27	(25,878)	(23,243)
Profit for the period		56,979	59,267
Attributable to			
Equity holders of the company		56,291	57,072
Minority interest		688	2,195
Basic earnings per share (in US dollars)	28	1.40	1.41
Diluted earnings per share (in US dollars)	28	1.38	1.38
In thousands			
Average number of shares outstanding	28	40,295	40,423
Average number of shares outstanding assuming dilution	28	40,697	41,365

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

**Consolidated statements of changes in shareholders' equity**

<i>In thousands of US\$</i>	Number of shares	Attributable to equity holders of the company							Minority interest	Total equity
		Share capital	Share premium	Treasury shares	Shareholders' invested equity	Fair value and other reserves	Cumulative translation adj.	Retained earnings		
Stockholders' equity as of January 1, 2004	18,000	23	1,610	-	412,020	129,193	-	(3,345)	9,876	549,377
Movements in fair value and other reserves										
- Currency translation adjustments							40,490	(204)		40,286
- Fair value gains (losses), net of tax:										
- financial assets available for sale						(1,476)				(1,476)
- cash flow hedges						5,998				5,998
Net income/(expense) recognized directly in equity						4,522	40,490	(204)	-	44,808
Profit for the period								56,291	688	56,979
Total recognized income for 2004						4,522	40,490	56,087	688	101,787
Employee share option scheme						2,336				2,336
Contribution from Schlumberger					51,191					51,191
Recapitalization and issuance of Share capital, net capital contribution by Schlumberger	40,027,000	50,034	542,370		(463,211)	(129,193)				-
Capital increase reserved to employees	445,668	547	7,546							8,093
Equity of the Phones business of the HSTE JV (*)									1,784	1,784
Dividend									(5,289)	(5,289)
Balance as of December 31, 2004	40,490,668	50,604	551,526	-	-	6,858	40,490	52,742	7,059	709,279
Movements in fair value & other reserves										
- Currency translation adjustments							(57,422)		61	(57,361)
- Gain/(losses) on treasury shares						(14)				(14)
- Fair value gains (losses), net of tax:										
- financial assets available for sale						(851)				(851)
- cash flow hedges						(13,647)				(13,647)
- machinery and equipment further to HSTE acquisition of minority interest								806	(202)	604
Net income/(expense) recognized directly in equity						(14,512)	(57,422)	806	(140)	(71,268)
Profit for the period								57,072	2,195	59,267
Total recognized income for 2005						(14,512)	(57,422)	57,878	2,054	(12,002)
Employee share option scheme						3,544				3,544
Contribution from Schlumberger further to dividend payment to HSTE JV minority interest			8,718							8,718
Purchase of Treasury shares, net (135,409 shares)				(4,275)						(4,275)
Capital increase reserved to employees	87,767	106	2,502							2,608
Equity of the Phones business of the HSTE JV (*)									(73)	(73)
Dividend									(6,171)	(6,171)
Balance as of December 31, 2005	40,578,435	50,710	562,746	(4,275)	-	(4,110)	(16,932)	110,620	2,869	701,628

(\*) On March 11, 2005, Axalto purchased the 49% minority interests in H.S.T.E., a company located in China of which Axalto had owned 51% until then. A portion of H.S.T.E.'s business includes Schlumberger's public phones equipment business in China, which is not in the scope of Axalto's operations. Pursuant to the Master Separation Agreement signed on March 19, 2004 between Schlumberger and Axalto, Schlumberger has agreed to assume all the risks and rewards of past and future operations of the public phone equipment business in H.S.T.E. 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.

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

## Consolidated statements of cash flows

*In thousands of US\$*

	Notes	Year ended December 31,	
		2004	2005
<b>Cash flows from operating activities</b>			
Cash generated from operations	29	182,671	135,099
Interest paid		(1,910)	(2,493)
Income tax paid		(10,383)	(26,453)
Net cash provided by operating activities		<u>170,378</u>	<u>106,153</u>
<b>Cash flows from (used in) investing activities</b>			
Purchase of property, plant and equipment	7	(36,783)	(31,744)
Proceeds from sale of property, plant and equipment		408	558
Purchase of intangible assets	8	(2,547)	(5,130)
Purchase of non-current assets		(173)	(38)
Purchase of investments in other companies		-	(3,717)
Interest received		2,202	6,451
Dividends received		159	229
Net cash used in investing activities		<u>(36,734)</u>	<u>(33,391)</u>
<b>Cash flows from (used in) financing activities</b>			
Invested equity		18,335	8,718
Proceeds from issuance of ordinary shares		6,879	2,219
Purchase of shares held in Treasury (net)		-	(4,275)
Gains/(losses) on stock options and treasury stocks transactions		-	(836)
Proceeds from borrowings		26,340	-
Repayments of borrowings		(15,380)	(30,058)
Dividends paid to minority interests		-	(10,128)
Net cash provided by (used in) financing activities		<u>36,174</u>	<u>(34,360)</u>
Net increase in cash and bank overdrafts		169,818	38,402
Cash and bank overdrafts, beginning of period		50,154	223,820
Exchange gains (losses) on cash and bank overdrafts		3,848	(2,938)
Cash and bank overdrafts, end of period	13	<u>223,820</u>	<u>259,284</u>

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

## **Notes to the consolidated financial statements as of December 31, 2005**

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

### **Note 1 General information**

Axalto Holding N.V. (« the Company ») and its subsidiaries (together « Axalto » or « the Group ») manufacture and sell Smart Cards ("Cards") and Point of Sale Terminals ("POS Terminals"). Cards includes microprocessor, magnetic stripe, memory and other cards and related services for mobile communication, financial, public sector and access applications including licensing of intellectual property rights, and prepaid phone cards. POS Terminals include point of sales terminals, systems and related services. The Group has manufacturing plants and sells around the world.

The company is a limited liability company incorporated and domiciled in the Netherlands. The address of its registered office is Koningsgracht Gebouw 1, Joop Geesinkweg 541-542, Amstel Business Park, Amsterdam, Netherlands.

The company was first listed on Euronext Paris on May 18, 2004.

These consolidated financial statements for the year ended December 31, 2005 have been authorized for issue by the Board of Directors of the Company on March 1st, 2006 and are subject to adoption at the annual general meeting of shareholders on May 19, 2006.

### **Note 2 Summary of significant accounting policies**

#### **2.1 Basis of preparation**

The consolidated financial statements of Axalto have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. They include comparative information restated in accordance with the same standards in respect of financial year 2004, except for IAS 32 and IAS 39, which have been applied as from January 1, 2005. In addition, Axalto elected for early application as of January 1, 2005 of the amendment to IAS 39 endorsed by the European Union in 2005. This amendment relates to the application of hedge accounting to future inter-company transactions.

As the Group's consolidated financial statements were prepared in accordance with the accounting principles generally accepted in the United States of America (US GAAP) until December 31, 2004, the Group applied the specific rules and principles related to first time adoption as defined in IFRS 1. Reconciliations and the description of the effect of the transition from US GAAP to IFRS on the Group's equity, net income and cash flows are provided in Note 3. As there is no difference for Axalto between previously applied US GAAP and IFRS regarding financial instruments (IAS 39), no reconciliation between previously applied US GAAP and IFRS is presented as of January 1, 2005.

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

### *Standards, interpretations and amendments to published standards that are not yet effective*

Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for the Group's accounting periods beginning on or after January 1, 2006 or later periods but which the Group has not early adopted. Management is currently assessing the potential impact of the following standards on the Group operations or disclosures:

- IAS 19 (Amendment), Employee Benefits (effective from January 1, 2006). This amendment introduces the option of an alternative recognition approach for actuarial gains and losses. It may impose additional recognition requirements for multi-employer plans where insufficient information is available to apply defined benefit accounting. It also adds new disclosure requirements.
- IAS 39 (Amendment), The Fair Value Option (effective from January 1, 2006). This amendment changes the definition of financial instruments classified at fair value through profit or loss and restricts the ability to designate financial instruments as part of this category.
- IFRS 7, Financial Instruments: Disclosures, and a complementary amendment to IAS 1, Presentation of Financial Statements – Capital Disclosures (effective from January 1, 2007). IFRS 7 introduces new disclosures to improve the information about financial instruments. It requires the disclosure of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk, including sensitivity analysis to market risk. The amendment to IAS 1 introduces disclosures about the level of an entity's capital and how it manages capital.
- IFRIC 4, Determining whether an Arrangement contains a Lease (effective from January 1, 2006). IFRIC 4 requires the determination of whether an arrangement is or contains a lease to be based on the substance of the arrangement. It requires an assessment of whether: (a) fulfillment of the arrangement is dependent on the use of a specific asset or assets (the asset); and (b) the arrangement conveys a right to use the asset.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (derivative instruments) at fair value through profit and loss.

The preparation of consolidated financial statements in conformity with IFRS requires the use of certain critical accounting estimates as explained in note 2.21. It also requires management to exercise its judgment in the process of applying Axalto's accounting policies.

## **2.2 Consolidation**

### **(a) Subsidiaries**

Subsidiaries are all entities (including special purpose entities) over which Axalto has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether Axalto controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to Axalto.

Inter-company transactions, balances and unrealized gains on transactions between group companies are eliminated. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset

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transferred. Subsidiary's accounting policies have been changed where necessary to ensure consistency with the policies adopted by Axalto.

#### (b) Associates

Associates are all entities over which Axalto has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognized at cost. Axalto's investment in associates includes goodwill (net of any accumulated impairment loss) identified on acquisition. Axalto's share of its associates' post-acquisition profits or losses is recognized in the income statement, and its share of post-acquisition movements in retained earnings is recognized in retained earnings. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When Axalto's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, Axalto does not recognize further losses, unless it has incurred obligations or made payments on behalf of the associate. Unrealized gains on transactions between Axalto and its associates are eliminated to the extent of Axalto's interest in the associates. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

#### (c) Transactions and minority interests

The Group applies a policy of treating transactions with minority interests as transactions with parties external to the Group. Disposals to minority interests result in gains and losses for the Group that are recorded in the income statement. Purchases from minority interests result in goodwill, being the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary.

## 2.3 Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns that are different from those of segments operating in other economic environments.

## 2.4 Foreign currency translation

#### (a) Functional and reporting currency

Items included in the financial statements of each of Axalto's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in US dollars, which is the Company's reporting currency.

#### (b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the income statement, except when deferred in equity as qualifying cash flow hedges. Translation differences on non-monetary items, such as equities classified as available-for-sale financial assets, are included in the fair value reserve in equity.

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

### (c) Group companies

The results and financial position of all the Group entities that have a functional currency different from the reporting currency are translated into the reporting currency as follows:

- (i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- (ii) income and expenses for each Income statement are translated at average exchange rates; and
- (iii) all resulting exchange differences are recognized as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is sold, such exchange differences are recognized in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

## 2.5 Property, plant and equipment

Property, plant and equipment is stated at historical cost, excluding interest expense, less depreciation and, if any, impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to Axalto and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives, as follows:

Buildings	20-30 years
Leasehold improvement	5-10 years
Machinery and equipment	3-10 years

Leasehold improvements are amortized on a straight-line basis over their estimated useful lives, which cannot exceed the lease term.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with the carrying amount and are reflected in operations.

