

Letter to Shareholders

The year 2000 continued our pattern of record years for VASCO, and established your Company as a truly global provider of security products that support doing business anywhere, anytime, anyhow. From e-commerce and m-commerce to e-banking, m-banking, and access to corporate networks and extranets, VASCO continues to prosper by providing the security products critical to doing business today, and which will be even more important in the future. At the end of 2000, more than 500 corporations and 160 financial institutions, as well as large and small government agencies, had come to rely on VASCO to support their business initiatives with security that is effective, simple to implement, and easy to use, at a low Total Cost of Ownership. Even more telling, the number of new users of our strong authentication, digital signature, web portal, and enterprise-wide security products increased over 50% from 1999, as we added over 1.3 million new users of our products in 2000.

The financial results for 2000 speak for themselves. Our revenues increased 45% in the year 2000 to \$28.1 million, from \$19.4 million in 1999. Gross profit increased 49% to \$18.0 million, versus \$12.1 million in 1999. Gross margin improved to 64% of sales from 62% of sales. Additionally, your Company's financial position has never been stronger. We ended the year with \$13.8 million of cash on hand, with working capital of \$14.3 million and a working capital ratio of 2.7 to 1. Stockholders' equity at the end of 2000 was \$17.3 million compared with negative equity at the end of 1999. We solidified our financial stability by raising over \$17 million through the sale of common and preferred stock.

During 2000, your Company also solidified a top-notch management team and structure. Our financial expertise was strengthened through the addition of a Chief Financial Officer, a new position for VASCO, which was filled in 2000 by a financial professional with extensive experience in multinational organizations. Our worldwide sales, marketing, and product management activities were consolidated under the leadership of a highly skilled and proven manager, responsible for VASCO's ongoing top-line growth. And to develop and implement our aggressive product development strategy, your Company is calling on a recognized expert with more than 20 years of experience at every level of the security software industry. This extensive management experience played an instrumental role in VASCO's successful acquisitions and capital-raising activities, as well as the fact that the year 2000 ended with your Company in the best financial position that it has ever seen.

We were able to achieve another record year thanks to the ingenuity and hard work of our growing and talented worldwide employee base, our expansion into dynamic and growing geographic regions, and the addition of important new security products for both existing and new markets.

Milestones for your Company in the year 2000 include:

Corporate and Financial

- Listing of VASCO's Common Stock on both the Nasdaq National Market System and the Nasdaq Europe pan-European exchange (formerly EASDAQ), greatly enhancing our visibility in and reach to the financial markets.
- Addition of VASCO to the Russell 2000 and Russell 3000 Indexes, which are widely used and respected benchmarks for institutional investors.
- The investment of \$15 million in your Company by Ubizen, a leading multinational security company.
- The acquisition of Invincible Data Systems, which brought to VASCO experienced software engineers and a location in the heart of Silicon Valley, giving us greater access to the markets and companies in one of the world's most dynamic economic regions.

Products

In 2000, VASCO announced several new market-driven products, which enabled us to triple our security software revenue from \$1.5 million in 1999 to \$4.5 million in 2000:

- Digipass 800, your Security Portal: a secure, intelligent, and fully portable smart card reader which provides any smart card with strong authentication and digital signature capability, expanding the functionality and usage of smart cards worldwide. We also released a Proton-compatible Digipass 800, which we are marketing and selling with Proton World, the worldwide leader in smart card licenses with more than 62 million issued.

- Digipass software, allowing companies to implement strong authentication and digital signature with the flexibility of a software-based platform, and which is being integrated into products from third-party software vendors. On our own and with partners, VASCO is also integrating Digipass technology into market-leading platforms such as the PDA market for both Palm OS and Pocket PC, smart cards, and the mobile phones of the world's leading phone manufacturers.
- SnareWorks SecureServer, LAN authentication management software that enables Digipass security for secure access to corporate networks, from within the company's physical surroundings and remotely via the Internet or dial-in.

Sales and Marketing

- Strong revenue growth, particularly in the United States, which in 2000 comprised 39% of your Company's total revenue stream. Sales growth continued both through a larger direct sales force and expanded worldwide indirect sales channels. Representative new customers include UBS PaineWebber, the US Department of Defense, Southern California Edison, Duke University, Hamburgische Landesbank in Germany, and OCBC bank in Singapore. Significant new orders include a single contract for three hundred thousand Digipass 800 from Rabobank in the Netherlands, and a single order for two hundred and forty thousand Digipass from SEB Group of Sweden.
- New sales and market-driven partnerships, as well as increased leverage from existing strategic partnerships. Some of the new members of the VASCO Partner Alliance in 2000 were Intel, Proton World, Brokat, and Celso (a Gemplus company), encompassing application developers, systems integrators, security consultants, and PKI/wireless technology companies.
- An increase in the number of employees involved with sales, marketing, and customer support to 64 full-time positions as of March 13, 2001, representing approximately one-half of VASCO employees worldwide.
- New sales offices in Paris, to access the leading smart card market in Europe, Singapore to enter the business and financial center of the Asia-Pacific region, and Silicon Valley, to place your company at the center of the world's capital of software technology.
- Consolidation of worldwide marketing activities under a Chief Marketing Officer, who brings extensive strategic and tactical marketing experience from multinational technology companies.

As a result of these growth strategies, your Company is poised to be a world leader in the growth of the AAA Security market (authentication, authorization, administration) which is projected by IDC to grow to be a \$7.1 billion market by 2003. Your Company is committed to the strategy of "Security beyond e-magination" by enabling security on any platform imaginable, at anytime, from anywhere, and anyway, whether Web, LAN, RADIUS, or Enterprise-Wide. We will continue to develop real products that serve real customers that are real solutions in today's world. Through our worldwide research and development, we are equally committed to developing security products that will be used in the applications of tomorrow. VASCO has the people and products to be a market leader. We see your Company poised for continued rapid top line growth in the year 2001, and ready to achieve our goal of sustained profitability by the end of the year.

(signature)
T. Kendall Hunt
Chairman

(signature)
Mario Houthoof
President & CEO

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

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO
SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2000

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR
THE TRANSITION PERIOD FROM _____ TO _____

Commission file number 000-24389

VASCO Data Security International, Inc.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE

(State or Other Jurisdiction of
Incorporation or Organization)

36-4169320

(IRS Employer
Identification No.)

**1901 South Meyers Road, Suite 210
Oakbrook Terrace, Illinois 60181**

(Address of Principal Executive Offices)(Zip Code)

Registrant's telephone number, including area code: **(630) 932-8844**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, par value \$.001 per share**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

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

As of March 13, 2001, 27,887,416 shares of the Company's Common Stock, \$.001 par value per share ("Common Stock"), were outstanding. On that date, the aggregate market value of voting and non-voting common equity (based upon the last sale price of the Common Stock as reported on Nasdaq on March 13, 2001) held by non-affiliates of the registrant was \$75,403,086 at \$6.00 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the Annual Meeting of Stockholders to be held on June 12, 2001 are to be incorporated by reference into Part III of this Form 10-K.

PART I

Cautionary Statement for Purposes of the “Safe Harbor” Provisions of the Private Securities Litigation Reform Act of 1995

This Annual Report on Form 10-K, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995 concerning, among other things, the prospects, developments and business strategies for the Company (as defined) and its operations, including the development and marketing of certain new products and the anticipated future growth in certain markets in which the Company currently markets and sells its products or anticipates selling and marketing its products in the future. These forward-looking statements (i) are identified by their use of such terms and phrases as “expected,” “expects,” “believe,” “believes,” “will,” “anticipated,” “emerging,” “intends,” “plans,” “could,” “may,” “estimates,” “should,” “objective” and “goals” and (ii) are subject to risks and uncertainties and represent the Company’s present expectations or beliefs concerning future events. The Company cautions that the forward-looking statements are qualified by important factors that could cause actual results to differ materially from those in the forward-looking statements, including (a) risks of general market conditions, including demand for the Company’s products and services, competition and price levels and the Company’s historical dependence on relatively few products, certain suppliers and certain key customers, and (b) risks inherent to the computer and network security industry, including rapidly changing technology, evolving industry standards, increasing numbers of patent infringement claims, changes in customer requirements, price competitive bidding, changing government regulations and potential competition from more established firms and others. Therefore, results actually achieved may differ materially from expected results included in, or implied by, these statements.

Item 1 - Description of Business

General Description of Business

VASCO Data Security International, Inc. was incorporated in Delaware in 1997 and is the successor to VASCO Corp., a Delaware corporation. Our principal executive offices are located at 1901 South Meyers Road, Suite 210, Oakbrook Terrace, Illinois 60181 and the telephone number at that address is (630) 932-8844. Our principal offices in Europe are located at Koningin Astridlaan 164, B-1780 Wemmel (Belgium) and the telephone number at that address is 32(0)2/456.98.10. Unless otherwise noted, specifically in the section entitled Management’s Discussion and Analysis of Financial Condition and Results of Operations, references in this prospectus to “VASCO,” “company,” “we,” “our,” and “us” refer to VASCO Data Security International, Inc., its predecessor, VASCO Corp., and its subsidiaries.

The Company, through its operating subsidiaries, designs, develops, markets and supports open standards-based hardware and software security systems which manage and secure access to information assets.

Financial Information Relating to Foreign and Domestic Operations and Export Sales

See Note 10 to VASCO Notes to Consolidated Financial Statements for certain information about foreign and domestic operations and export sales.

This report contains the following trademarks of the Company, some of which are registered: VASCO, AccessKey, VACMan Server and VACMan/CryptaPak, AuthentiCard and Digipass.

Narrative Description of the Business

General

We design, develop, market and support security products and services which manage and secure access to computer systems of corporate and governmental clients. Additionally, we enable secure financial transactions made over private enterprise networks and public networks, such as the Internet. We believe that our software and hardware products provide organizations with strong, flexible, and effective Internet and enterprise security solutions and they compete favorably against those of our competitors. Our Digipass product line provides greater flexibility and a more affordable means than competing products of authenticating to any network, including the Internet. The Digipass family of user authentication devices, all of which incorporate an electronic digital signature capability to guarantee the integrity of electronic transactions and data transmissions, are commonly referred to as security tokens. Our SnareWorks product line provides enterprise-wide solutions to secure Internet, client/server, and mainframe applications.

Our security solutions are sold worldwide through our direct sales force, as well as through distributors, resellers and systems integrators. We currently have approximately 500 customers in more than 50 countries. Representative customers of our products include Rabobank Nederland, ABN AMRO Bank, Merkantildata Norway, SE Banken Sweden, John Hancock, Paine Webber Incorporated, Liberty Mutual, Allmerica Financial Services and the U.S. Government.