Leases of property, plant and equipment where Axalto has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate of interest on the finance balance

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outstanding. The corresponding rental obligations, net of finance charges, are included in other long-term payables. The interest element of the finance cost is charged to the income statement over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The property, plant and equipment acquired under finance leases is depreciated over the shorter of the useful life of the asset or the lease term.

## 2.6 Goodwill and intangible assets

### (a) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary/associate at the date of acquisition. Goodwill on acquisition of subsidiaries is presented separately in the balance sheet. Goodwill on acquisitions of associates is included in 'investments in associates'. Separately recognized goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose.

Almost all of the net book value of goodwill relates to the acquisition in 2001 of the Card division of the Bull Group, named Bull CP8, and is denominated in euros. The remaining balance of the net book value of goodwill relates to older, smaller acquisitions belonging to the Cards business. As a consequence, the whole goodwill of Axalto is allocated to the Cards segment, considered as the relevant cash-generating unit for that purpose.

### (b) Other intangible assets

Other intangible assets are shown at historical cost. Other intangible assets have a definite useful life and are carried at cost less accumulated amortization. Amortization is calculated using the straight-line method to allocate the cost of other intangible assets over their estimated useful lives as follows:

Software	3-5 years
Patents and technologies	5-10 years
Other	1-15 years

## 2.7 Impairment of non-financial assets

Assets that have an indefinite useful life are not subject to amortization and are tested annually for impairment. Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets other than goodwill that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

## 2.8 Investments

Axalto classifies its investments in the following categories: financial assets held through profit or loss, loans and receivables, and available-for-sale financial assets. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition and re-evaluates this designation at every reporting date.

### (a) Financial assets at fair value through profit and loss

This category has two sub-categories: "financial assets held for trading" and those designated at fair value through profit or loss at inception. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term or if so designated by management. Derivatives are also categorized as "held for trading" unless they are designated as hedges. Assets in this category are classified as current assets.

### (b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when Axalto provides money, goods or services directly to a debtor with no intention of trading the receivable. They are included in current assets in trade and other receivables in the balance sheet, except for maturities greater than twelve months after the balance sheet date, which are classified as other non-current assets in the balance sheet. Loans and receivables are initially recognized at fair value and subsequently recorded at amortized cost using the effective interest method.

### (c) Available-for-sale financial assets

Available-for-sale financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories. They are included in non-current assets, as management does not intend to dispose of the investment within 12 months of the balance sheet date.

Investments representing less than 20% of the equity of the investee are classified as available for sale financial assets. Available-for-sale financial assets are carried at fair value. Unrealized gains and losses arising from changes in the fair value of available-for-sale financial assets are recognized in equity.

In the case of equity securities classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the securities are impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized in profit or loss – is removed from equity and recognized in the income statement. Impairment losses recognized in the Income statement on equity instruments are not reversed through the income statement.

## 2.9 Inventories

Inventories are stated at the lower of cost or net realizable value. Cost is determined using first in / first out method. The cost of finished goods and work in progress comprises design costs, raw materials, direct labor, other direct costs and related production overheads (based on normal operating capacity). It excludes borrowing costs. Net realizable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses. Axalto also provides inventory allowances for excess and obsolete inventories. Gains / losses on qualifying cash flow hedges relating to purchases of raw material are kept in equity until the related inventories affect the income statement. At that time, Axalto reclassifies these gains / losses to the income statement.

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

## **2.10 Trade receivables**

Trade receivables are recognized initially at fair value less provision for impairment. A provision for impairment of trade receivables is established when there is objective evidence that Axalto will not be able to collect all amounts due according to the original terms of the receivables. The amount of the provision is recognized in the income statement within general and administrative expenses.

## **2.11 Cash and cash equivalents**

Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts are shown within borrowings in current liabilities on the balance sheet.

## **2.12 Share capital**

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

Where any Axalto company purchases the Company's equity share capital (Treasury shares), the consideration paid, including any directly attributable incremental costs (net of income taxes,) is deducted from equity attributable to the Company's equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects, is included in equity attributable to the Company's equity holders.

## **2.13 Borrowings**

Borrowings are recognized initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortized cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognized in the income statement over the period of the borrowings using the effective interest method. Borrowings are classified as current liabilities unless Axalto has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

## **2.14 Taxes on income**

The provision for income taxes presented in these consolidated financial statements 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 sheets for the periods presented.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. The deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business

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combination, that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted at the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the Group controls the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

## **2.15 Research tax credit**

Research tax credits are provided by various governments to give incentives for companies to perform technical and scientific research. Companies that have qualifying expenses can receive such grants in the form of a tax credit irrespective of taxes ever paid or ever to be paid. Therefore these research tax credits are presented as a reduction of research and development expenses in the income statement and included in "Other non-current assets" in the balance sheet. The Company records the benefit of this grant only when all qualifying research has been performed and the Company has obtained sufficient evidence from the relevant government authority that the credit will be granted.

## **2.16 Research and development cost**

Research and development costs mainly comprise software development. Axalto capitalizes eligible software development costs upon achievement of commercial and technological feasibility, reliability of measurement costs and 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 development 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 on a straight-line basis, 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.

## **2.17 Employee benefits**

(a) Pension and similar obligations

### ***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, no liability in the balance sheet was recognized as of December 31, 2004 and 2005.

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

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pension plans. Upon the separation from Schlumberger, Schlumberger retained the obligations and liabilities associated with US defined benefits plans.

### ***Non US employee benefit plan***

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, in 2004, the employees of Axalto remained under the defined benefit or defined contribution plans managed by Schlumberger at UK level. Schlumberger retained the obligations and liabilities related to the UK defined benefits plans at the date when employees of Axalto in the UK joined the Axalto UK defined contribution plan.

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 in note 15.

### **(b) Share-based compensation**

Axalto operates an equity-settled, share-based compensation plan. The fair value of the employee services received in exchange for the grant of the options is recognized as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non-market vesting conditions (for example, profitability and sales growth targets). Non-market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. It recognizes the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to equity over the remaining vesting period.

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

### **(c) Termination benefits**

Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. Axalto recognizes termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal, or providing termination benefits as a result of an offer made to encourage voluntary redundancy. Benefits falling due more than 12 months after balance sheet date are discounted to present value.

### **(d) Profit-sharing and bonus plans**

Axalto recognizes liabilities and expenses for bonuses and profit sharing. The Group recognizes a provision where contractually obliged or where there is a past practice that has created a constructive obligation.

## 2.18 Provisions

Provisions for environmental restoration, restructuring costs, legal claims and warranty are recognized when the Group has a present legal or constructive obligation as a result of past events and it is more likely than not that an outflow of resources will be required to settle the obligation and the amount has been reliably estimated. Provisions are not recognized for future operating losses.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

## 2.19 Revenue recognition

Revenue comprises the fair value for the sale of goods and services, net of value-added tax, rebates and discounts and after eliminating sales within Axalto. Revenue is recognized as follows:

### (a) 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 but for customary warranty terms. 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 the development of specific software platforms. 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.

### (b) 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.

### (c) Collectibility

As part of the revenue recognition process, Axalto determines whether trade receivables and notes receivable 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.

### (d) Deferred and unbilled revenue

Deferred revenue includes amounts that have been billed per contractual terms but have not been recognized as income.

## 2.20 Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

## 2.21 Use of estimates

The preparation of the consolidated 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 consolidated 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, warranty obligations, recoverability of goodwill, intangible assets and property, plant and equipment, 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.

## Note 3 First time adoption of IFRS

### 3.1 Basis of transition to IFRS

#### 3.1.1 Application of IFRS 1

The Axalto Group has prepared its consolidated financial statements for the years ended December 31, 2001, 2002, 2003 and 2004 in accordance with the accounting principles generally accepted in the United States (US GAAP).

As indicated in Note 2 above, the Group's consolidated financial statements for the year ended December 31, 2005 are the first annual financial statements established in accordance with IFRS.

Axalto's date of transition to IFRS is January 1, 2004. The Group prepared its opening IFRS balance sheet as of that date.

The Group's IFRS adoption date is January 1, 2005.

The reporting date of the first interim condensed consolidated financial statements was June 30, 2005. Consequently, the interim condensed consolidated financial statements for the period ended June 30, 2005, were prepared in accordance with IFRS. The Group applied IFRS 1 (First-time adoption of International Financial Reporting Standards) for the preparation of the interim condensed consolidated financial statements and of these full-year consolidated financial statements.

In accordance with IFRS 1, the Group has applied certain of the optional exemptions from full retrospective application of IFRS.

### 3.1.2 Exemptions from full retrospective application elected by the Group

Axalto has elected to apply the following optional exemptions from full retrospective application.

#### (a) Business combination

Axalto has applied the business combination exemption in IFRS 1. It has not restated business combinations that took place prior to the January 1, 2004 transition date.

#### (b) Fair value as deemed cost

Axalto has elected to generally maintain property, plant and equipment at their historical net book value as of January 1, 2004.

#### (c) Employee benefits

Axalto has elected to recognize against equity all cumulative actuarial gains and losses as of January 1, 2004.

#### (d) Restatement of comparatives for IAS 32 and IAS 39.

The Group has elected to apply this exemption. It applied previous US GAAP rules to derivatives, financial assets and financial liabilities and to hedging relationships for the 2004 comparative information.

As there is no difference for Axalto between previously applied US GAAP and IFRS (IAS 39) regarding financial instruments, no reconciliation between previously applied US GAAP and IFRS is presented as of January 1, 2005.

#### (e) Share-based payment transaction

The Group has elected to apply the share-based payment exemption: it has therefore applied IFRS 2 from January 1, 2004 to stock option and employee stock purchase plans (SOP and ESPP, respectively) that were issued after November 7, 2002.