Industry Background

The growth in electronic banking and electronic commerce, and the increasing use and reliance upon proprietary or confidential information by businesses, government and educational institutions that is remotely accessible by many users, has made information security a paramount concern. We believe that enterprises are seeking solutions which will continue to allow them to expand access to data and financial assets while maintaining network security.

According to International Data Corporation (IDC), the global market for security products is growing from \$4.0 billion in 1999 to over \$11.3 billion in 2004, a compound annual growth rate of 23%.

Internet and Enterprise Security. With the advent of personal computers and distributed information systems in the form of wide area networks, intranets, local area networks and the Internet, as well as other direct electronic links, many organizations have implemented applications to enable their work force and third parties, including vendors, suppliers and customers, to access and exchange data and perform electronic transactions. As a result of the increased number of users having direct and remote access to such enterprise applications, data and financial assets have become increasingly vulnerable to unauthorized access and misuse.

Individual User Security. In addition to the need for enterprise-wide security, the proliferation of personal computers, personal digital assistants and mobile telephones in both the home and office settings, combined with widespread access to the Internet, have created significant opportunities for electronic commerce by individual users such as electronic bill payment, home banking and home shopping.

Fueled by recent and well-publicized incidents including misappropriation of credit card information and denial of service attacks, there is a growing perception among many consumers that there is a risk involved in transmitting information via the Internet. These incidents and this perception may hamper the development of consumer-based electronic commerce. Accordingly, we believe that electronic commerce will benefit from the implementation of improved security measures that accurately identify users and reliably encrypt data transmissions over the Internet.

Components of Security. Data and financial asset security, and secured access to and participation in on-line commerce, generally consist of the following components:

- *Encryption:* Maintains data privacy by converting information into an unreadable pattern and allowing only authorized parties to decrypt the data. Encryption can also maintain data integrity by creating digital signatures for transmitted data, enabling the recipient to check whether the data has been changed since or during transmission.
- *Identification and Authentication:* Serves as the foundation for other security mechanisms by verifying that a user is who he or she claims to be. Identification and authentication mechanisms are often employed with encryption tools to authenticate users, to determine the proper encryption key for encrypting/decrypting data, or to enable users to digitally "sign" or verify the integrity of transmitted data.

- *Access Control*: Software that provides authentication, authorization, and accounting functions, controlling a user's access to only that data or the financial assets which he or she is authorized to access, and which keep track of a user's activities after access has been granted.
- *Administration and Management Tools*: Software which sets, implements, and monitors security policies, the access to which is typically regulated by access control systems. These tools are extremely important to the overall effectiveness of a security system.

The most effective security policies employ most, if not all, of the above components. Most companies, however, only implement a patchwork of these components, which can result in their security systems being compromised.

The VASCO Solution

To date, most approaches to network security, including Internet security, have been limited in scope and have failed to address all of the critical aspects of data security. We believe that an effective enterprise-wide solution must address and assimilate issues relating to the following:

- speed and ease of implementation, use, and administration;
- reliability;
- interoperability with diverse enterprise environments, existing customer applications, and the security infrastructure;
- scalability; and
- overall cost of ownership.

Accordingly, we have adopted the following approach to data security:

- In designing our products, we have sought to incorporate all industry-accepted, open, and non-proprietary protocols. This permits interoperability between our products and the multiple platforms, products, and applications widely in use.
- We have designed our products and services to minimize their integration effort with, and disruption of, existing legacy applications and the security infrastructure, such as public key infrastructure, known as PKI. We provide customers with easier implementations and a more rapid means of implementing security across the enterprise, including the Internet. With security being a critical enabling technology for on-line business initiatives, speed and ease of security implementation has become crucial to an organization's success.
- We design our products and services to have a lower total cost of security ownership than competing products and services. We have found that product improvements and tools that lower a customer's total cost of ownership create differentiating sales and marketing tools, and also help in the development of a highly loyal customer base that is open to new solutions that we offer.

As a result of this approach, we believe that we are positioned to be a leading provider of our open standards-based software and hardware security solutions.

VASCO's Strategy

We believe we have one of the most complete lines of security products and services available in the market today and we intend to become a leading worldwide provider of these products and services. A key element of our growth strategy is to demonstrate to an increasing number of distributors, resellers and systems integrators that, by incorporating our security products into their own products, they can more effectively differentiate themselves in their marketplaces and increase the value of their products. In addition, we demonstrate to our corporate users that our products provide mission critical security to their internal and external security infrastructures. Following this aggressive marketing and promotion effort, we work with these resellers and integrators to support their sales of solutions which include our products. Also, we plan to expand our direct sales marketing program to new and existing blue chip customers.

For example Novell, S-1, Brokat and Intel Network Services (formerly Shiva) have all built support for our products. We currently market to the distribution channels of these companies and are already recognizing increasing revenue as these channels sell our solutions to their end customers. In addition, our SnareWorks product line has a base of customers we market to directly such as Allmerica and 3M. We are aggressively expanding the use of this strategy world wide. Further, we intend to:

Increase Sales and Marketing Efforts Worldwide. We intend to increase sales of our security products and services in our firmly established European markets and to aggressively increase our sales and support presence and marketing efforts in North America, South America, Asia/Pacific, Australia and the Middle East. We plan to:

- market new services and products to our existing customers by providing testimonial evidence of user experiences from other customers;
- launch a worldwide marketing campaign to raise awareness of our solutions among the decision makers in the security products industry;
- form additional strategic relationships with resellers and vendors of complementary, innovative security products and systems; and
- develop a marketing and sales infrastructure in new markets.

Continue Innovation. We intend to continue to enhance and broaden our line of security products to meet the changing needs of our existing and potential customers by:

- building on our core software and hardware security expertise, such as expanding our technology for use on different platforms (like mobile phones and personal digital assistants) and incorporating biometrics into our products;
- acquiring complementary technologies or businesses;
- developing additional applications for our products in areas which may include securing the exchange of data in the healthcare field and providing security for Internet gambling and lottery transactions, among others.

VASCO's Products

Digipass Product Line

Our Digipass product line, which exists as a family of authentication devices as well as extensive software libraries, provides a flexible and affordable means of authenticating users to any network, including the Internet.

Security can be broken into three factors:

- What you have (the Digipass device itself);
- What you know (the PIN code to activate the Digipass); and

- Who you are (biometrics).

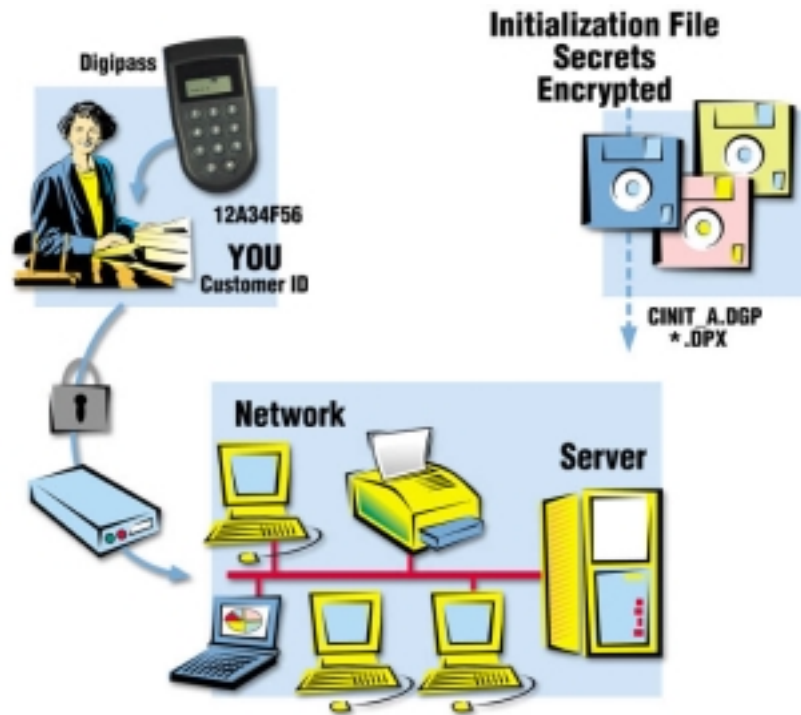
The Digipass family is currently based on the first two factors. We are developing voice technology to incorporate the third factor into the Digipass. Using the Digipass system, in order to enter a remote system or to digitally sign data one needs:

- the hardware device (the token) itself so that if you do not physically have the token, you will not be able to log on to the system; and
- the PIN code for the token so if you do not know the appropriate code the user will not be able to use the applications stored inside.

Both of these factors help to make sure that a natural person is authenticating (or signing), instead of a computer or another device. These factors also enable extremely high portability for security anytime, anywhere and anyhow.

Digipasses calculate dynamic passwords, also known as one-time passwords to authenticate users on a computer network and for a variety of other applications. There are several versions of the Digipass, the 50, 100, 300, 500, 600, 700 and 800, each of which has its own distinct characteristics depending on the platform that they use and the functions they perform. However, the Digipass family is designed to work together and customers can switch their users' devices without requiring any changes to the customers' existing infrastructure. In addition, these devices can be used to calculate digital signatures, also known as electronic signatures or message authentication codes, to protect electronic transactions and guarantee the integrity of the contents of these transactions. In addition, the Digipass 50 is designed to be used on other platforms such as mobile phones and personal digital assistants.

Digipass At Work



The above illustration shows the various steps in the Digipass initialization process. In the first step, the devices are initialized with their unique set of secrets and keys per device. These secrets are stored in an encrypted way on a diskette that is sent to the application owner (for example, the information technology manager in a company or the security department of a bank). These floppy disks are one way of safely transporting the Digipass secrets to the host computer.

The files on the floppy disks will be used to read all the necessary secrets and other data from the delivered Digipasses into a database. Then the application owner will assign those Digipass secrets to the end-users.

This assignment is based on the serial number of the Digipass and the identity of the end-user. The Digipass is then shipped to the end-user together with a manual and, the protected PIN-code on a secure PIN-mailer is sent by a separate shipment.

Using a Digipass requires a connection to the host (server) computer that knows the parameters of the end-user's Digipass. Every time the user sends a dynamic password or digital signature to the host computer, the computer will retrieve all the necessary information from the database and will check the validity of the password or signature. After the host has checked the validity of the dynamic password or signature, it will notify the end-user of the correctness or incorrectness of the validity check.

Digipass security devices are not terminal dependent and do not require any specific software platform since they only interact with a person.

Currently, the Digipass is used in many applications, the largest of which is banking. Different banking applications are:

- corporate banking through direct dial-up, as well as over the Internet and
- retail banking to secure transactions made through the use of a dial-up connection with a personal computer, the traditional phone system, the Internet, and wireless phones and other communication devices such as personal digital assistants.