### 3.2 Reconciliations between US GAAP and IFRS

#### 3.2.1 Summary of equity

	<u>January 1, 2004</u>	<u>December 31, 2004</u>	<u>Note in 3.2.6 below</u>
<u>Total Stockholders' equity – US GAAP</u>	542,846	705,027	
Restatement of "Land and Building" to take into account the component approach and residual value	636	1,617	(a)
Recognition of actuarial gains and losses on post-employment benefits	(3,625)	(3,600)	(b)
Impact on deferred taxes of transition to IAS 12	(131)	(254)	(c) & (d2)
Deferred tax on IFRS adjustments	(225)	(570)	(d1)
	<hr/>	<hr/>	
<i>Capital and reserves attributable to the company's equity holders – IFRS</i>	539,501	702,220	
Minority interest	9,876	7,059	
	<hr/>	<hr/>	
<u>Total Equity - IFRS</u>	<u>549,377</u>	<u>709,279</u>	

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

### 3.2.2 Reconciliation of balance sheet as of January 1, 2004

	Note in 3.2.6 below	US GAAP	Effect of transition to IFRS	IFRS
<b>ASSETS</b>				
<b>Non current assets</b>				
Property, plant and equipment	(a)	105,410	636	106,046
Goodwill		287,621		287,621
Intangible assets	(b)	33,197	(977)	32,220
Investments in associates		4,910		4,910
Deferred income tax assets	(c)	21,350	(93)	21,257
Available for sale financial assets		1,886		1,886
Other non-current assets (*)		1,029		1,029
Total non-current assets		455,403	(434)	454,969
<b>Current assets</b>				
Inventories		103,827		103,827
Trade and other receivables (*)		234,542		234,542
Derivative financial instruments		2,456		2,456
Cash and cash equivalents		50,154		50,154
Total current assets		390,979		390,979
<b>Total assets</b>		<b>846,382</b>	<b>(434)</b>	<b>845,948</b>
<b>EQUITY</b>				
<b>Capital and reserves attributable to the company's equity holders</b>				
Share capital				
Share premium				
Treasury shares				
Fair value and other reserves				
Cumulative translation adjustment				
Retained earnings				
		541,213	(3,345)	537,868
<b>Minority interest</b>		9,876		9,876
<b>Total equity</b>		<b>551,089</b>	<b>(3,345)</b>	<b>547,744</b>
<b>LIABILITIES</b>				
<b>Non-current liabilities</b>				
Borrowings		2,287		2,287
Deferred income tax liabilities	(d)	5,047	263	5,310
Retirement benefit obligation	(b)	11,175	2,648	13,823
Provision and other liabilities		22,807		22,807
Total non-current liabilities		41,316	2,911	44,227
<b>Current liabilities</b>				
Trade and other payables		218,690		218,690
Current income tax liabilities		11,036		11,036
Borrowings		21,615		21,615
Provisions and other liabilities		2,636		2,636
Total current liabilities		253,977		253,977
<b>Total liabilities</b>		<b>295,293</b>	<b>2,911</b>	<b>298,204</b>
<b>Total equity and liabilities</b>		<b>846,382</b>	<b>(434)</b>	<b>845,948</b>

(\*) Compared with the IFRS consolidated balance sheet as of January 1, 2004 published in the interim consolidated financial statements as of June 30, 2005, \$1,029 Long-term deposits were reclassified from "Trade and other receivables" to "Other non-current assets".

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

### 3.2.3 Reconciliation of balance sheet as of December 31, 2004

	Note in 3.2.6 below	US GAAP	Effect of transition to IFRS	IFRS
<b>ASSETS</b>				
<b>Non current assets</b>				
Property, plant and equipment	(a)	108,899	1,617	110,516
Goodwill		311,310		311,310
Intangible assets	(b)	27,801	(1,244)	26,557
Investments in associates		5,220		5,220
Deferred income tax assets	(c)	54,027	(213)	53,814
Available for sale financial assets		1,553		1,553
Other non-current assets (*)		1,202		1,202
Total non-current assets		510,012	160	510,172
<b>Current assets</b>				
Inventories		122,492		122,492
Trade and other receivables (*)		250,409		250,409
Derivative financial instruments		7,105		7,105
Cash and cash equivalents		223,820		223,820
Total current assets		603,826		603,826
<b>Total assets</b>		<b>1,113,838</b>	<b>160</b>	<b>1,113,998</b>
<b>EQUITY</b>				
<b>Capital and reserves attributable to the company's equity holder</b>				
Share capital		50,604		50,604
Share premium	(f)	550,312	1,214	551,526
Treasury shares		-		-
Fair value and other reserves	(e)	4,522	2,336	6,858
Cumulative translation adjustment		40,490		40,490
Retained earnings		59,099	(6,357)	52,742
		705,027	(2,807)	702,220
<b>Minority interest</b>		<b>7,059</b>		<b>7,059</b>
<b>Total equity</b>		<b>712,086</b>	<b>(2,807)</b>	<b>709,279</b>
<b>LIABILITIES</b>				
<b>Non-current liabilities</b>				
Borrowings		30,249		30,249
Deferred income tax liabilities	(d)	6,427	611	7,038
Retirement benefit obligation	(b)	15,013	2,356	17,369
Provision and other liabilities		16,224		16,224
Total non-current liabilities		67,913	2,967	70,880
<b>Current liabilities</b>				
Trade and other payables		295,026		295,026
Current income tax liabilities		20,548		20,548
Borrowings		8,592		8,592
Provisions and other liabilities		9,673		9,673
Total current liabilities		333,839		333,839
<b>Total liabilities</b>		<b>401,752</b>	<b>2,967</b>	<b>404,719</b>
<b>Total equity and liabilities</b>		<b>1,113,838</b>	<b>160</b>	<b>1,113,998</b>

(\*) Compared with the IFRS consolidated balance sheet for the year ended December 31, 2004 published in the interim consolidated financial statements as of June 30, 2005, \$1,202 Long-term deposits were reclassified from "Trade and other receivables" to "Other non-current assets".

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

### 3.2.4 Reconciliation of net income for the year ended December 31, 2004

	Note in 3.2.6 below	US GAAP	Effect of transition to IFRS	IFRS
Revenue		960,427		960,427
Cost of sales	(a),(b),(e),(f)	(645,027)	392	(644,635)
Gross profit		315,400	392	315,792
Operating expenses				
Research and engineering	(b),(e),(f)	(63,962)	(146)	(64,108)
Sales and marketing	(b),(e),(f)	(109,842)	(981)	(110,823)
General and administrative	(b),(e),(f)	(55,216)	(1,041)	(56,257)
Other income (loss), net	(g)		4,035	4,035
Operating income		86,380	2,259	88,639
Finance costs, net	(b)	(5,424)	(620)	(6,044)
Share of profit of associates	(g)	262		262
Other income (loss), net	(g)	4,035	(4,035)	
Income (loss) before taxes		85,253	(2,396)	82,857
Tax benefit (expense)	(c), (d)	(25,466)	(412)	(25,878)
Income for the period		59,787	(2,808)	56,979
Attributable to				
Equity holders of the company		59,099	(2,808)	56,291
Minority interest		688		688

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

### 3.2.5 Reconciliation of cash flow for the year ended December 31, 2004

	Note in 3.2.6 below	US GAAP	Effect of transition to IFRS	IFRS
<b>Cash flows from operating activities</b>				
Cash generated from operations (see 3.2.7 below) (*)		182,498	173	182,671
Interest paid		(1,910)		(1,910)
Interest received		2,202	(2,202)	
Income tax paid		(10,383)		(10,383)
Net cash (used in) provided by operating activities		<u>172,407</u>	<u>(2,029)</u>	<u>170,378</u>
<b>Cash flows from (used in) investing activities</b>				
Purchase of property, plant and equipment		(36,783)		(36,783)
Proceeds from sale of property, plant and equipment		408		408
Purchase of intangible assets		(2,547)		(2,547)
Purchase of non-current assets (*)			(173)	(173)
Interest received			2,202	2,202
Dividends received		159		159
Net cash (used in) provided by investing activities		<u>(38,763)</u>	<u>2,029</u>	<u>(36,734)</u>
<b>Cash flows from (used in) financing activities</b>				
Invested equity	(e), (f)	18,335		18,335
Proceeds from issuance of ordinary shares		6,879		6,879
Proceeds from borrowings		26,340		26,340
Repayments of borrowings		(15,380)		(15,380)
Net cash provided by (used in) financing activities		<u>36,174</u>		<u>36,174</u>
Net increase (decrease) in cash and bank overdrafts		169,818		169,818
Cash and bank overdrafts, beginning of period		50,154		50,154
Exchange gains (losses) on cash and bank overdrafts		3,848		3,848
Cash and bank overdrafts, end of period		<u>223,820</u>		<u>223,820</u>

Reclassifications have been made to the 2004 US GAAP cash flow presentation. In particular, \$5,997 related to "Derivative financial instruments" were shown as a decrease to the cash generated from operating activities in the initial presentation and the counterpart in "Fair value and other reserves" as an increase in cash from financing activities. Both effects have been neutralized in the current presentation.

(\*) Compared with the IFRS consolidated statement of cash flow for the year ended December 31, 2004 published in the interim consolidated financial statements as of June 30, 2005:

- \$3,550 representing the non-cash stock compensation charge recorded in 2004 were reclassified from "Invested equity" to "Cash generated from operations"
- \$173 representing the variation of long term deposits in 2004 were reclassified from "Cash generated from operations" to "Purchase of non-current assets".

### 3.2.6 Description of the effects of the transition to IFRS

The following notes describe the adjustments to the 2004 opening and closing consolidated balance sheets, the 2004 consolidated Income statement and consolidated statement of cash flow, originally established in accordance with US GAAP, necessary to give effect to the adoption of IFRS.

The sign convention in the tables below is (+) for debit adjustments and (-) for credit adjustments to the opening and closing balance sheets items and consequently (+) for credit adjustments and (-) for debit adjustments to the Income statement.

*(a) Property, plant and equipment (IAS 16)*

	Impact on the Jan. 1, 2004 Balance Sheet	Impact on the 2004 Income statement	Impact on the Dec. 31, 2004 Balance Sheet
Application of a component approach to buildings	(1,431)	13	(1,418)
Consideration of a residual value to determine the depreciable value of buildings	2,067	194	2,261
Partial reversal of the write-down of one of our industrial sites recognized in 2004 (see Note 7 to the consolidated financial statements in the 2004 "Document de Référence")		623	623
Translation adjustment			151
<b>Total</b>	<b><u>636</u></b>	<b><u>830</u></b>	<b><u>1,617</u></b>

The value of each component has been determined on the basis of information provided by a real estate expert, and corresponding to industry averages for the type of buildings under review.

The residual values are the values of the buildings at the end of their useful life, and were determined by an independent real estate expert.

In the Group's 2004 US GAAP consolidated Income statement, the depreciation charge included 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. As a result of the application of a component approach and the consideration of a residual value under IFRS, the net book value of this asset in the 2004 consolidated opening balance sheet under IFRS was decreased. A portion of the write-down expense booked in 2004 was therefore reversed so that the net book value of this asset as of December 31, 2004 under IFRS is equal to the realizable value reported under previously applied US GAAP.

*(b) Retirement benefit obligation (IAS 19)*

	Impact on the Jan. 1, 2004 Balance Sheet	Impact on the 2004 Income statement	Other Impact on the Dec. 31, 2004 Balance Sheet	Impact on the Dec. 31, 2004 Balance Sheet
<b><u>Intangible assets</u></b>				
Write-off of an intangible asset recognized in relation with the recognition of a minimum retirement benefit liability under US GAAP	(977)		(175)	(1,152)
Translation adjustment				(92)
<b>Total</b>	<b><u>(977)</u></b>		<b><u>(175)</u></b>	<b><u>(1,244)</u></b>
<b><u>Retirement benefit obligation</u></b>				
Recognition of actuarial gains and losses at the date of transition	(2,648)	325	175	(2,148)
Translation adjustment				(208)
<b>Total</b>	<b><u>(2,648)</u></b>	<b><u>325</u></b>	<b><u>175</u></b>	<b><u>(2,356)</u></b>
<b><u>Grand total</u></b>	<b><u>(3,625)</u></b>			<b><u>(3,600)</u></b>

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

Axalto has elected to apply the employee benefit exemption to the liabilities representing the lump sum payments made to French employees upon retirement, as described in Note 15 below. These lump sum payments are regarded as defined-benefits under IAS 19. Therefore, as authorized by IFRS1, the Group has decided to recognize in equity all cumulative actuarial gains and losses at the date of transition to IFRS and applied the corridor method to subsequent actuarial gains and losses. All actuarial gains and losses not previously recognized pursuant to the corridor method in the Income statement in US GAAP consolidated financial statements have been recognized in equity at the date of transition. Therefore, in the 2004 IFRS Income statement, the actuarial gains and losses previously recognized in the US GAAP Income statement had to be reversed: \$117 in cost of sales, \$78 in research and engineering expenses, \$104 in sales and marketing expenses and \$26 in general and administrative expenses.

Also, the interest cost component of the pension expense was reclassified from an element of operating income to a finance cost in the 2004 IFRS Income statement, for the sake of better comparability going forward.

*(c) Deferred income tax asset (IAS 12)*

	Jan. 1, 2004	2004 P&L	Dec. 31, 2004
Impact of change of method in recognizing deferred tax on elimination of profit in intra-group inventory	(93)	(120)	(213)
Total	<u>(93)</u>	<u>(120)</u>	<u>(213)</u>

Under previously applied US GAAP, deferred income tax on the elimination of intra-group profit on inventory sales was recognized at seller's rate while IAS 12 requires that deferred income tax must be computed at buyer's rate.

*(d) Deferred income tax liabilities (IAS 12)*

		Jan 1, 2004	2004 P&L	Dec 31, 2004
(d1)	Deferred tax on IFRS adjustments	(225)	(292)	(517)
(d2)	Deferred tax in connection with the treatment of undistributed profits in certain subsidiaries	(38)		(38)
	Translation adjustment			(56)
	Total	<u>(263)</u>	<u>(292)</u>	<u>(611)</u>

(d1) A deferred tax charge was computed on the IFRS adjustment related to plant, property and equipment (see (a) above).

(d2) In the subsidiaries where Axalto does not control the dividend distribution process, which has been considered to be the case in all entities where Axalto is not a majority shareholder, a deferred tax liability corresponding to the income tax charge to be recognized upon distribution of this profit is recognized under IAS 12 on all undistributed profit, unlike under previously applied US GAAP.

*(e) Recognition of a compensation charge on stock based payments (IFRS 2)*

A compensation charge was recognized in the 2004 IFRS Income statement in relation to the stock options granted to Axalto employees on May 18, 2004. The compensation charge was computed as being the fair value of the option at the time of the grant under the Black and Scholes model, amortized over the expected lifetime of the options. The compensation charge has been recorded on the appropriate line of the Income statement, depending on the position held by the employees who received options. In the 2004 IFRS Income statement, a compensation expense of \$2,336, corresponding to the amortization of the fair value of the option for the period between the grant date and the end of the year, was recorded for \$ 361 in cost of sales, \$142 in research and engineering expenses, \$888 in sales and marketing expenses and \$945 in general and administrative expenses.

Had Axalto not elected to apply the share-based payment exemption (see 1.2. e. above), an additional expense of \$1.3 million would have been recorded in the Income statement of the periods ended June 30, 2004 and December 31, 2004.

*(f) Recognition of a compensation charge on employee stock purchase plans (IFRS 2)*

In the period from May 4, 2004 to May 14, 2004, Axalto employees were offered the opportunity to buy Axalto shares at a price 15% below the future initial listing price of the company. 445,668 ordinary shares of Axalto were subscribed by employees at 12.58 Euros per share. The \$1,214 discount thus granted to employees under that program was recorded in US GAAP as a debit to equity in the share premium account.

Under IFRS 2, this discount must be recognized as a compensation expense on the appropriate line of the Income statement, depending on the position held by the employees who elected to participate in the plan. Accordingly, \$417 were recorded in cost of sales, \$231 in research and engineering expenses, \$395 in sales and marketing expenses and \$171 in general and administrative expenses.

*(g) Reclassification of the "Other income, net" line of the Income statement*

Under IFRS, the share of profit in associates was reclassified from the "Other income, net" line of the Income statement, where it is recorded under US GAAP, to a dedicated line named "share of profit in associates".

All other items reported under the US GAAP "Other income, net" line of the Income statement are now reported on a line with the same name, part of the operating income under IFRS.

### 3.2.7 Cash generated from operations

		US GAAP	Effect of transition to IFRS	IFRS
Income for the period before minority interest		59,787	(2,808)	56,979
Adjustments for:				
- tax		25,466	412	25,878
- depreciation		35,311	(830)	34,481
- amortization		9,604		9,604
- stock option compensation charge	(*)	-	2,336	2,336
- ESPP discount	(*)	-	1,214	1,214
- gains and losses on sale of fixed assets and write offs		3,988		3,988
- net movement in provisions for liabilities and charges		(1,921)		(1,921)
- interest income		(2,202)		(2,202)
- interest expense		1,910	620	2,530
- share of loss (profit) from associates		(262)		(262)
- inventories		(10,750)		(10,750)
- trade and other receivables	(*)	3,831	173	4,004
- retirement benefit obligations		1,735		1,735
- derivative financial instruments		1,348		1,348
- trade and other payables		54,653	(944)	53,709
Cash generated from operations	3.2.5	182,498	173	182,671

(\*) Compared with the IFRS consolidated statement of cash flow for the year ended December 31, 2004 published in the interim consolidated financial statements as of June 30, 2005:

- \$3,550 representing the non-cash stock compensation charge recorded in 2004 were reclassified from "Invested equity" to "Cash generated from operations"

- \$173 representing the variation of long term deposits in 2004 were reclassified from "Cash generated from operations" to "Purchase of non-current assets".

#### **Note 4 Consolidated entities**

The consolidated financial statements as of December 31, 2005 include the accounts of Axalto Holding NV and the following entities:

Country of incorporation	Company name	Direct or indirect ownership	Percentage of Group voting rights
Australia	Axalto Pty Ltd	Direct	100%
Brazil	Axalto do Brazil Cartoes e Terminais Ltda	Direct	100%
British Virgin Islands	Axalto Cards & Terminals Ltd	Indirect	100%
British Virgin Islands	Axalto Technology Ltd	Indirect	100%
Canada	Axalto Canada Ltd	Direct	100%
China	Axalto (Beijing) Smart Cards Technology Co Ltd	Indirect	100%
China	Hunan Telecommunications Equipment Co Ltd	Indirect	100%
China	Shanghai Axalto IC Cards Technology Co Ltd	Indirect	51%
China	Shanghai Solaic Smart Card Co Ltd	Indirect	31%
Czech Republic	Axalto SRO	Direct	100%
Egypt	Makxalto Advanced Card Technology	Direct	34%
France	CP8 Technologies S.A.	Indirect	100%
France	Electronics Transactions Integration Services S.A.	Indirect	100%
France	Axalto S.A.	Direct	100%
France	Axalto International S.A.S.	Direct	100%
France	Axalto Participations S.A.S.	Indirect	100%
France	Trusted Logic S.A.	Indirect	37%
France	Xiring S.A.	Indirect	23%
Germany	Axalto GmbH	Direct	100%
Hong Kong	CP8 Hong Kong Ltd	Indirect	100%
Hong Kong	Axalto Technologies Asia Ltd	Direct	100%
Hungary	Axalto Hungary Commercial and Services Ltd	Direct	100%
India	Axalto Cards & Terminals India Ltd	Direct	100%
India	Axalto Terminals India Private 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	CP8 Mexico SA de CV	Indirect	100%
Mexico	Distribucion S.A. de CV	Direct	100%
Mexico	Axalto Cards Mexico S.A. de CV	Indirect	100%
Netherlands	Axalto BV	Direct	100%
Netherlands Antilles	Cards & Terminals N.V.	Direct	100%
Panama	Axalto Eastern Holdings Inc	Indirect	100%
Philippines	Axalto Philippines Inc	Indirect	100%
Singapore	Axalto Singapore Pte Ltd	Direct	100%
South Africa	Axalto RSA Pty 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	Indirect	100%
United Kingdom	Axalto Terminals Ltd	Indirect	100%
United Kingdom	Axalto UK Ltd	Direct	100%

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

United Kingdom	Axalto Cards Ltd	Indirect	100%
United States	Axalto CP8 Inc	Indirect	100%
United States	Axalto Inc	Direct	100%

For all companies listed above, the percentage of ownership is the same as the percentage of voting right except for Booleanakam Holdings (Thailand) Ltd that is held at 49%.

## **Note 5 Financial risk management**

### **5.1 Financial risk factors**

(a) Foreign exchange risk

#### ***Cash flow hedges***

Axalto publishes its audited consolidated 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 is generated in currencies other than U.S. dollars. As a result, revenue and gross profit vary in accordance with exchange rate fluctuations, principally between the U.S. dollar and the euro.

In order to mitigate the effect of exchange rate fluctuations from one period to another, Axalto hedges the effect of foreign currency fluctuations on a portion of the forecast earnings and cash flows 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 consolidated income statement.

Forward and option contracts are recorded in the balance sheet at their fair market value as "Derivative financial instruments". Unrealized gains and losses on hedging contracts are recorded in the Shareholders' Equity under "Fair value and other reserves". Realized gains and losses from hedging instruments are recognized in the consolidated income statement consistently with the underlying transactions being hedged (see note 18).

#### ***Fair value hedges***

Also, Axalto enters 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 of each of Axalto entities (see note 18).

(b) Counterparty and credit risk

Axalto's risk management contracts are only entered into with a limited group of approved first rate/high quality banks in order to minimize the risk of failure. Moreover Axalto limits its exposure to each counterparty. Axalto's trade receivables and investments do not represent a significant concentration of credit risk as of December 31, 2005 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.

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

(c) Liquidity risk

Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions. Due to the dynamic nature of the underlying businesses, Group Treasury aims to maintain flexibility in funding by keeping committed credit lines available including a syndicated loan.

(d) Interest rate risk

The credit facilities arranged in favor of Axalto are at fluctuating rates based on the LIBOR and the EURIBOR. The Company is thus exposed to the fluctuations of those reference rates. The Company however considers that the interest rates risk may not have a significant impact on its financial situation in the short term since the Company's credit facilities have a short and medium term maturity and the amounts borrowed as of December 31, 2005 were small relative to the Company's net equity. Cash and cash equivalents, which are invested with original maturity of three months or less, are subject to the evolution of the interest rates.