Another significant application for the Digipass is to secure access to corporate networks for home-based, traveling and other remote users. Finally, Digipasses are increasingly being used in a variety of e-commerce applications where the user is part of a pre-defined user group. We intend to expand the use of the Digipass to other groups of users and applications, including electronic commerce transactions directed at the general public.

Cryptech Product Line. The Cryptech product line produces encrypted microprocessor chips. These chips are used to encrypt data for use in ATMs, fax machines, modems and security servers at high speeds using DES and RSA algorithms.

SnareWorks Product Line

SnareWorks is uniquely positioned to provide the security bridge between the existing software infrastructure of legacy mainframe and client-server applications that are powering large enterprises, and the world of the Web, e-commerce and business-to-business on the Internet. The critical differentiating benefit of SnareWorks is that it fits into existing computing environments transparently because no new programming is required. Not a single line of application code needs to be modified. As a result of its unique design, the SnareWorks product line is the only one in the industry that spans all three architectures (Web, client-server and mainframe) and enables rapid, low-cost, widespread deployment of true, end-to-end security.

We believe that our competitors' products generally require extensive customization and integration which requires a complex and time-consuming deployment effort. In comparison, SnareWorks products are different because of the following key factors:

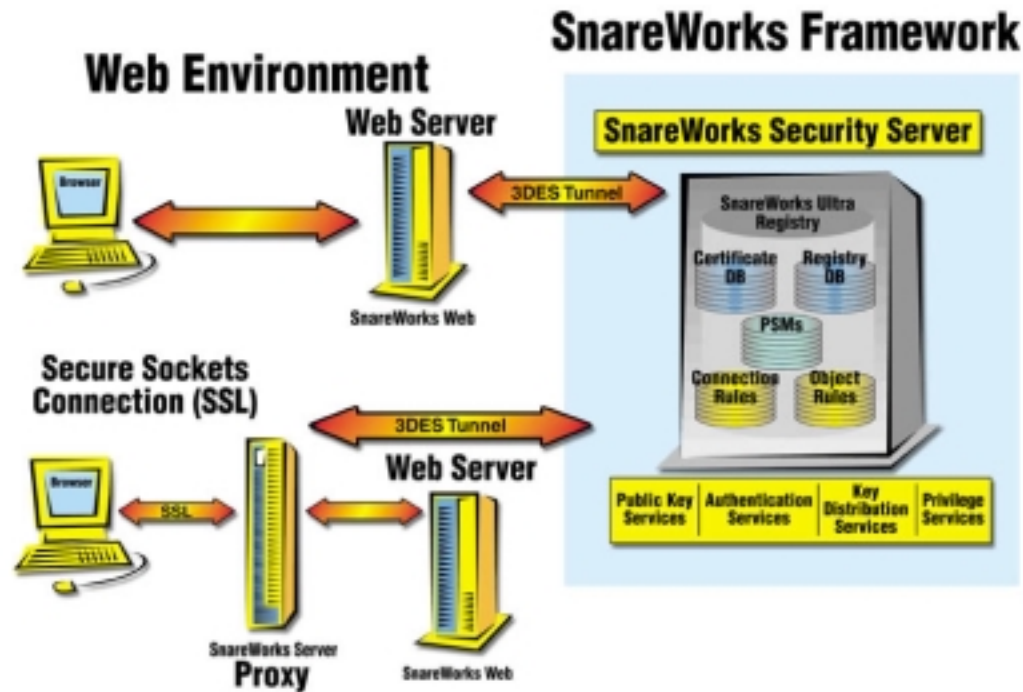
- *Protocol Support Modules.* These are small segments of computer code that represent the knowledge modules that describe the application protocol to SnareWorks. With these small knowledge modules it is possible to teach SnareWorks how to apply state-of-the-art security features to existing applications without requiring any retooling of the applications themselves.
- *Rapid and Flexible Authentication.* SnareWorks enables an enterprise to deploy rapidly a variety of authentication mechanisms, including those available from competitors, on the desktop.
- *True Secure Single Sign-On.* Once initial authentication is achieved, SnareWorks provides single sign-on to a variety of applications, including web-based and desktop-based applications. In the case of Web-servers, a user will not have to log into more than a single web server or application. SnareWorks is different from other competing products because it can adapt to all commonly deployed authorization and authentication methodologies.

Additional key features and benefits of the SnareWorks product line are as follows:

- *Transparent Encryption.* SnareWorks enables strong encryption of all TCP/IP network traffic on every computer in a network simply by installing it. When SnareWorks is involved in the transfer of data, the default is automatically to encrypt all data.
- *Easy Installation.* SnareWorks client or desktop software can be downloaded and installed on desktop computers and web browsers in a matter of minutes, and does not require additional software or alterations to existing application software programs. For Internet-based applications that require only the use of a browser, there is no software to be installed on, or downloaded to, the user's desktop. This feature significantly reduces the time, cost and inconvenience to the customer of securing their networks.
- *Automated User Registration.* SnareWorks provides an automated process to register new users by providing them with their network identity along with their public key certificates without the assistance of a human administrator. This feature allows large companies to deploy SnareWorks more rapidly than it would normally take to deploy a solution of this scope.
- *Scalable Authorization.* Users or groups of related users can be granted access to different portions or applications on a network based upon their SnareWorks profile. SnareWorks is scalable, allowing a virtually unlimited number of groups and users to be efficiently handled by the software. Common groupings of users are made on the basis of their members, roles, locations and/or time of day, among other factors.
- *Log Files Based Auditing.* SnareWorks provides "log files" or detailed records of the activity surrounding a data transfer, including identity of user, time, application accessed and date transferred. These log files are used to monitor and audit network activity by administrators. SnareWorks can create these files even if the applications or software programs do not provide for the creation of log files.
- *Use of Digital Signatures.* A distinctive feature of SnareWorks is its ability to significantly enhance the reliability of applications and data through the use of digital signatures. A digital signature is an authentic piece of data attached to an object. The recipient as well as a third party can verify that the object to which the signature is attached has not been altered since it was signed.
- *Distributed Management.* SnareWorks can be managed from a central location or from over a dozen graphical management editors and viewers to provide a comprehensive view of security in the enterprise.
- *Standards Based.* SnareWorks supports a wide variety of standard encryption devices, including DES, 3DES and SSL, digital signatures (RSA), message integrity (MD5), key management (DCE/Kerberos, RSA), digital certificates (X.509), access control (POSIX), and strong authentication (RADIUS).

SnareWorks At Work

Below is a graphical rendition of how SnareWorks is implemented followed by a description of each of the elements.



SnareWorks Desktop Client is a thin, ultra-lightweight customer package that provides a complete security environment for Internet-based applications residing on a user's desktop. It enables rapid deployment of a comprehensive security solution to thousands of users across multiple server and operating system environments. It provides commercial off-the-shelf products and legacy applications with:

- strong network encryption;
- pluggable authentications;
- a scalable access control model;
- secure single sign-on;
- enforcement of auditing; and
- digital signatures.

SnareWorks Web enables existing Web-based applications to utilize a single network identity for authentication and true single sign-on. It delivers secure authorization using a proven access control model, which enable administrators to control even the most detailed aspects of the Web. SnareWorks Web can be distributed to multiple Web servers across the enterprise and managed from one central node through a sophisticated graphical user interface.

The SnareWorks Certificate Server Security Infrastructure provides certificate management services to the SnareWorks security framework. These services include issuance, revocation, query and reporting services for X.509-based certificates. The Certificate Server supports both Web and command line access to the certificate repository.

SnareWorks Rule Server provides the security services necessary to integrate both Web and non-Web applications into the SnareWorks Framework. These services include:

- network authentication;
- secure single sign-on;
- fine-grain access control;
- network data encryption;
- auditing;
- event notification; and
- enforcement of numerous other security policies.

The SnareWorks Software Development Kit is a set of library files that a developer can use to build extensions to the SnareWorks framework. It is used to develop protocol support modules which enable SnareWorks servers to analyze the behavior and the operation of legacy applications without requiring these applications to be modified. Protocol support modules can provide advanced security features to new or legacy applications. With the SnareWorks Software Development Kit developers can extend SnareWorks to perform a variety of functions for these applications, including:

- automatic login and secure single sign-on;
- operation-to-rule mapping;
- object-to-rule mapping;
- identity transformation;
- digital signatures;
- application verification;
- auditing;
- automated keystroke capture;
- chargeback accounting; and
- authorization products interface.

The SnareWorks Security Server is a highly scalable authentication service that combines the best of security technologies, supporting both secret as well as public key authentication. It provides signed network credentials that form the basis for an enterprise-wide authorization infrastructure that can be applied uniformly to all applications. The Security Server also includes a distributed database for users, groups, roles, policies, passwords and security attributes. It also provides encryption services, key generation and password-strength facilities.

The SnareWorks Administration Console is the control center for the SnareWorks framework. It enables security administrators to perform remote management of SnareWorks servers and is also the primary interface for creating connection and object rules. These rules govern the behavior of all applications and the access rights to all data throughout the SnareWorks framework. The Administration Console includes numerous graphical editors, which enable administrators to control virtually all aspects of SnareWorks from anywhere in the enterprise.

PUBLIC KEY INFRASTRUCTURE

Many corporations are increasingly relying upon digital certificates to authenticate and identify users on a network, including the Internet. In addition, digital certificates are used to transmit data in an encrypted format over a network. The issuance, revocation, management and policies surrounding these digital certificates is commonly referred to as public key infrastructure or PKI. Like any other new comprehensive technology infrastructure, large companies need to integrate PKI into their legacy and new applications. This takes time, money, and specialized, hard-to-find personnel. While there may be significant commercial potential for PKI, the process of integrating PKI into other enterprise-wide applications has proven so difficult that few companies have existing PKI deployments beyond the pilot stage.

For companies that are using certificate authority vendors such as Entrust, Baltimore, or Verisign, SnareWorks interoperates and allows for easy integration of PKI. In addition, for companies that have not committed to a particular certificate authority vendor, SnareWorks provides its own certificate authority capabilities. Finally, as described above, SnareWorks can work with non-PKI related authentication such as tokens, smart cards, and passwords.

We also have patent pending technology that allows for secure storage of a digital certificate's private key on a server that can be accessed from any network using any of our Digipass family of products. The effect of this technology is that it gives digital certificates the portability of PKI deployed on smartcards, without the cost or infrastructure development required for deploying smartcards and their associated smartcard readers.

Intellectual Property and Proprietary Rights and Licenses

We rely on a combination of patent, copyright, trademark and trade secret laws, as well as employee and third-party non-disclosure agreements to protect our proprietary rights. In particular, we hold several patents in the United States and a corresponding patent in certain European countries, which cover certain aspects of our technology. The majority of our patents cover our Digipass family of security tokens. The U.S. patents expire between 2003 and 2010 and the European patent expires in 2008. We believe these patents to be valuable property rights and we rely on the strength of our patents and on trade secret law to protect our intellectual property rights. To the extent that we believe our patents are being infringed upon, we intend to assert vigorously our patent protection rights, including but not limited to, pursuing all available legal remedies.

On March 25, 1998, we entered into an arm's-length license agreement with Lernout & Hauspie Speech Products N.V. pursuant to which we received a five-year world wide, non-exclusive, non-transferable license to use certain speaker verification software in access control applications. For this license, we agreed to pay a royalty of 10% of revenue associated with the software which will be credited against royalty prepayments aggregating \$800,000. On December 31, 1998, the license was extended for an additional 5 years and we made additional royalty prepayments to reach an aggregate of \$1.7 million. In addition, the revised agreement also provides for the initiation of a co-marketing and co-sales effort.

Further, in connection with sales of our SnareWorks product, we offer a SnareTools tool kit pursuant to a perpetual license agreement with Computer Associates dated December 2, 1996, pursuant to which we pay a 2% royalty based on net sales of the product. SnareWorks also contains infrastructure software which is provided by IBM under an original equipment manufacturing agreement dated October 6, 1999, and by Gradient Technologies under an original equipment manufacturing agreement dated July 13, 1999. Both of these agreements are for three-year terms and also provide for small royalty payments based on how our product is configured with the end users. In the ordinary course of our business we have entered, and may periodically enter, into license agreements with software providers, as needed.

Research and Development

Our research and development efforts historically have been, and will continue to be, concentrated on product enhancement, new technology development and related new product introductions. We employ 38 full-time engineers and, from time to time also engage independent engineering firms to conduct non-strategic research and development efforts on our behalf. For the fiscal years ended December 31, 1998, 1999 and 2000, we expended \$2,459,000, \$3,587,000 and \$4,581,000 respectively, on research and development, representing approximately 14.9%, 18.5% and 16.3% of consolidated revenues for 1998, 1999 and 2000, respectively.

While management is committed to enhancing our current product offerings, and introducing new products, we cannot be certain that our research and development activities will be successful. Furthermore, we may not have sufficient financial resources to identify and develop new technologies and bring new products to market in a timely and cost effective manner, and we cannot ensure that any such products will be commercially successful if and when they are introduced.

Production

Our security hardware products are manufactured by third parties pursuant to purchase orders that we issue. Our hardware products are made primarily from commercially available electronic components which are purchased globally. Our software products are produced either in-house or by several outside sources in North America and Europe.

The security tokens utilize commercially available programmable microprocessors, or chips. We use two microprocessors, made by Samsung and Epson, for the various hardware products we produce. The Samsung microprocessors are purchased from Samsung Semiconductor in Belgium, and the Epson microprocessors are purchased from Alcom Electronics NV/SA, also located in Belgium. The microprocessors are the only components of our security tokens that are not commodity items readily available on the open market. While there is an inherent risk associated with each supplier of microprocessors, we believe having two sources reduces the overall risk to a commercially acceptable level.

Orders of microprocessors and some other components generally require a lead time of 12-16 weeks. We attempt to maintain a sufficient inventory of all parts to handle short term increases in orders. Large orders that would significantly deplete our inventory are typically required to be placed with more than 12 weeks of lead time, allowing us to attempt to make appropriate arrangements with our suppliers.

We purchase the majority of our product components and arrange for shipment to third parties for assembly and testing in accordance with our design specifications. Our security token products are assembled exclusively by two independent companies, each of which is based in Hong Kong. Purchases from one of the companies are made on a purchase order by purchase order basis. Purchases from the other company are under a contract with automatic one-year renewals and subject to termination on six months notice. Each of these companies assembles our security tokens at facilities in mainland China. One of the companies also maintains manufacturing capacity in Hong Kong. Equipment designed to test product at the point of assembly is supplied by us and periodic visits are made by our personnel for purposes of quality assurance, assembly process review and supplier relations.

There can be no assurance that we will not experience interruptions in the supply of either the component parts that are used in our products or fully-assembled token devices in general. In the event that the flow of components or finished product was interrupted there could be a considerable delay in finding suitable replacement sources for those components, as well as in replacement assembly subcontractors with the result that our business and results of operations could be adversely affected. For further information about our suppliers, refer to the "Risk Factors" section.

Competition

The market for computer and network security solutions is very competitive and, like most technology-driven markets, is subject to rapid change and constantly evolving products and services. With respect to Digipass, our main competitor is RSA Security, Inc. and with respect to SnareWorks, our main competitor is Netegrity, Inc.. There are many other companies such as Computer Associates International, Inc., AXENT Technologies, Inc., ActivCard and Gradient Technologies, Inc. which offer hardware, software and services that range from simple locking mechanisms to sophisticated encryption technologies. We believe that competition in this market is likely to intensify as a result of increasing demand for security products.

We believe that the principal competitive factors affecting the market for computer and network security products include the strength and effectiveness of the solution, technical features, ease of use, quality/reliability, customer service and support, name recognition, distribution channels and price. Although we believe that our products currently compete favorably with respect to such factors, other than name recognition in certain markets, there can be no assurance that we can maintain our competitive position against current and potential competitors, especially those with significantly greater financial, marketing, service, support, technical and other competitive resources.

Many of our present and potential competitors have significantly greater financial, technical, marketing, purchasing and other resources than we do, and as a result, may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of products, or to deliver competitive products at a lower end user price. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances may emerge and rapidly acquire significant market share.

Our products are designed to allow authorized users access to a computing environment, in some cases using patented technology as a replacement for the static password. Although certain of our security token technologies are patented, there are other organizations that offer token-type password generators incorporating challenge-response or response-only approaches that employ different technological solutions and compete with us for market share. For additional information regarding our competition, please refer to the section titled "Risk Factors."

Sales and Marketing

Our security solutions are sold through our direct sales force, as well as through distributors, resellers and systems integrators. A sales staff of 55 coordinates our sales through both our sales channels and these strategic partners' sales channels and makes direct sales calls either alone or with sales personnel of vendors of computer systems. Our sales staff also provides product education seminars to sales and technical personnel of vendors and distributors with whom we have working relationships and to potential end-users of our products.

Part of our expanded selling effort includes approaching our existing strategic partners to find additional applications for our security products. In addition, our marketing plan calls for the identification of new business opportunities that may require enhanced security over the transmission of electronic data or transactions where we do not currently market our products. Our efforts also include the preparation and dissemination of white papers prepared by our support engineers which explain how we believe our security products can add value or otherwise be beneficial.

Customers and Markets

Customers for our products include some of the world's most recognized names. Customers of Digipass tokens include:

Banking/Financial Services

ABN AMRO Bank
 SNS Bank
 Rabobank Nederland
 SE Banken Sweden

Education

University of Groningen

Other

Honda Europe
 Telindus
 Pekao Infomatyka

A growing number of businesses are using SnareWorks. These include:

Banking/Financial Services

John Hancock
 Allmerica
 UBS/Paine Webber
 Peoples' Bank

Education

Duke University
 Univ of CA – Santa Barbara

Other

U.S. Department of Defense
 Southern California Edison

During 1998, 1999 and 2000, sales to one customer from the Company's United States operations (a reseller of the Company's product in the Netherlands) aggregated approximately \$1,950,000, \$3,533,000 and \$2,844,616 respectively, representing 12%, 18% and 10% of the total revenues, respectively. Accounts receivable from this customer represented 30% and 18% of the Company's gross accounts receivable balance at December 31, 1999 and 2000, respectively. We are aware of the risks associated with this degree of customer concentration and expect to further minimize our reliance on these customers.

Long term contracts with the U.S. government accounted for 4% of revenues for the year 2000. Revenues are only recognized from these contracts when receipt of payment is assured. Future amounts due under the contracts are cancelable by the U.S. government and are not recognized as revenue by the Company.

A significant portion of our sales are denominated in various foreign currencies that could impact results of operations. To minimize exposure to risks associated with fluctuations in currency exchange rates, we attempt to match the timing of delivery, amount of product and the currency denomination of purchase orders from vendors with sales orders to customers.

See Note 10 to VASCO Notes to Consolidated Financial Statements for a breakdown of revenues between U.S. and European operations.

Employees

As of March 13, 2001, we employed 121 full-time employees. Of these, 63 were located in North America and 57 were located in Europe and 1 assigned in Asia/Pacific. Of the total, 64 were involved in sales, marketing and customer support, 39 in product production, research and development and 18 in administration.

Item 2 – Properties

Our corporate offices and North American administrative, sales and marketing, research and development and support facilities are located in the United States in an office complex in Oakbrook Terrace, Illinois, a suburb of Chicago. These facilities are leased through November 30, 2004, and consist of approximately 9,000 square feet. An expansion plan to add 3,000 square feet is scheduled by the end of the second quarter of 2001 to accommodate present growth needs.

Our European administrative, sales and marketing, research and development and support facilities are located in a suburb of Brussels, Belgium. These facilities consist of approximately 23,500 square feet of office space which are occupied under a lease expiring in October 30, 2006. We believe that these facilities are adequate for our present growth plans.

Item 3 – Legal Proceedings

The Company is from time to time involved in litigation incidental to the conduct of its business. The Company is currently not a party to any lawsuit or proceeding which, in the opinion of management, is likely to have a material adverse effect on the Company's business, financial condition or results of operations.

Item 4 – Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of security holders during the fourth quarter of 2000, through solicitation of proxies or otherwise.

PART II

Item 5 - Market for Registrant's Common Equity and Related Stockholder Matters

On March 20, 1998, the Company's Common Stock was approved for trading on the NASD Electronic Bulletin Board system under the symbol "VDSI." On April 7, 2000, the Company's Common Stock was listed on the Nasdaq National Market in the United States under the trading symbol "VDSI".

On March 12, 2001, the closing sale price for the Common Stock on the Nasdaq was \$5.81 per share. Such market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent an actual transaction. On February 28, 2001, there were approximately 125 holders of record of the Common Stock

The following table sets forth the high and low closing bid quotations for the Common Stock for the periods indicated.

	<u>High</u>	<u>Low</u>
1999		
First Quarter.....	5.38	2.97
Second Quarter	4.88	3.50
Third Quarter	3.78	2.94
Fourth Quarter.....	8.75	2.94
2000		
First Quarter.....	26.00	6.44
Second Quarter	21.50	10.00
Third Quarter	16.25	7.75
Fourth Quarter.....	14.38	4.81

The Company has not paid any dividends on its Common Stock since incorporation. Dividends were paid relating to the Company's Series B Preferred Stock, which was converted to Common Stock in September 1997. Restrictions or limitations on the payment of dividends may be imposed under the terms of credit agreements or other contractual obligations. In the absence of such restrictions or limitations, the declaration and payment of dividends will be at the sole discretion of the Board of Directors of the Company and subject to certain limitations under the General Corporation Law of the State of Delaware. The timing, amount and form of dividends, if any, will depend, among other things, on the Company's results of operations, financial condition, cash requirements, plans for expansion and other factors deemed relevant by the Board of Directors. The Company intends to retain any future earnings for use in its business and therefore does not anticipate paying any cash dividends in the foreseeable future.