## 5.2 Accounting for cash flow hedge

The effective portions of changes in the fair value of foreign exchange forward and option contracts that are designated and qualify as cash flow hedges are recognized in equity. The gains or losses relating to the ineffective portion are recognized immediately in the income statement.

Realized gains and losses on hedging contracts are recognized in the income statement consistently with the underlying transactions being hedged.

When a hedging instrument expires or is sold, or when a hedge no longer qualifies for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognized when the forecast transaction is ultimately recognized in the income statement. When a forecast transaction is no longer expected to occur the cumulative gain or loss on the related hedging instrument that was reported in equity is immediately recognized in the income statement.

Foreign exchange forward and option contracts are recorded in the balance sheet as current assets or liabilities at their fair value determined on the basis of quoted market prices (see note 18).

## **Note 6 Segment information**

### *Primary reporting format – Business segment*

Axalto's operations are organized into two business segments: Cards and Point of Sales Terminals (POS Terminals). The Cards segment is organized into four product lines: Mobile Communication, Financial Cards, Public Sector, Access and Other and Prepaid Phone Cards. The two segments are 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 following tables present Axalto's revenue, gross profit, operating expenses and finance costs by segment:

	Year ended December 31,					
	2004			2005		
	Cards	POS Terminals	Axalto	Cards	POS Terminals	Axalto
Revenue	883,082	77,345	960,427	916,979	75,353	992,332
Gross profit	297,689	18,103	315,792	301,347	19,448	320,795
Operating expenses excl. Other Income, net	(214,790)	(16,398)	(231,188)	(223,806)	(16,760)	(240,566)
Other Income, net	4,037	(2)	4,035	(1,189)	965	(224)
Operating income	86,936	1,703	88,639	76,352	3,653	80,005
Finance costs	(4,761)	(1,283)	(6,044)	2,182	(822)	1,360
Share of profit/(loss) of associates	262	-	262	1,145	-	1,145
Profit before income tax	82,437	420	82,857	79,679	2,831	82,510
Income tax expense			(25,878)			(23,243)
Profit for the period			56,979			59,267

As complementary information, Axalto provides revenue and gross profit for the year ended December 31, 2004 and December 31, 2005 for the Card segment product lines:

	Year ended December 31,									
	2004					2005				
	Mobile Communication	Financial Cards	Public Sector, Access and Other	Prepaid Phone cards	Cards Total	Mobile Communication	Financial Cards	Public Sector, Access and Other	Prepaid Phone cards	Cards Total
Revenue	548,799	196,195	98,425	39,663	883,082	597,963	200,198	79,750	39,068	916,979
Gross profit	214,461	42,279	37,850	3,099	297,689	211,510	49,104	35,680	5,053	301,347

Axalto's Income statement includes the following expenses:

	Year ended December 31,					
	2004			2005		
	Cards	POS Terminals	Axalto	Cards	POS Terminals	Axalto
Depreciation	32,528	1,953	34,481	29,186	1,543	30,729
Amortization	8,136	14	8,150	6,450	1	6,451
Impairment of intangible assets	2,758	-	2,758	-	-	-
Reversal of unused inventory impairment	(2,498)	(6,225)	(8,723)	(3,201)	(2,649)	(5,850)
Net impairment costs of trade receivables	251	821	1,072	(1,830)	(276)	(2,106)
Stock based compensation	3,483	67	3,550	3,991	74	4,065
Restructuring costs	3,555	(14)	3,541	3,703	46	3,749

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

The assets, liabilities and capital expenditure of the two segments as of December 31, 2004 and December 31, 2005 and for the years then ended are as follows:

	Year ended December 31,					
	2004			2005		
	Cards	POS Terminals	Axalto	Cards	POS Terminals	Axalto
Assets	1,066,836	41,942	1,108,778	1,006,436	30,596	1,037,032
Associates	5,220	-	5,220	6,963	-	6,963
Total assets	<u>1,072,056</u>	<u>41,942</u>	<u>1,113,998</u>	<u>1,013,399</u>	<u>30,596</u>	<u>1,043,995</u>
Liabilities	<u>311,276</u>	<u>93,443</u>	<u>404,719</u>	<u>266,520</u>	<u>75,847</u>	<u>342,367</u>
Capital expenditure (Intangibles)	4,280	1	4,281	5,091	39	5,130
Capital expenditure (PPE) (*)	36,522	261	36,783	33,149	461	33,610

(\*) Includes fixed assets revaluation resulting from the purchase of minority interest in HSTE amounting to \$1,866 in 2005.

*Secondary reporting format – Geographical segments*

The table below shows revenue attributed to geographic areas, on the basis of the location of the customer:

	Year ended December 31,	
	2004	2005
North and South America	187,238	243,601
Europe, Middle East and Africa	535,885	541,981
Asia	237,304	206,750
Total revenues	<u>960,427</u>	<u>992,332</u>

The tables below show assets and capital expenditure allocated based on where the assets are located:

	Year ended December 31,	
	2004	2005
Assets		
North and South America	132,062	164,027
Europe, Middle East and Africa	784,751	709,622
Asia	191,965	163,383
	<u>1,108,778</u>	<u>1,037,032</u>
Associates	5,220	6,963
Total assets	<u>1,113,998</u>	<u>1,043,995</u>

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

## **Note 7 Property, plant and equipment**

Property, plant and equipment (net) consist of the following:

	Land	Buildings and improvements	Machinery and equipment	Total property, plant and equipment
<b>Gross book value as of January 1, 2004</b>	2,483	69,746	206,354	278,583
Additions	-	2,483	34,300	36,783
Disposals	(684)	(211)	(4,643)	(5,538)
Currency translation adjustment	138	4,924	11,191	16,253
<b>Gross book value as of December 31, 2004</b>	<b>1,937</b>	<b>76,942</b>	<b>247,202</b>	<b>326,081</b>
<b>Accumulated depreciation as of January 1, 2004</b>	-	(27,972)	(144,567)	(172,539)
Additions	-	(277)	(34,204)	(34,481)
Disposals	-	(13,471)	15,694	2,223
Currency translation adjustment	-	(3,055)	(7,713)	(10,768)
<b>Accumulated depreciation as of December 31, 2004</b>	<b>-</b>	<b>(44,775)</b>	<b>(170,790)</b>	<b>(215,565)</b>
<b>Net book value as of December 31, 2004</b>	<b>1,937</b>	<b>32,167</b>	<b>76,412</b>	<b>110,516</b>
	Land	Buildings and improvements	Machinery and equipment	Total property, plant and equipment
<b>Gross book value as of January 1, 2005</b>	1,937	76,942	247,202	326,081
Additions (*)	-	7,107	26,503	33,610
Disposals	-	(1,264)	(19,056)	(20,320)
Currency translation adjustment	(251)	(8,359)	(17,359)	(25,969)
<b>Gross book value as of December 31, 2005</b>	<b>1,686</b>	<b>74,426</b>	<b>237,290</b>	<b>313,402</b>
<b>Accumulated depreciation as of January 1, 2005</b>	-	(44,775)	(170,790)	(215,565)
Additions	-	(5,190)	(25,539)	(30,729)
Disposals	-	561	17,831	18,392
Transfer (**)	-	(15)	(160)	(175)
Currency translation adjustment	-	4,779	12,364	17,143
<b>Accumulated depreciation as of December 31, 2005</b>	<b>-</b>	<b>(44,640)</b>	<b>(166,294)</b>	<b>(210,934)</b>
<b>Net book value as of December 31, 2005</b>	<b>1,686</b>	<b>29,786</b>	<b>70,996</b>	<b>102,468</b>

(\*) Includes fixed assets revaluation resulting from the purchase of minority interest in HSTE amounting to \$1,866.

(\*\*) Includes transfer of fixed assets from company accounted for by equity method.

For the year ended December 31, 2004, depreciation expense of \$31,268 was recorded in cost of sales, \$1,345 in research and engineering expenses, \$690 in sales and marketing expenses and \$1,178 in general and administrative expenses.

For the year ended December 31, 2005, depreciation expense of \$27,951 was recorded in cost of sales, \$884 in research and engineering expenses, \$497 in sales and marketing expenses and \$1,397 in general and administrative expenses.

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

Capitalized leases included in Property, Plant and Equipment above are as follows:

	Year ended December 31,	
	2004	2005
Gross book value	18,941	16,475
Accumulated depreciation	(13,792)	(13,535)
Net book value	5,149	2,940

Capitalized leases consist of a lease of a production facility and of a lease of POS terminals in relation with the sale on a recourse basis to a French financial institution of Axalto's POS terminals.

### **Note 8 Goodwill and intangible assets**

Goodwill and intangible assets consist of the following:

	Goodwill	Patents and technology	Other	Total
<b>Gross book value as of January 1, 2004</b>	303,158	191,973	11,238	506,369
Additions	-	-	4,281	4,281
Disposals	-	-	(1,018)	(1,018)
Currency translation adjustment	25,124	18,687	468	44,279
<b>Gross book value as of December 31, 2004</b>	328,282	210,660	14,969	553,911
<b>Accumulated amortization as of January 1, 2004</b>	(15,537)	(164,768)	(6,223)	(186,528)
Additions	-	(5,556)	(2,594)	(8,150)
Disposals	-	-	255	255
Impairment charge	-	(2,758)	-	(2,758)
Currency translation adjustment	(1,435)	(16,082)	(1,346)	(18,863)
<b>Accumulated amortization as of December 31, 2004</b>	(16,972)	(189,164)	(9,908)	(216,044)
<b>Net book value as of December 31, 2004</b>	311,310	21,496	5,061	337,867

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

	Goodwill	Patents and technology	Other	Total
<b>Gross book value as of January 1, 2005</b>	328,282	210,660	14,969	553,911
Additions	1,700	-	5,130	6,830
Disposals	-	-	(152)	(152)
Currency translation adjustment	(37,631)	(27,387)	(2,220)	(67,238)
<b>Gross book value as of December 31, 2005</b>	<b>292,351</b>	<b>183,273</b>	<b>17,727</b>	<b>493,351</b>
<b>Accumulated amortization as of January 1, 2005</b>	(16,972)	(189,164)	(9,908)	(216,044)
Additions	-	(3,535)	(2,917)	(6,452)
Disposals	-	-	12	12
Impairment charge	-	-	-	-
Currency translation adjustment	873	24,790	1,454	27,117
<b>Accumulated amortization as of December 31, 2005</b>	<b>(16,099)</b>	<b>(167,909)</b>	<b>(11,359)</b>	<b>(195,367)</b>
<b>Net book value as of December 31, 2005</b>	<b>276,252</b>	<b>15,364</b>	<b>6,368</b>	<b>297,984</b>

The company carries out goodwill impairment reviews at least on an annual basis, as required by IAS36. These reviews are based on projected cash flows, using the weighted average cost of capital used by the Company, estimated when the reviews were carried out at 10.5% in 2004 and 11.0% in 2005. No impairment charge was recognized in 2004 and 2005.