Item 6 - Selected Financial Data
(in thousands, except per share data)⁽¹⁾

	<u>Year Ended December 31,</u>				
	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
	(unaudited)				
Statements of Operations Data:					
Total revenues	\$ 11,265	\$ 13,208	\$ 16,500	\$ 19,397	\$ 28,066
Operating loss	(8,523) ⁽²⁾	(4,168) ⁽³⁾	(1,327)	(893)	(2,601)
Net loss available to common stockholders	(9,215) ⁽²⁾	(6,242) ⁽³⁾	(3,782)	(2,212)	(4,162)
Basic and diluted loss per common share	\$ (0.47) ⁽²⁾	\$ (0.30) ⁽³⁾	\$ (0.17)	\$ (0.09)	\$ (0.17)
Shares used in computing per share amounts	19,533	21,106	22,431	25,559	27,341
	<u>As of December 31,</u>				
	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
	(unaudited)				
Balance Sheet Data:					
Cash	\$ 1,851	\$ 2,065	\$ 1,662	\$ 2,576	\$ 13,833
Working capital (deficiency)	5,388	(291)	(3,734)	2,473	14,307
Total assets	12,898	9,004	9,557	12,318	29,313
Long term obligations, less current portion	9,289	8,618	8,436	8,409	3,764
Common stock subject to redemption	742	495	-	-	-
Stockholders' equity (deficit)	(843)	(6,746)	(9,660)	(1,037)	17,348

(1) Represents the financial information of VASCO Corp. prior to March 11, 1998, as the Company had not begun operations until the Exchange Offer.

(2) Includes a pretax charge for acquired in-process research and development of \$7,351.

(3) Includes legal, accounting and printing costs of approximately \$1,218 related to preparing for the Exchange Offer that was completed in March 1998.

Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Certain statements contained in the following Management's Discussion and Analysis of Financial Condition and Results of Operations are forward-looking statements. All forward-looking statements included herein are based on information available to the Company on the date hereof and assumptions which the Company believes are reasonable. The Company does not assume any obligation to update any such forward-looking statements. These forward-looking statements involve risks and uncertainties. The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth elsewhere in this Form 10-K and the Company's other filings with the Securities and Exchange Commission.

Background

Our predecessor company, VASCO Corp., entered into the data security business in 1991 through the acquisition of a controlling interest in ThumbScan, Inc., which we renamed VASCO Data Security, Inc. in 1993. In 1996, we began an expansion of our computer security business by acquiring Lintel Security NV/SA, a Belgian corporation, including assets associated with the development of security tokens and security technologies for personal computers and computer networks. In addition, in 1996, we acquired the stock of Digipass NV/SA, a Belgian corporation, which was also a developer of security tokens and security technologies and whose name we changed to VASCO Data Security NV/SA in 1997. All of these acquisitions were accounted for under the purchase method of accounting.

On March 11, 1998, we completed a registered Exchange Offer with the holders of the outstanding securities of VASCO Corp. In the Exchange Offer, holders of the common stock and warrants, options and other rights to acquire common stock of our predecessor company exchanged their securities for the same number and kind of securities of our present company, and released any potential claims that such holders might have had against our predecessor in connection with the issuances of its securities and other corporate actions which occurred mostly during the 1980's. In the Exchange Offer, almost 98% of our predecessor's securities were tendered and accepted for exchange. In October 1998, we completed the merger of our predecessor with and into the current company and thereby eliminated all remaining outstanding securities of our predecessor and our predecessor thereby ceased to exist.

Since the Exchange Offer, we have engaged in three acquisitions. In May 1999, we acquired the assets of SecureWare SA, a French company for a combination of approximately \$1.4 million in our stock and cash.

In October 1999, we acquired Intellisoft Corp. for a combination of approximately \$8 million in our stock and cash distributed to dissenting shareholders. This acquisition was accounted for under the pooling-of-interests method of accounting and, therefore, all of our financial information has been restated to include the results of IntelliSoft.

Our latest acquisition occurred in August 2000 when we acquired Invincible Data Systems (IDS) in a transaction which was accounted for under the pooling-of-interests method. A total of 322,565 shares were issued in the transaction. Our financial information was not restated for this transaction, which was deemed immaterial.

Overview

We design, develop, market and support security products and services which manage and protect against unauthorized access to computer systems of corporate and governmental clients.

Revenue and Earnings. We sell the majority of our products in European countries with significant sales in the United States, although we intend to actively pursue additional markets outside of Europe, particularly South America, Asia/Pacific, Australia and the Middle East.

Revenues from sales from our Digipass family, specifically the Digipass 300 and 500 tokens, continue to represent the majority of our total revenues. During 1998 and 1999, Digipass products accounted for more than 80% of revenues. For 2000, in excess of 70% of the Company's sales were comprised of security token devices. Although we believe it is likely that sales of the Digipass family of tokens, which can be used on various platforms, will continue to account for a majority of our total revenues for the next few years, we also believe that revenues from sales of our other hardware and software data security products, including the SnareWorks product line, will continue to increase in the future. The percentage of revenue from SnareWorks products increased from 9% in 1999 to 20% in 2000.

Research and Development. We are devoting substantial capital and other resources to enhancing our existing security products and developing new products to provide enterprise-wide hardware and software security solutions. Costs of research and development, principally the design and development of hardware and software prior to the determination of technological feasibility, are expensed as incurred on a project-by-project basis. Our software capitalization policy currently defines technological feasibility as a functioning beta test prototype with confirmed manufacturability (a working model), within a reasonably predictable range of costs. Additional criteria include receptive customers, or potential customers, as evidenced by interest expressed in a beta test prototype, at some suggested selling price.

Variations in Operating Results. Our quarterly operating results have in the past varied and may in the future vary significantly. Factors affecting operating results include:

- the level of competition;
- the size, timing, cancellation or rescheduling of significant orders; market acceptance of new products and product enhancements;
- new product announcements or introductions by our competitors;
- adoption of new technologies and standards; changes in pricing by us or our competitors;
- our ability to develop, introduce and market new products and product enhancements on a timely basis, if at all;
- component costs and availability;
- our success in expanding our sales and marketing programs;
- technological changes in the market for data security products;
- foreign currency exchange rates;
- and general economic trends and other factors.

In addition, we have experienced, and may experience in the future, long sales cycles due to the size of our contracts and the timing of when our customers take delivery of our products. We also experience seasonality in our business. These seasonal trends have included higher revenue in the last quarter of the calendar year and lower revenue in the next succeeding quarter. We believe that revenue has tended to be higher in the last quarter due to the tendency of certain customers to implement or complete changes in computer or network security prior to the end of the calendar year. In addition, revenue has tended to be lower in the summer months, particularly in Europe, when many businesses defer purchase decisions. Because our operating expenses are based on anticipated revenue levels and a high percentage of our expenses are fixed, a small variation in the timing of recognition of revenue could cause significant variations in operating results from quarter to quarter.

Currency Fluctuations. The majority of our supply and sales transactions are denominated in U.S. dollars, however, a significant portion of those transactions are denominated in various foreign currencies. In order to reduce the risks associated with fluctuations in currency exchange rates, we attempt to match the timing of delivery, amount of product and the currency denomination of purchase orders received from vendors with sales orders to customers.

The financial position and results of operations of the Company's foreign subsidiaries are measured using the local currency as the functional currency. Accordingly, assets and liabilities are translated into U.S. dollars using current exchange rates as of the balance sheet date. Revenues and expenses are translated at average exchange rates prevailing during the year. Translation adjustments arising from differences in exchange rates are included as a separate component of stockholders' equity (deficit). Gains and losses resulting from foreign currency transactions are included in the consolidated statements of operations. Foreign exchange transaction losses aggregating \$174,000, \$272,000 and \$289,000 are included in other non-operating expense for 1998, 1999, and 2000, respectively.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain consolidated financial data as a percentage of revenues for the years ended December 31, 1998, 1999 and 2000.

	Percentage of Revenue					
	Year Ended December 31,					
	<u>1998</u>		<u>1999</u>		<u>2000</u>	
Revenues	100.0	%	100.0	%	100.0	%
Cost of goods sold.....	43.7		37.7		35.9	
Gross profit	<u>56.3</u>		<u>62.3</u>		<u>64.1</u>	
Operating costs:						
Sales and marketing	28.9		30.7		35.4	
Research and development.....	14.9		18.5		16.3	
General and administrative.....	20.5		17.7		19.8	
Non-cash compensation	-		-		1.8	
Total operating costs	<u>64.3</u>		<u>66.9</u>		<u>73.3</u>	
Operating loss.....	(8.0)		(4.6)		(9.2)	
Interest expense.....	(8.8)		(4.2)		0.1	
Other expense, net.....	(1.9)		(0.9)		(4.3)	
Loss before income taxes	<u>(18.7)</u>		<u>(9.7)</u>		<u>(13.4)</u>	
Provisions for income taxes	4.2		1.7		1.4	
Net loss.....	<u>(22.9)</u>		<u>(11.4)</u>		<u>(14.8)</u>	

The following discussion is based upon the Company's consolidated results of operations for the years ended December 31, 2000, 1999 and 1998 (percentages in the discussion are rounded to the closest full percentage point) and should be read in conjunction with our consolidated financial statements included elsewhere in this Form 10-K.

1999 COMPARED TO 2000

Revenues

Our consolidated revenues for the year ended December 31, 2000 were \$28,066,000, an increase of \$8,669,000, or 45%, as compared to the year ended December 31, 1999. This increase is due to a strong performance from international operations, as the demand for Digipass products continues to grow, resulting in increased unit sales, as well as increasing orders with smaller quantities and less volume discounting. Also, sales of SnareWorks products in the U.S. more than doubled 1999 revenues. The European operations contributed \$17,000,000 or 61% of total consolidated revenues, with the United States operations contributing the remaining \$11,066,000 or 39%.

Cost of Goods Sold

Our consolidated cost of goods sold for the year ended December 31, 2000 was \$10,069,000, an increase of \$2,763,000, or 38%, as compared to the year ended December 31, 1999. Cost of goods sold has not increased at the same rate as our revenues primarily due to product sales mix and also from efficiencies in the manufacturing process, as well as the increasing demand for products with a more favorable cost structure.

Gross Profit

Our consolidated gross profit for the year ended December 31, 2000 was \$17,997,000, an increase of \$5,905,000, or 49%, over the year ended December 31, 1999. This represents a gross margin of 64% compared to 1999's consolidated gross margin of 62%. The increase in gross margin is due to product sales mix as SnareWorks products provide higher gross margins.

Sales and Marketing Expenses

Consolidated sales and marketing expenses for the year ended December 31, 2000 were \$9,954,000, an increase of \$3,992,000, or 67%, over 1999. This increase can be attributed to increased sales efforts including increased travel costs, headcount, and an increase in marketing activities, including tradeshows and advertising. Sales and marketing headcount increased from 44 at the end of 1999 to 61 at the end of 2000.

Research and Development Expenses

Consolidated research and development costs for the year ended December 31, 2000 were \$4,581,000, an increase of \$994,000, or 28%, as compared to the year ended December 31, 1999. Most of this increase is due to activities relating to the development of the SnareWorks product line.

General and Administrative Expenses

Consolidated general and administrative expenses for the year ended December 31, 2000 were \$5,561,000, an increase of \$2,126,000, or 62%, over 1999. This increase can be attributed to growth in infrastructure needed to support our growth, increased recruiting expenses and amortization charges related to royalties. Administrative headcount increased from 12 at the end of 1999 to 18 at the end of 2000. In addition, the Company recorded approximately \$150,000 of merger costs in 2000 related to the Invincible Data Systems transaction.

Interest Income (Expense)

Consolidated interest income, net in 2000 was \$29,000 compared to interest expense, net of \$815,000 in 1999. Interest income from the proceeds generated upon the issuance of convertible preferred stock offset interest expense related to borrowings. See "Liquidity and Capital Resources" below. Additionally, interest expense from debt outstanding decreased as long-term debt was reduced from \$8,409,000 at the end of 1999 to \$3,764,000 at the end of 2000.

Income Taxes

We recorded tax expense for the year ended December 31, 2000 of \$395,000, which relates to one of our European subsidiaries.

At December 31, 2000, we have United States net operating loss carryforwards approximating \$12,500,000 and foreign net operating loss carryforwards approximating \$2,000,000. Such losses are available to offset our future taxable income in the respective jurisdictions and expire in varying amounts beginning in 2002 and continuing through 2020. In addition, if certain substantial changes in ownership are deemed to have occurred, there would be an annual limitation on the amount of the U.S. carryforwards which could be utilized.

1998 COMPARED TO 1999

Revenues

Our consolidated revenues for the year ended December 31, 1999 were \$19,397,000, an increase of \$2,897,000, or 18%, as compared to the year ended December 31, 1998. This increase was due to a strong performance from international operations, as the demand for Digipass 300 and Digipass 500 grew, resulting in increased unit sales, as well as increased orders with smaller quantities and less volume discounting.

Cost of Goods Sold

Our consolidated cost of goods sold for the year ended December 31, 1999 was \$7,306,000, an increase of \$97,000, or 1%, as compared to the year ended December 31, 1998. This increase was consistent with the increase in revenues for the year, further compounded by benefits from efficiencies in the manufacturing process, as well as the increased demand for products with a more favorable cost structure.

Gross Profit

Our consolidated gross profit for the year ended December 31, 1999 was \$12,091,000, an increase of \$2,800,000, or 30%, over the year ended December 31, 1998. This represents a gross margin of 62%, as compared to 1998's consolidated gross margin of 56%. The increase in gross margin was due to efficiencies in manufacturing related to increased volumes, an increase in the mix of sales of higher margin products, as well as increased orders with smaller quantities, and less volume discounting.

Sales and Marketing Expenses

Consolidated sales and marketing expenses for the year ended December 31, 1999 were \$5,962,000, an increase of \$1,189,000, or 25%, over 1998. This increase can be attributed to increased sales efforts including, in part, increased travel costs, headcount, and an increase in marketing activities, including tradeshow. Additionally, the acquisition of IntelliSoft in October 1999 resulted in additional headcount, as the sales operations were expanded in the fourth quarter of 1999.

Research and Development Expenses

Consolidated research and development costs for the year ended December 31, 1999 were \$3,587,000, an increase of \$1,128,000, or 46%, as compared to the year ended December 31, 1998. This increase was, in part, related to the acquisition of SecureWare during 1999. As SecureWare is primarily a development center, the acquisition resulted in increased research and development headcount and expenditures. Additionally, during 1999, we entered into a development agreement with Intel Network Systems, Inc. related to the further enhancement of the VACMAN product line.

General and Administrative Expenses

Consolidated general and administrative expenses for the year ended December 31, 1999 were \$3,435,000, an increase of \$50,000, or 1%, over 1998. This increase can be attributed to growth in infrastructure needed to support our growth, as well as the impact of the acquisition of SecureWare during 1999.

Interest Expense

Consolidated interest expense in 1999 was \$815,000 compared to \$1,458,000 in 1998. The decrease can be attributed to a lower borrowing base being maintained during 1999 as compared to the prior year. See "Liquidity and Capital Resources" below.

Income Taxes

We recorded tax expense for the year ended December 31, 1999 of \$322,000, which relates to one of our European subsidiaries.

RECENT DEVELOPMENTS

On February 2, 2001, the Company entered into a Letter of Intent to purchase all of the outstanding stock of Identikey, Ltd., a software company headquartered in Brisbane, Australia. The terms of the agreement provide for an initial purchase price of 406,667 shares of common stock and a contingent purchase price of additional shares of common stock based on targeted sales over a 15 month period. The maximum number of additional shares that can be earned is based upon \$12,750,000 and a price of the greater of 80% of the average closing price of the stock for the 10 days preceding the end of the measurement period, or \$7.50 per share. The revenues of Identikey, Ltd., for the year 2000 were immaterial in relation to the Company's revenues. The transaction is expected to close by April 2001 and will be accounted for under the purchase method.

The effect of this transaction on operating income before amortization of goodwill and on cash flow during the next twelve months is largely related to the amount of revenues that can be generated from their product sales. The Company anticipates that the sales of their products will not generate positive operating income before amortization of goodwill or positive cash flow for the first twelve months after the acquisition.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2000, our aggregate consolidated indebtedness was \$4,126,000. Cash used in operating activities was \$2,150,000 for the year ended December 31, 2000. During that period we used \$3,474,000 in investing activities and financing activities provided \$17,282,000. Capital expenditures were \$3,474,000 for the year ended December 31, 2000.

In 1996, we issued a 9% convertible note to Kyoto Securities, Ltd., a Bahamian corporation, in the amount of \$5,000,000. The note provided for quarterly interest payments and was payable in full on May 29, 2001. The note was convertible into shares of our Common Stock at a conversion price of \$12.00 per share, or 416,667 shares. In April 2000, the note and accrued interest were converted into 435,910 shares of common stock.

In 1997, we entered into a convertible loan agreement with Artesia Bank N.V., formerly Banque Paribas Belgique S.A., in order to refinance the \$3,400,000 payment due December 31, 1997 in connection with our acquisition of Digipass. The terms of the agreement provide that the \$3,400,000 principal amount is convertible, upon an offering, into shares of our Common Stock. This loan bears interest at the rate of 3.25%, payable annually, and matures on September 30, 2002. After January 1, 1999, the loan is convertible at the average closing market price for shares of our Common Stock on the NASD Electronic Bulletin Board system for the 20 trading days prior to the date of the notice of conversion, less 10%. In the event a public offering is completed, the lender may at its option (by written notice within seven days after our receipt of the proceeds of the public offering) require the principal amount of the loan to be repaid in cash, in which case additional special interest is payable as follows: \$680,000 if repayment is on January 1, 1999 or later.

In April 1999, we completed a private placement of Common Stock in the amount of \$11.5 million. The transaction represented a sale of our Common Stock to European institutional investors at a price of \$3.50 per share. A total of 3,285,714 shares of Common Stock were issued as a part of this transaction.

During the first quarter of 2000, the Company filed a registration statement in connection with an offering of its Common Stock to the public. On April 13, 2000, the Company terminated this offering due to the volatility of market conditions. Costs related to this offering of \$1,331,000 were written off and included in other expense in the consolidated statement of operations.

In July 2000, the Company issued 150,000 shares of preferred stock for cash of \$15,000,000. The preferred stock is convertible into 1,052,632 shares of Common Stock at any time over the next 48 months.

The net effect of 2000 activity resulted in an increase in cash of \$11,256,000, resulting in a cash balance of \$13,833,000 at December 31, 2000, compared to \$2,576,000 at the end of 1999. Our working capital at December 31, 2000 was \$14,307,000, an increase of \$11,834,000, or 479% from \$2,473,000 at December 31, 1999. The majority of the change is attributable to the issuance of preferred stock. Our current ratio was 2.7 to 1.0 at December 31, 2000. We believe that our current cash balances and anticipated cash generated from operations will be sufficient to meet our anticipated cash needs for the foreseeable future.

We intend to seek acquisitions of businesses, products and technologies that are complementary or additive to ours. There can be no assurance that any such acquisitions will be made.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Financial Accounting Standards Board Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions Involving Stock Compensation," an interpretation of Accounting Principles Board Opinion No. 25, was effective for financial statements beginning after July 1, 2000. The Company has evaluated the impact of this pronouncement on its financial statements and has recorded a charge as part of its operating expenses as "Non-cash compensation". The Company has determined that options granted to two full-time executive officers are deemed non-employees under FIN No. 44 because their services are rendered under consulting agreements. This resulted in compensation expense charges of \$501,743 in 2000. These options were accounted for using variable plan accounting and the amounts of future compensation expense will be determined based upon the Company's stock price at each reporting date.

During 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities"), which is effective for all fiscal years beginning after June 15, 2000. SFAS No. 133 establishes a comprehensive standard for the recognition and measurement of derivative instruments

and hedging activities. We do not expect the adoption of the new standard to have a material effect on our consolidated financial position, liquidity, or results of operations.

Item 7A - Quantitative and Qualitative Disclosures About Market Risk.

Approximately 61% of our business is conducted outside the United States, in Europe and Asia/Pacific. A significant portion of our business operations are transacted in foreign currencies. As a result, we have exposure to foreign exchange fluctuations. We are affected by both foreign currency translation and transaction adjustments. Translation adjustments result from the conversion of the foreign subsidiaries' balance sheets and income statements to U.S. dollars at year-end exchange rates and weighted average exchange rates, respectively. Translation adjustments resulting from this process are recorded directly into stockholders' equity. Transaction adjustments result from currency exchange movements when a foreign subsidiary transacts business in a currency that differs from its local currency. These transactions are recorded as gains or losses in our statement of operations.

Our foreign exchange exposure was minimized in 2000 as the majority of our foreign subsidiaries' business transactions were spread across approximately 50 different countries and currencies. This geographic diversity reduces the risk to our operating results. Also, we perform periodic reviews of outstanding balances and settle intercompany accounts to minimize foreign exchange transaction gains and losses.