For the year ended December 31, 2004, amortization expense of \$9,324 related to Patents and Technology was charged to cost of goods sold, \$1,413 in research and engineering expenses and \$171 in general and administrative expenses.

For the year ended December 31, 2005, amortization expense of \$5,930 related to Patents and Technology was charged to cost of goods sold, \$312 in research and engineering expenses and \$210 in general and administrative expenses.

In 2004, capitalized software development costs amounted to \$4.2 million, of which \$1.4 million were amortized as of December 31, 2004. In 2005, additional capitalized software development costs were incurred for \$1.7 million, bringing the total balance at year end to \$5.4 million of which \$1.9 million were amortized as of December 31, 2005.

## **Note 9 Investments in associates**

Investments in associates consist of the following:

	2004	2005
<b>Investments as of beginning of period</b>	4,910	5,220
Acquisition	-	1,048
Share of profit/(loss)	(378)	1,145
Dilution impact	640	(40)
Currency translation adjustment	207	(348)
Other movements	(159)	(62)
<b>Investments as of end of period</b>	<b>5,220</b>	<b>6,963</b>

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

Axalto's interest in its principal associates were as follows:

2004

Entity	Country of incorporation	Associate's Total				% interest held
		Assets	Liabilities	Revenue	Profit/loss	
SSJV	China	12,456	6,499	7,002	(247)	31%
Trusted Logic	France	7,750	2,092	6,470	847	38%
Xiring	France	11,211	5,834	4,171	(2,747)	23%

2005

Entity	Country of incorporation	Associate's Total				% interest held
		Assets	Liabilities	Revenue	Profit/loss	
SSJV	China	11,869	1,768	6,566	3,299	31%
Trusted Logic	France	7,350	2,134	5,689	874	37%
Xiring	France	11,464	6,703	12,174	(35)	23%
Makxalto (*)	Egypt	-	-	-	(588)	34%

(\*) Since no financial statements for the period ended December 31, 2005 were prepared by Makxalto, \$588 total loss was estimated since incorporation.

### **Note 10 Available-for-sale financial assets**

Available-for-sales financial assets consist of the following:

	2004	2005
<b>Available-for-sale financial assets as of beginning of period</b>	1,887	1,553
Additions	-	-
Revaluations surplus transfer to equity	(334)	(925)
Currency translation adjustment	-	-
<b>Available-for-sale financial assets as of end of period</b>	<u>1,553</u>	<u>628</u>

There were no disposals or impairment provisions on available-for-sale financial assets in 2004 and in 2005.

## **Note 11 Inventories**

Inventories consist of the following:

	Year ended December 31,	
	2004	2005
<b>Gross book value</b>		
Raw materials and spares	83,755	71,193
Work in progress	26,762	15,245
Finished goods	30,545	20,525
Total	141,062	106,963
<b>Obsolescence reserve</b>		
Raw materials and spares	(11,959)	(6,992)
Work in progress	(3,937)	(3,188)
Finished goods	(2,674)	(3,452)
Total	(18,570)	(13,632)
<b>Net book value</b>	122,492	93,331

## **Note 12 Trade and other receivables**

Trade and other receivables consist of the following:

	Year ended December 31,	
	2004	2005
Trade receivables	222,051	198,405
Provision for impairment of receivables	(17,996)	(9,136)
Trade receivables, net	204,055	189,269
Prepaid expenses	5,496	8,386
VAT recoverable and tax receivable	13,260	17,777
Advances to suppliers	5,886	4,273
Unbilled revenue	10,739	4,233
Other	10,973	7,021
<b>Total</b>	250,409	230,959

There is no concentration of credit risk with respect to trade receivables, as the group has a large number of customers, internationally dispersed.

Axalto has recognized a net profit of \$2,106 due to the reversal of impaired receivables during the year ended December 31, 2005. For the year ended December 31, 2004, a charge amounting to \$1,072 had been recognized. The profit and the charge were recorded in "General and administrative expenses" in the income statement.

## **Note 13 Cash and cash equivalents**

Cash and cash equivalents consist of the following:

	Year ended December 31,	
	2004	2005
Cash at bank and in hand	17,157	33,533
Short-term bank deposits and investment funds	206,663	225,751
<b>Total</b>	223,820	259,284

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

The average effective interest rate on short-term deposits was 3.12% in 2005. These deposits have a maturity of less than 3 months. These deposits are invested in the form of overnight and fixed term loan or in money market funds.

Cash and bank overdrafts include the following for the purpose of cash flow statement:

	Year ended December 31,	
	2004	2005
Cash and cash equivalents	223,820	259,284
Bank overdrafts	(83)	-
<b>Total</b>	<b>223,737</b>	<b>259,284</b>

#### **Note 14 Borrowings**

Borrowings consist of the following:

	Year ended December 31,	
	2004	2005
<b>Non-current</b>		
Syndicated bank loan	28,888	6,908
Finance lease liabilities	1,361	-
	<b>30,249</b>	<b>6,908</b>
<b>Current</b>		
Short term loans	1,921	569
Bank overdraft	83	-
Syndicated bank loan	5,758	-
Finance lease liabilities	830	1,266
	<b>8,592</b>	<b>1,835</b>
<b>Total</b>	<b>38,841</b>	<b>8,743</b>

The syndicated bank loan, which amounts to \$250 million, has a maturity date on August 24, 2010. At December 31, 2005, the undrawn portion of the syndicated loan amounts to \$243,092 (\$121,106 in 2004). The \$6,908 amount outstanding as of December 31, 2005 consists of a revolving facility, with short-term maturity, drawn under the syndicated bank loan.

The nominal interest rates as of the end of 2004 and 2005 were the following:

	2004				2005			
	USD	EURO	GBP	RMB	USD	EURO	GBP	RMB
Short-term loans	2.61%	-	-	4.62%	-	-	-	-
Syndicated bank loan	-	2.55%	5.28%	-	-	-	4.89%	-
Finance lease liabilities	-	3.89%	-	-	-	3.37%	-	-

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

The carrying amount of Axalto's borrowings are denominated in the following currencies:

	Year ended December 31,	
	2004	2005
USD	1,183	552
EURO	25,322	1,266
GBP	11,516	6,908
RMB	820	-
BRL	-	17
<b>Total</b>	<b>38,841</b>	<b>8,743</b>

Finance lease liabilities are as follows:

	Year ended December 31,	
	2004	2005
Finance lease liabilities – minimum lease payments		
Not later than 1 year	830	1,266
Later than 1 year and not later than 5 years	1,361	-
	2,191	1,266
Future finance charges on finance leases	159	77
Present value of finance lease liabilities	2,350	1,343

The present value of finance leases liabilities is as follows:

	Year ended December 31,	
	2004	2005
Not later than 1 year	901	1,343
Later than 1 year and not later than 5 years	1,449	-
	2,350	1,343

## **Note 15 Pension and other benefit plans**

*Retirement benefit obligation liability:*

	Year ended December 31,	
	2004	2005
Pension (Germany)	397	339
Retirement indemnity (France)	13,414	12,519
Jubilee premium (France)	3,558	3,367
	17,369	16,225

*Income statement charge:*

	Year ended December 31,	
	2004	2005
Pension (Germany)	56	64
Retirement indemnity (France)	1,303	1,135
Jubilee premium (France)	620	411
	1,979	1,610

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

The amounts recorded in the balance sheet are determined as follows:

	Year ended December 31,					
	2004			2005		
	France	Germany	Total	France	Germany	Total
Present value of unfunded obligations	16,057	449	16,506	16,381	489	16,870
Unrecognized actuarial losses	915	(52)	863	(495)	(150)	(645)
<b>Retirement benefit obligation</b>	<b>16,972</b>	<b>397</b>	<b>17,369</b>	<b>15,886</b>	<b>339</b>	<b>16,225</b>

The amounts recognized in the Income statement are the following:

	Year ended December 31,	
	2004	2005
Service costs	1,160	968
Interest costs	620	598
Net actuarial losses recognized during the year	199	44
<b>Total pension costs</b>	<b>1,979</b>	<b>1,610</b>

	Year ended December 31,	
	2004	2005
Cost of sales	414	293
Research and engineering	301	213
Sales and marketing	413	316
General and administrative	231	190
Finance expense	620	598
<b>Total pension costs</b>	<b>1,979</b>	<b>1,610</b>

The changes in liabilities recognized in the balance sheet are as follows:

	2004	2005
<b>Beginning of period</b>	<b>13,758</b>	<b>17,369</b>
Total pension costs charged to the income statement	1,979	1,610
Contributions paid	-	(212)
Currency translation adjustment	1,632	(2,542)
<b>End of period</b>	<b>17,369</b>	<b>16,225</b>

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

The main actuarial assumptions used were the following:

	<u>2004</u>	<u>2005</u>
<b>France:</b>		
Discount rate	4.75%	4.20%
Future salary increase	2.75%-3.00%	3.00%
Inflation rate	2.00%	2.00%
INSEE Mortality tables	TV/TD 1998	TV/TD 2002
<b>Germany:</b>		
Discount rate	5.50%	4.75%
Future salary increase	3.00%	3.00%
Inflation rate	2.00%	2.00%
Dr Klaus Heubeck Mortality table	Richttafeln 1998	Richttafeln 1998

### **Note 16 Non-current provisions and other liabilities**

Non-current provisions and other liabilities consist of the following for 2005:

	Warranty Non- current	Litigation	Def comp and empl benefits	Other Non- current liabilities	Other	Total
<b>Beginning of period</b>	1,799	2,121	223	6,040	6,041	16,224
Charged to income statement:						
Additional provisions	-	1,206	128	-	9,750	11,084
Unused amount reversed	(164)	(1,105)	(10)	(993)	(8,390)	(10,662)
Used during the year	(177)	(589)	-	(2,745)	(1,229)	(4,740)
Currency translation adjustment	(500)	(99)	(40)	(497)	(642)	(1,778)
<b>End of period</b>	<u>958</u>	<u>1,534</u>	<u>301</u>	<u>1,805</u>	<u>5,530</u>	<u>10,128</u>

### **Note 17 Trade and other payables**

Trade and other payables consist of the following:

	<u>Year ended December 31,</u>	
	<u>2004</u>	<u>2005</u>
Trade payables	126,791	126,559
Employee related payables	70,405	62,156
Accrued expenses	45,279	32,946
Accrued VAT	11,112	11,689
Deferred revenue	33,812	31,309
Other	7,627	5,342
<b>Total</b>	<u>295,026</u>	<u>270,001</u>

A \$6.0 million currency translation adjustment accounts for most of the decrease in Employee related payables. The decrease in accrued expenses reflects in particular lower accruals for freight on goods sold and commissions to agents and distributors (\$5.2 million in total), as well as lower advances from customers (\$2.7 million).