We have minimal interest rate risk. Our \$3.4 million long-term debt has a fixed rate of 3.25%, which is not subject to market fluctuations. This note matures in September 2002.

Item 8 - Financial Statements and Supplementary Data

The information in response to this item is included in our consolidated financial statements, together with the report thereon of KPMG LLP, appearing on pages F-1 through F-17 of this Form 10-K, and in Item 7 under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

PART III

Item 10 - Directors and Executive Officers of the Registrant

The sections entitled "Election of Directors" and "Section 16(a) Beneficial Ownership Report Compliance" contained in the Company's Proxy Statement for the Annual Meeting of Stockholders to be held on June 12, 2001, are incorporated herein by reference.

Item 11 - Executive Compensation

The section entitled "Executive Compensation" contained in the Company's Proxy Statement for the Annual Meeting of Stockholders to be held on June 12, 2001, is incorporated herein by reference.

Item 12 - Security Ownership of Certain Beneficial Owners and Management

The section entitled "Security Ownership of Certain Beneficial Owners and Management" contained in the Company's Proxy Statement for the Annual Meeting of Stockholders to be held on June 12, 2001, is incorporated herein by reference.

Item 13 - Certain Relationships and Related Transactions

None.

PART IV

Item 14 - Exhibits, Financial Statement Schedules, and Reports on Form 8-K

- a. (1) The following consolidated financial statements and notes thereto, and the related independent auditors' report, are included on pages F-1 through F-17 of this Form 10-K:

Independent Auditors' Report

Consolidated Balance Sheets as of December 31, 1999 and 2000

Consolidated Statements of Operations for the Years Ended December 31, 1998, 1999 and 2000

Consolidated Statements of Comprehensive Loss for the Years Ended December 31, 1998, 1999 and 2000

Consolidated Statements of Stockholders' Equity (Deficit) for the Years Ended December 31, 1998, 1999 and 2000

Consolidated Statements of Cash Flows for the Years Ended December 31, 1998, 1999 and 2000

Notes to Consolidated Financial Statements

- (2) The following consolidated financial statement schedule of the Company is included on this Form 10-K:

Schedule II – Valuation and Qualifying Accounts

All other financial statement schedules are omitted because such schedules are not required or the information required has been presented in the aforementioned consolidated financial statements.

- (3) The following exhibits are filed with this Form 10-K or incorporated by reference as set forth in the next page:

EXHIBIT INDEX

Exhibit Number	Description
+3.1	Certificate of Incorporation of Registrant, as amended.
++3.2	Bylaws of Registrant, as amended and restated.
4.1	Intentionally Omitted.
+4.2	Specimen of Registrant's Common Stock Certificate.
4.3	Intentionally Omitted.
+4.4	Form of Letter of Transmittal and Release.
+4.5	Form of Registrant's Warrant Agreement.
+4.6	Form of Registrant's Option Agreement.
+4.7	Form of Registrant's Convertible Note Agreement.
+10.1	Netscape Communications Corporation OEM Software Order Form dated March 18, 1997 between VASCO Data Security, Inc. and Netscape Communications Corporation.**
+10.2	License Agreement between VASCO Data Security, Inc. and SHIVA Corporation effective June 5, 1997.**
+10.3	Heads of Agreement between VASCO Data Security International, Inc., VASCO Data Security Europe S.A., Digiline International Luxembourg, Digiline S.A., Digipass S.A., Dominique Colard and Tops S.A. dated May 13, 1996.
+10.4	Agreement relating to additional terms and conditions to the Heads of Agreement dated July 9, 1996, among the parties listed in Exhibit 10.3.
+10.5	Agreement between VASCO Data Security International, Inc., VASCO Data Security Europe SA/NV, Mario Houthoof and Guy Denudt dated March 1, 1996.
+10.6	Asset Purchase Agreement dated as of March 1996 by and between Lintel Security SA/NV and Lintel SA/NV, Mario Houthoof and Guy Denudt.
+10.7	Management Agreement dated January 31, 1997 between LINK BVBA and VASCO Data Security NV/SA (concerning services of Mario Houthoof).
+10.8	Sublease Agreement by and between VASCO Data Security International, Inc. and APL Land Transport Services, Inc. dated as of August 29, 1997.
+10.9	Office Lease by and between VASCO Data Security International, Inc. and LaSalle National Bank, not personally, but as Trustee under Trust Agreement dated September 1, 1997, and known as Trust Number 53107, dated July 22, 1985.
+10.10	Lease Agreement by and between TOPS S.A. and Digipass S.A. effective July 1, 1996.
+10.11	Lease Agreement by and between Perkins Commercial Management Company, Inc. and VASCO Data Security, Inc. dated November 21, 1995.
+10.12	Asset Purchase Agreement by and between VASCO Data Security International, Inc. and Wizdom Systems, Inc. dated August 20, 1996.
+10.13	1997 VASCO Data Security International, Inc. Stock Option Plan, as amended.

Exhibit Number	Description
+10.14	Distributor Agreement between VASCO Data Security, Inc. and Hucom, Inc. dated June 3, 1997.**
+10.15	Non-Exclusive Distributor Agreement by and between VASCO Data Security, Inc. and Concord-Eracom Nederland BV dated May 1, 1994.**
+10.16	Banque Paribas Belgique S. A. Convertible Loan Agreement for \$3.4 million.
+10.17	Pledge Agreement dated July 15, 1997 by and between T. Kendall Hunt and Banque Paribas Belgique S.A.
+10.18	Engagement Letter between Banque Paribas S.A. and VASCO Data Security International, Inc. dated June 20, 1997, as amended.
+10.19	Financing Agreement between Generale Bank and VASCO Data Security International, Inc. dated as of June 27, 1997.
+10.20	Letter Agreement between Generale Bank and VASCO Data Security International, Inc. dated June 26, 1997.
+10.21	Form of Warrant dated June 16, 1997 (with Schedule).
+10.22	Form of Warrant dated October 31, 1995 (with Schedule).
+10.23	Form of Warrant dated March 7, 1997 (with Schedule).
+10.24	Form of Warrant dated August 13, 1996 (with Schedule).
+10.25	Form of Warrant dated June 27, 1996 (with Schedule).
+10.26	Form of Warrant dated June 27, 1996 (with Schedule).
+10.27	Convertible Note in the principal amount of \$500,000.00, payable to Generale de Banque dated July 1, 1997 (with Schedule).
+10.28	Agreement by and between VASCO Data Security NV/SA and S.I. Electronics Limited effective January 21, 1997.**
+10.29	Agreement effective May 1, 1993 by and between Digipass s.a. and Digiline s.a.r.l.
+10.30	VASCO Data Security, Inc. purchase order issued to National Electronic & Watch Co. LTD. **
+10.31	VASCO Data Security, Inc. purchase order issued to Micronix Integrated Systems.**
+10.32	Agreement between Registrant and VASCO Data Security International, Inc. dated as of August 25, 1997.
+10.33	Convertible Note dated June 1, 1996 made payable to Mario Houthoof in the principal amount of \$373,750.00.
+10.34	Convertible Note dated June 1, 1996 made payable to Guy Denudt in the principal amount of \$373,750.00.

**Exhibit
Number**

Description

-
- +10.35 Osprey Partners Warrant (and Statement of Rights to Warrant and Form of Exercise) issued June 1, 1992.
 - +10.36 Registration Rights Agreement dated as of October 19, 1995 between certain purchasing shareholders and VASCO Data Security International, Inc.
 - +10.37 First Amendment to Registration Rights Agreement dated July 1, 1996.
 - +10.38 Second Amendment to Registration Rights Agreement dated March 7, 1997.
 - +10.39 Purchase Agreement by and between VASCO Data Security International, Inc. and Kyoto Securities Ltd.
 - +10.40 Convertible Note dated May 28, 1996 payable to Kyoto Securities, Ltd. in principal amount of \$5 million.
 - +10.41 Amendment to Purchase Agreement and Convertible Note by and between VASCO Data Security International, Inc. and Kyoto Securities, Ltd.
 - +10.42 Executive Incentive Compensation Plan.
 - +10.43 Letter for Credit granted by Generale de Banque to Digipass SA dated January 27, 1997.
 - ++10.44 License Agreement dated as of March 25, 1998 by and between VASCO Data Security International, Inc., for itself and its subsidiaries, and Lernout & Hauspie Speech Products N.V.
 - ++10.45 Loan Agreement dated as of March 31, 1998 by and between Lernout & Hauspie Speech Products N.V. and VASCO Data Security International, Inc.
 - ++10.46 Convertible Note dated April 1, 1998 payable to Lernout & Hauspie Speech Products N.V. in the principal amount of \$3 million.
 - #10.47 Amendment I dated as of December 31, 1998 to the License Agreement dated as of March 25, 1998 by and between VASCO Data Security International, Inc., for itself and its subsidiaries, and Lernout & Hauspie Speech Products N.V.
 - 21 Subsidiaries of Registrant.
 - 23 Consent of KPMG LLP.

+ Incorporated by reference to the Registrant's Registration Statement on Form S-4, as amended (Registration No. 333-35563), originally filed with the Securities and Exchange Commission on September 12, 1997.

++ Incorporated by reference to the Registrant's Annual Report on Form 10-K, originally filed with the Securities and Exchange Commission on May 5, 1998.

Incorporated by reference to the Registrant's Annual Report on Form 10-K, originally filed with the Securities and Exchange Commission on April 14, 1999.

** Confidential treatment has been granted for the omitted portions of this document.

VASCO Data Security International, Inc. will furnish any of the above exhibits to its stockholders upon written request addressed to the Secretary at the address given on the cover page of this Form 10-K. The charge for furnishing copies of the exhibits is \$.25 per page, plus postage.

(b) Reports on Form 8-K

No reports on Form 8-K have been filed by the Registrant during the quarter ended December 31, 2000.