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

## **Note 18 Derivative Financial instruments**

As exposed in note 5 Financial risk management above, Axalto enters into foreign exchange contracts as cash flow and fair value hedges. These derivative financial instruments consist of the following:

	Year ended December 31,			
	2004		2005	
	Assets	Liabilities	Assets	Liabilities
Forward foreign exchange contracts – cash flow hedge	222	-	-	9,081
Forward foreign exchange contracts – fair value hedge	-	-	-	70
Forward exchange option contracts – cash flow hedge	6,883	-	-	-
<b>Total</b>	<b>7,105</b>	<b>-</b>	<b>-</b>	<b>9,151</b>

Axalto transacts business globally and is subject to the effects of fluctuations in foreign exchange rates. Axalto's objective is to reduce earnings and cash flow fluctuations caused by foreign exchange rate fluctuations.

Axalto enters into various option 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 and USD denominated revenue.

Gains and losses on these contracts are initially recorded under "Fair value and other reserves" in stockholders' equity, and reclassified to current earnings under cost of sales when related cost of sales (for sales to third parties) are recognized, offsetting changes in the value of the foreign currency costs.

As of December 31, 2005, Axalto had net unrecognized losses of \$5.9 million recorded under "Fair value and other reserves", which the company would, at constant market conditions, reclassify as a debit to the cost of sales and credit to income tax over the next 12 months.

The result of cash flow hedging activities on the income statement for the year ended December 31, 2005, was a net gain of \$2.1 million (in 2004: \$2.9 million), booked as a credit to cost of sales, and a charge of \$2.7 million (in 2004: \$4.1 million), booked as a debit to finance costs.

## **Note 19 Provisions and other liabilities – Current**

Provisions and other liabilities – Current consist of the following:

	Year ended December 31,	
	2004	2005
POS Terminals operating lease	5,420	2,627
Warranty - Current	3,180	3,309
Provision for loss on contracts	1,073	492
	<b>9,673</b>	<b>6,428</b>

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

## **Note 20 Revenue**

Revenue by category are analyzed as follows:

	Year ended December 31,	
	2004	2005
Sales of goods	897,947	937,787
Revenue from services	18,730	18,722
Other (*)	43,750	35,823
<b>Total revenue</b>	<b>960,427</b>	<b>992,332</b>

(\*) "Other" include mainly the postage and freight on goods sold recharged to customers and the revenue derived from Axalto patents and technologies.

## **Note 21 Operating expenses by nature**

The operating expenses by nature are as follows:

	Year ended December 31,	
	2004	2005
Depreciation, amortization and impairment charges	51,214	34,829
Employee compensation and benefit expense (see Note 22)	252,565	264,181
Change in inventories (finished goods and work in progress)	(13,366)	16,093
Raw materials used and consumables	387,853	375,413
Freight and transportation costs	28,042	29,280
Travel costs	22,938	24,881
Buildings and office leases	37,536	38,054
Royalties, legal and professional fees	39,635	43,687
Subcontracting and temporary workforce	29,768	44,276
Other	35,603	41,633
<b>Total expenses</b>	<b>871,788</b>	<b>912,327</b>

## **Note 22 Employee compensation and benefit expense**

	Year ended December 31,	
	2004	2005
Wages and salaries	143,311	152,648
Bonuses and performance incentives	23,805	21,394
Social security	44,635	48,041
Vacation accruals	2,038	2,217
Pension – Defined benefit plans (*)	1,376	999
Pension – Defined contribution plans	12,785	14,350
Profit sharing	4,070	5,044
Stock options	5,377	4,870
Other	15,168	14,618
<b>Employee benefit expense</b>	<b>252,565</b>	<b>264,181</b>

(\*) Includes mainly IFC ("Indemnités de fin de carrière"), which are lump sum payments made to French employees upon their retirement.

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

## **Note 23 Stock compensation plan**

Axalto has established a *Global Equity Incentive Plan* (« GEIP ») for its employees, approved by the general meetings of shareholders held on March 18, 2004 and April 21, 2004.

### ***Stock option plans***

The GEIP authorizes the company to grant to employees over the duration of the plan (ending on April 21, 2014) the right to acquire total of 7 million ordinary shares of Axalto Holding NV. The Board of Directors 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 and authorized to grant options to buy or subscribe for 3,300,000 ordinary shares with an exercise price equal to the initial listing price, i.e. 14.80 Euros per share. 3,196,000 stock options were granted in May 2004. 5,000 stock options were granted in December 2004 at stock price, i.e. 18.21 Euros per share. 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.

The fair value of each grant is estimated on the date of grant using the multiple option Black & Scholes option-pricing model. For the stock options granted in May 2004, the following assumptions were used: no dividend, expected volatility of 25%, risk-free interest rate of 3%, and expected option life of 4.13 years. For the stock options granted in December 2004, the assumptions were: no dividend, expected volatility of 25%, risk-free interest rate of 3%, and expected option life of 3 years.

In the income statement for the period ended December 31, 2004, a compensation expense of \$2,336 corresponding to the amortization of the fair value of the options granted between the grant date (May 18, 2004) and December 31, 2004, was recorded for \$361 in cost of sales, \$142 in research and engineering expenses, \$888 in sales and marketing expenses and \$945 in general and administrative expenses.

In 2005, the Board of Directors of Axalto Holding NV approved the main terms and conditions of two grants. 15,000 shares were granted at market price in June 2005 at stock price, i.e. 22.41 Euros and 685,000 shares were granted in September 2005 at market price, i.e. 30.65 Euros. 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.

For the stock options granted in June 2005, the following assumptions were used: no dividend, expected volatility of 27%, risk-free interest rate of 3%, and expected option life of 4.5 years. For the stock options granted in September 2005, the assumptions were: no dividend, expected volatility of 28%, risk-free interest rate of 2.8%, and expected option life of 4.12 years.

In the income statement for the period ended December 31, 2005, a compensation expense of \$3,674 corresponding to the amortization of the fair value for the full year, was recorded for \$474 in cost of sales, \$243 in research and engineering expenses, \$928 in sales and marketing expenses and \$2,029 in general and administrative expenses

Movements in the number of share options outstanding and their related weighted average exercise price are as follows:

	2004		2005	
	Average exercise price	Options	Average exercise price	Options
<b>Beginning of period</b>	-	-	14.81	3,201,000
Granted	14.81	3,201,000	30.42	700,000
Forfeited	-	-	14.80	(99,750)
Exercised	-	-	14.80	(79,342)
<b>End of period</b>	14.81	3,201,000	17.75	3,721,908

Share options outstanding at the end of the period have the following expiry date and exercise prices:

Expiry Date	Exercise price	Year ended December 31,	
		2004	2005
2014	14.81	3,201,000	3,021,908
2015	30.42	-	700,000
		3,201,000	3,721,908

### ***Employee Stock Purchase plan***

In the period from May 4, 2004 to May 14, 2004, Axalto employees were offered the opportunity to buy Axalto shares at a price 15% below the initial listing price. 445,668 ordinary shares were subscribed by the employees at 12.58 Euros per share. The amount of \$1,214 equal to the total discount granted to employees under that program was recorded as a compensation expense in the 2004 IFRS income statement: \$417 were recorded in cost of sales, \$231 in research and engineering expenses, \$395 in sales and marketing expenses and \$171 in general and administrative expenses.

In the period from June 20, 2005 to July 1, 2005, Axalto employees were offered the opportunity to buy Axalto shares at a price 15% below the lowest of the closing price for the Axalto stock on June 20, 2005 or July 1, 2005. 87,767 ordinary shares were subscribed by the employees at 20.98 Euros per share. The compensation expense corresponding to the discount granted to employees under that program of \$391 was recorded as a compensation expense in the 2005 income statement: \$81 were recorded in cost of sales, \$110 in research and engineering expenses, \$125 in sales and marketing expenses and \$75 in general and administrative expenses.

### **Note 24 Other income**

	Year ended December 31,	
	2004	2005
Fixed asset sales gains / losses and write-offs	(6)	(1,336)
Subsidies and grants	421	1,251
Montrouge and Louveciennes relocation costs	-	(974)
Bull litigation favorable resolution	3,238	-
Other	382	835
<b>Other income, net</b>	<b>4,035</b>	<b>(224)</b>

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

## **Note 25 Financial income (expenses)**

Financial income (expense) include the following:

	Year ended December 31,	
	2004	2005
<b>Interests:</b>		
Interest cost related to the French IFC obligation (*)	(620)	(598)
Interest expense	(1,904)	(1,662)
Interest income	2,195	6,216
<b>Foreign exchange transaction gains (losses):</b>		
Foreign exchange gains (losses), net of fair value hedges	(1,609)	107
Cash flow hedges	(4,106)	(2,663)
<b>Gain (loss) on sales of investments:</b>		
Loss resulting from dilution in an Associate	-	(40)
<b>Finance income (expenses), net</b>	<b>(6,044)</b>	<b>1,360</b>

(\*) IIFC ("Indemnités de fin de carrière") are lump sum payments made to French employees upon their retirement.

## **Note 26 Net foreign exchange gains (losses)**

The exchange differences (charged)/credited to the income statement are as follows (see note 18):

	Year ended December 31,	
	2004	2005
Cost of sales	2,878	2,122
Finance income (expenses), net	(5,715)	(2,556)
<b>Net foreign exchange gains (losses)</b>	<b>(2,837)</b>	<b>(434)</b>

## **Note 27 Taxes**

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same tax authority. Net amounts are as follows:

	Year ended December 31,	
	2004	2005
<b>Deferred tax assets:</b>		
- Deferred tax assets to be recovered after more than 12 months	42,739	35,858
- Deferred tax assets to be recovered within 12 months	11,075	13,398
	<b>53,814</b>	<b>49,256</b>
<b>Deferred tax liabilities:</b>		
- Deferred tax liabilities to be recovered after more than 12 months	(6,918)	(5,747)
- Deferred tax liabilities to be recovered within 12 months	(120)	(8)
	<b>(7,038)</b>	<b>(5,755)</b>
<b>Net deferred tax assets</b>	<b>46,776</b>	<b>43,501</b>

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

The changes in the net deferred income tax assets are as follows:

	2004	2005
<b>Beginning of period</b>	15,902	46,776
Charge to income statement	(6,440)	(772)
Tax credit recognized in equity	32,686	3,046
Currency translation adjustment	4,628	(5,549)
<b>End of period</b>	<u>46,776</u>	<u>43,501</u>

The changes in deferred tax assets and liabilities during the years ended December 31, 2004 and 2005 are as follows:

	Net operating losses	Depreciation and amortization	Employee and retirement benefits	Warranty, reserves and accruals	Other	Total
<b>Deferred tax assets:</b>						
<i>As of January 1<sup>st</sup>, 2004</i>	7,617	4,777	2,577	2,961	3,325	21,257
- Charged (credited) to income statement	(11,231)	1,387	1,060	1,294	3,125	(4,365)
- Charged (credited) to equity	34,067	(152)	2,042	(1,107)	(2,645)	32,205
- Currency translation adjustment	3,560	418	325	164	250	4,717
<i>As of December 31, 2004</i>	<u>34,013</u>	<u>6,430</u>	<u>6,004</u>	<u>3,312</u>	<u>4,055</u>	<u>53,814</u>
- Charged (credited) to income statement	(3,874)	100	(1,013)	(1,143)	3,823	(2,107)
- Charged (credited) to equity	-	-	-	-	3,090	3,090
- Currency translation adjustment	(4,533)	(11)	(570)	(83)	(344)	(5,541)
<i>As of December 31, 2005</i>	<u>25,606</u>	<u>6,519</u>	<u>4,421</u>	<u>2,086</u>	<u>10,624</u>	<u>49,256</u>

	Depreciation and amortization	Other	Total
<b>Deferred tax liabilities:</b>			
<i>As of January 1<sup>st</sup>, 2004</i>	(5,272)	(83)	(5,355)
- (Charged) credited to income statement	(2,059)	(16)	(2,075)
- (Charged) credited to equity	481	-	481
- Currency translation adjustment	(88)	(1)	(89)
<i>As of December 31, 2004</i>	<u>(6,938)</u>	<u>(100)</u>	<u>(7,038)</u>
- (Charged) credited to income statement	920	414	1,334
-(Charged) credited to equity	(280)	236	(44)
- Currency translation adjustment	-	(7)	(7)
<i>As of December 31, 2005</i>	<u>(6,298)</u>	<u>543</u>	<u>(5,755)</u>

The total deferred income tax charged to equity for fair value adjustments in 2005 amounted to \$2,480 of which a charge of \$2,760 relating to fair value losses on cash flow hedge and a profit of \$280 relating to fair value gains on machinery and equipment.

The income tax expense is as follows:

	Year ended December 31,	
	2004	2005
Current tax	(19,438)	(22,471)
Deferred tax	(6,440)	(772)
<b>Income tax expense</b>	<u>(25,878)</u>	<u>(23,243)</u>

The reconciliation between the income tax expense on Axalto's profit before income tax and the amount that would arise using the weighted average tax rate applicable to profits of the consolidated entities is as follows:

	Year ended December 31,			
	2004		2005	
	\$	%	\$	%
Profit before income tax	82,857	100.0	82,510	100.0
Tax calculated at domestic rate applicable to profits of the consolidated entities	24,669	29.8	31,318	38.0
Effect of utilization of tax assets not recognized in earlier years	(11,003)		(7,249)	
Effect of unrecognized deferred tax assets	2,500		1,142	
Other permanent differences	9,712		(1,968)	
<b>Income tax expense</b>	<u>25,878</u>	<u>31.2</u>	<u>23,243</u>	<u>28.2</u>

Deferred income tax assets are recognized for tax loss carry forwards and other future deductions to the extent that the realization of the related tax benefit through the future taxable profits is probable. As of December 31, 2005 and 2004, Axalto did not recognize tax assets amounting to \$22.4 million and \$31.4 million relating to tax losses and other future tax deductions.

Tax losses that can be carried forward against future taxable income amount to \$91 million (in 2004: \$118 million).

No deferred income tax liabilities have been recognized for withholding tax and other tax payable on the unremitted earnings of the subsidiaries either because the remittance of earnings does not trigger such taxes or because Axalto intends to permanently reinvest its earnings. However deferred taxes are accrued on unremitted earnings of associates when Axalto does not control the dividend distribution process.

### Note 28 Earnings per share

	Year ended December 31,	
	2004	2005
<b>Basic</b>		
Profit attributable to equity holders of the company	56,291	57,072
Weighted average number of ordinary shares outstanding (in thousands)	40,295	40,423
Basic earnings per share	<u>\$1.40</u>	<u>\$1.41</u>

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

<b>Diluted</b>	<b>Year ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
Profit attributable to equity holders of the company	56,291	57,072
Weighted average number of ordinary shares outstanding (in thousands)	40,295	40,423
Adjustment for share options (in thousands)	402	942
Weighted average number of ordinary shares for diluted earnings per share (in thousands)	40,697	41,365
Diluted earnings per share	\$1.38	\$1.38

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 by dividing net income by the average number of common shares outstanding assuming dilution. Dilution is determined assuming that all stock options, which are in the money, are exercised at the beginning of the period and the proceeds used, by the Company, to purchase shares at the average market price for the period.

## **Note 29 Cash generated from operations**

	<b>Notes</b>	<b>Year ended December 31,</b>	
		<b>2004</b>	<b>2005</b>
Income for the period before minority interest		56,979	59,267
Adjustment for:			
Tax	27	25,878	23,243
Research tax credit		-	(1,891)
Depreciation	7	34,481	30,729
Amortization	8	9,604	6,451
Stock option compensation charge (*)	23	2,336	3,674
ESPP discount (*)	23	1,214	391
Gains and losses on sales of fixed assets and write-offs		3,988	1,425
Net movement in provisions for liabilities and charges		(1,921)	(6,612)
Retirement benefit obligation	15	1,735	1,610
Interest income		(2,202)	(6,451)
Interest expense		2,530	2,493
Share of profit (loss) from associates	9	(262)	(1,145)
Changes in current assets and liabilities (excluding the effects of acquisitions and exchange differences in consolidation)			
Inventories		(10,750)	20,862
Trade and other receivables (*)		4,004	(3,935)
Retirement benefit obligation	15	-	(212)
Derivative financial instruments		1,348	(136)
Trade and other payables		53,709	5,336
Cash generated from operations		182,671	135,099

(\*) Compared with the IFRS consolidated statement of cash flow for the year ended December 31, 2004 published in the interim consolidated financial statements as of June 30, 2005:

- \$3,550 representing the non-cash stock compensation charge recorded in 2004 were reclassified from "Invested equity" to "Cash generated from operations"

- \$173 representing the variation of long term deposits in 2004 were reclassified from "Cash generated from operations" to "Purchase of non-current assets".

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

## **Note 30 Commitments and contingencies**

### *Schlumberger residuals*

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 undertakings 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 could not 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.

Therefore, the activities, assets and liabilities pertaining to Schlumberger activities falling under the provisions of the Separation Agreement are not disclosed in the accompanying consolidated financial statements of Axalto nor is the associated payable from Axalto to Schlumberger or the associated receivable by Axalto from Schlumberger.

As of December 31, 2005, the balance of the assets and liabilities belonging to Schlumberger was a net asset of \$12.7 millions.

### *Lease commitments*

Minimum rental lease commitments under non-cancelable operating leases, primarily real estate and office facilities in effect as of December 31, 2005, are as follows:

2006 .....	20,561
2007 .....	14,995
2008 .....	12,189
2009 .....	10,568
2010 .....	10,015
2011 and after .....	66,320

Operating lease rental expense aggregated: \$13,274 in 2004 and \$16,087 in 2005.

### *Microprocessor chips purchase commitments*

Axalto is committed by contract towards its suppliers of chips to purchase the whole quantity of products in safety stocks within a period of time of one year from the availability date of the safety stocks. At December 31, 2005, the commitments to purchase these safety stocks valued at the average purchase price amounts to \$18,590.

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

### *Montrouge and Louveciennes relocation*

On July 29, 2005, Axalto signed a twelve-year lease for 20,000 m<sup>2</sup> of office space located in Meudon near Paris that will allow Axalto to regroup the employees of its Montrouge and Louveciennes sites in one single location. The transfers into the new location are scheduled between March and December 2006. One-off costs related to the Montrouge and Louveciennes lease terminations, to the new lease and set up of the Meudon site are booked as incurred over 2005 and 2006. The project will also require capital expenditure in building improvements and equipment.

### *Axalto Holding NV guarantees*

During 2005, Axalto Holding N.V. has issued guarantees to secure several banking facilities against the risk of default of payment of its borrowing subsidiaries. These guarantees are continuing securities and will be valid until final payment in full of all amounts owed. The aggregate amount recoverable from Axalto Holding N.V. shall not exceed \$310 million. This includes the \$250 million syndicated facility referred to in Note 14.

### *SAIT Commitment*

Axalto holds a 51% interest in SAIT, a Chinese joint venture. This joint venture has been fully consolidated within Axalto. In 2005, Axalto 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 29 million (approximately \$3.6 million) for 2005, Chinese renminbi 32 million (approximately \$4.0 million) for 2006, Chinese renminbi 28 million (approximately \$3.5 million) for 2007 and Chinese renminbi 25 million (approximately \$3.1 million) for each fiscal year thereafter until 2009 (inclusive).
- In exchange, Axalto is granted and shall exercise control of the joint venture until December 31, 2009.

This commitment 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.

## **Note 31 Contemplated business combination with Gemplus**

On December 6, 2005, Axalto Holding N.V. ("Axalto") and Gemplus International S.A. ("Gemplus") entered into a combination agreement governed by French law under the terms of which the two companies agreed to a merger of equals.

The Board of Directors of each company unanimously approved this transaction. The two largest shareholders of Gemplus also approved this combination and have also entered into the combination agreement.

The combination will be completed in two distinct, successive steps:

- an increase in the share capital of Axalto through the contribution in kind of the entirety of the Gemplus shares held by the two largest shareholders of Gemplus (approximately 43.7% of the share capital of Gemplus)
- followed by a voluntary public offer launched by Axalto for the balance of the Gemplus shares that Axalto (which will have then changed its name to Gemalto) will not already hold (approximately 56.3% of the share capital of Gemplus).

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

The contribution in kind and the voluntary public exchange offer will be at the same exchange ratio of 2 Axalto shares for every 25 Gemplus shares.

Immediately prior to the contribution in kind, Gemplus will distribute 0.26 to all its shareholders. The contribution in kind and distribution are subject to anti-trust and other regulatory approvals, the approval of the Gemplus shareholders and certain other customary contractual conditions.

The Axalto shareholders meeting, which occurred on January 31, 2006, approved the combination.

The Gemplus shareholders meeting, which occurred on February 28, 2006, approved the resolutions related to the combination.

Approval by the anti-trust authorities of the relevant jurisdictions is expected to take place late in the second quarter or in the third quarter.

The press release announcing the combination and the description of its main terms are available on the Axalto and Gemalto websites ([www.axalto.com](http://www.axalto.com), [www.gemalto.com](http://www.gemalto.com)).

As of December 31, 2005, Axalto has deferred \$2.1 million of costs incurred in the second half of 2005 for the preparation, execution and announcement of the Combination Agreement. These costs consist mainly of lawyers and public relations firms fees. Axalto also committed to pay certain expenses in connection with the contemplated Combination, amounting to \$2.0 million as of December 31, 2005 and agreed to reimburse to Gemplus the external costs Gemplus has and will incur in relation with the combination, upon completion of the combination. The costs incurred by Gemplus in relation to the combination are estimated at \$3.9 million as of December 31, 2005.

### **Note 32 Post-closing events**

To management's knowledge, there is no significant event that occurred since December 31, 2005, which would materially impact the consolidated financial statements, as presented in this document.