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INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
VASCO Data Security International, Inc.:

We have audited the accompanying consolidated balance sheets of VASCO Data Security International, Inc. and subsidiaries (the "Company") as of December 31, 1999 and 2000 and the related consolidated statements of operations, comprehensive loss, stockholders' equity (deficit), and cash flows for each of the years in the three-year period ended December 31, 2000. In connection with our audits of the consolidated financial statements, we have also audited the accompanying consolidated financial statement Schedule II – Valuation and Qualifying Accounts. These consolidated financial statements and the consolidated financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and the consolidated financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of VASCO Data Security International, Inc. and subsidiaries as of December 31, 1999 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Chicago, Illinois
February 23, 2001

VASCO Data Security International, Inc.
CONSOLIDATED BALANCE SHEETS

	December 31, <u>1999</u>	December 31, <u>2000</u>
ASSETS		
Current assets:		
Cash	\$ 2,576,494	\$ 13,832,645
Accounts receivable, net of allowance for doubtful accounts of \$120,216 in 1999 and \$286,377 in 2000	2,871,367	6,486,397
Inventories, net	805,382	1,111,751
Prepaid expenses	157,620	463,094
Deferred income taxes	83,000	83,000
Other current assets	<u>925,334</u>	<u>532,081</u>
Total current assets	7,419,197	22,508,968
Property and equipment		
Furniture and fixtures	1,246,555	1,350,616
Office equipment	<u>1,013,870</u>	<u>4,043,015</u>
	2,260,425	5,393,631
Accumulated depreciation	<u>(1,070,046)</u>	<u>(1,596,102)</u>
	1,190,379	3,797,529
Goodwill, net of accumulated amortization of \$3,134,000 in 1999 and \$3,697,456 in 2000	1,989,960	1,438,537
Other assets	<u>1,718,493</u>	<u>1,568,285</u>
Total assets	<u><u>\$ 12,318,029</u></u>	<u><u>\$ 29,313,319</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Current maturities of long-term debt	\$ 639,322	\$ 362,250
Accounts payable	2,020,465	2,790,698
Deferred revenue	803,270	1,950,322
Other accrued expenses	<u>1,482,970</u>	<u>3,098,284</u>
Total current liabilities	4,946,027	8,201,554
Long-term debt, including stockholder note of \$5,000,000 in 1999 and \$0 in 2000, net of current maturities	8,408,862	3,763,858
Stockholders' equity (deficit):		
Common stock, \$.001 par value - 75,000,000 shares authorized; 26,462,083 shares issued and outstanding in 1999 27,866,583 shares issued and outstanding in 2000	26,462	27,867
Series C Convertible Preferred Stock, \$.01 par value - 500,000 shares authorized; 150,000 shares issued and outstanding in 2000	-	6,780,098
Additional paid-in capital	20,702,387	36,871,200
Accumulated deficit	(21,873,340)	(26,035,112)
Accumulated other comprehensive income- cumulative translation adjustment	<u>107,631</u>	<u>(296,146)</u>
Total stockholders' equity (deficit)	<u>(1,036,860)</u>	<u>17,347,907</u>
Total liabilities and stockholders' equity (deficit)	<u><u>\$ 12,318,029</u></u>	<u><u>\$ 29,313,319</u></u>

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.
CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Years Ended December 31,		
	1998	1999	2000
Net revenues	\$ 16,499,866	\$ 19,397,108	\$ 28,065,680
Cost of goods sold	<u>7,209,038</u>	<u>7,305,672</u>	<u>10,068,969</u>
Gross profit	9,290,828	12,091,436	17,996,711
Operating costs:			
Sales and marketing (exclusive of \$152,545 reported below as non-cash compensation)	4,773,153	5,961,970	9,953,598
Research and development	2,459,477	3,587,483	4,581,001
General and administrative (exclusive of \$349,198 reported below as non-cash compensation)	3,384,853	3,434,940	5,560,995
Non-cash compensation	-	-	501,743
Total operating costs	<u>10,617,483</u>	<u>12,984,393</u>	<u>20,597,337</u>
Operating loss	(1,326,655)	(892,957)	(2,600,626)
Interest income (expense)	(1,457,627)	(814,923)	29,334
Other expense, net	<u>(310,728)</u>	<u>(182,294)</u>	<u>(1,195,234)</u>
Loss before income taxes	(3,095,010)	(1,890,174)	(3,766,526)
Provision for income taxes	<u>687,002</u>	<u>322,310</u>	<u>395,246</u>
Net loss	(3,782,012)	(2,212,484)	(4,161,772)
Preferred stock accretion	<u>-</u>	<u>-</u>	<u>(581,992)</u>
Net loss available to common stockholders	<u>\$ (3,782,012)</u>	<u>\$ (2,212,484)</u>	<u>\$ (4,743,764)</u>
Basic and diluted net loss per common share	<u>\$ (0.17)</u>	<u>\$ (0.09)</u>	<u>\$ (0.17)</u>
Weighted average common shares outstanding	<u>\$ 22,430,684</u>	<u>\$ 25,558,847</u>	<u>\$ 27,341,439</u>

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

	For the Years Ended December 31,		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
Net loss	\$ (3,782,012)	\$ (2,212,484)	\$ (4,161,772)
Other comprehensive income (loss) - cumulative translation adjustment	<u>257,143</u>	<u>20,650</u>	<u>(403,777)</u>
Comprehensive loss	<u>\$ (3,524,869)</u>	<u>\$ (2,191,834)</u>	<u>\$ (4,565,549)</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

Description	Preferred Stock		Common Stock		APIC	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity(Deficit)
	Shares	Amount	Shares	Amount				
Balance at 12/31/97	-	\$ -	22,132,960	\$ 22,133	\$ 9,280,774	\$ (15,878,844)	\$ (170,162)	\$ (6,746,099)
Net loss	-	-	-	-	-	(3,782,012)	-	(3,782,012)
Foreign currency translation adjustment	-	-	-	-	-	-	257,143	257,143
Exercise of stock options	-	-	658,257	658	115,689	-	-	116,347
Exercise of stock warrants	-	-	14,472	15	(15)	-	-	-
Expiration of put option	-	-	-	-	494,668	-	-	494,668
Balance at 12/31/98	-	\$ -	22,805,689	\$ 22,806	\$ 9,891,116	\$ (19,660,856)	\$ 86,981	\$ (9,659,953)
Net loss	-	-	-	-	-	(2,212,484)	-	(2,212,484)
Foreign currency translation adjustment	-	-	-	-	-	-	20,650	20,650
Exercise of stock options	-	-	158,000	158	44,067	-	-	44,225
Exercise of stock warrants	-	-	200,000	200	49,800	-	-	50,000
Issuance of common stock	-	-	3,486,308	3,486	11,468,791	-	-	11,472,277
Common stock repurchased and retired	-	-	(187,914)	(188)	(751,387)	-	-	(751,575)
Balance at 12/31/99	-	\$ -	26,462,083	\$ 26,462	\$ 20,702,387	\$ (21,873,340)	\$ 107,631	\$ (1,036,860)
Net loss	-	-	-	-	-	(4,161,772)	-	(4,161,772)
Foreign currency translation adjustment	-	-	-	-	-	-	(403,777)	(403,777)
Exercise of stock options	-	-	342,400	342	556,871	-	-	557,213
Exercise of stock warrants	-	-	303,625	304	1,724,413	-	-	1,724,717
Conversion of note and interest to common stock	-	-	435,910	436	5,164,618	-	-	5,165,054
Common stock issued for acquisition	-	-	322,565	323	1,266	-	-	1,589
Issuance of Series C Convertible Preferred Stock and warrants	150,000	6,198,106	-	-	8,801,894	-	-	15,000,000
Preferred stock accretion	-	581,992	-	-	(581,992)	-	-	-
Non-cash compensation	-	-	-	-	501,743	-	-	501,743
Balance at 12/31/00	150,000	\$ 6,780,098	27,866,583	\$ 27,867	\$ 36,871,200	\$ (26,035,112)	\$ (296,146)	\$ 17,347,907

See accompanying notes to consolidated financial statements.

Vasco Data Security International, Inc.
CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Years ended December 31,		
	1998	1999	2000
Cash flows from operating activities:			
Net loss	\$ (3,782,012)	\$ (2,212,484)	(4,161,772)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,027,431	1,066,144	1,415,763
Common stock issued for interest	-	-	165,054
Loss on disposal of fixed assets	5,013	-	2,073
Gain on sale of fixed assets	-	(13,318)	-
Non-cash compensation expense	-	-	501,743
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable, net	(1,045,440)	715,523	(3,615,030)
Inventories, net	(271,033)	466,945	(306,369)
Prepaid expenses	231,660	(65,294)	(305,474)
Other current assets	(18,624)	(574,569)	393,253
Prepaid royalties and other assets	(600,000)	(1,118,493)	150,208
Accounts payable	105,045	788,332	770,234
Customer deposits	120,575	(1,550)	67,569
Accrued expenses	474,150	(662,790)	2,772,721
Net cash used in operations	(3,753,235)	(1,611,554)	(2,150,027)
Cash flows from investing activities:			
Acquisition of SecureWare/DMIC	-	(587,532)	-
Additions to property and equipment	(284,155)	(895,144)	(3,473,564)
Net cash used in investing activities	(284,155)	(1,482,676)	(3,473,564)
Cash flows from financing activities:			
Proceeds from issuance of debt	6,161,424	-	-
Repayment of debt	(2,900,000)	(6,091,586)	-
Proceeds from exercise of stock options/warrants	116,347	94,225	2,281,930
Net proceeds from sales of common stock	-	10,736,926	-
Issuance of Series C Convertible Preferred Stock	-	-	15,000,000
Repurchase of common stock	-	(751,575)	-
Net cash provided by financing activities	3,377,771	3,987,990	17,281,930
Adjustment to conform immaterial pooled business	-	-	1,589
Effect of exchange rate changes on cash	257,143	20,650	(403,777)
Net increase (decrease) in cash	(402,476)	914,410	11,256,151
Cash, beginning of year	2,064,560	1,662,084	2,576,494
Cash, end of year	\$ 1,662,084	\$ 2,576,494	\$ 13,832,645
Supplemental disclosure of cash flow information:			
Interest paid	\$ 878,892	\$ 893,799	\$ 323,341
Income taxes paid	\$ 709,661	\$ 900,373	\$ 293,875
Supplemental disclosure of non-cash activity - conversion of note to common stock	\$ -	\$ -	\$ 5,000,000

See accompanying notes to consolidated financial statements.

Note 1 - Summary of Significant Accounting Policies

Nature of Operations

VASCO Data Security International, Inc. and its wholly owned subsidiaries (the Company) designs, develops, markets and supports security products and services which manage and protect against unauthorized access to computer systems of corporate and government customers.

Principles of Consolidation

The consolidated financial statements include the accounts of VASCO Data Security International, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Foreign Currency Translation and Transactions

The financial position and results of operations of the Company's foreign subsidiaries are measured using the local currency as the functional currency. Accordingly, assets and liabilities are translated into U.S. dollars using current exchange rates as of the balance sheet date. Revenues and expenses are translated at average exchange rates prevailing during the year. Translation adjustments arising from differences in exchange rates are included as a separate component of stockholders' equity (deficit). Gains and losses resulting from foreign currency transactions are included in the consolidated statements of operations. Foreign exchange transaction losses aggregating \$174,000, \$272,000 and \$289,000 are included in other non-operating expense for 1998, 1999, and 2000, respectively.

Revenue Recognition

License Fees. Revenues from the sale of computer security hardware and software are recorded upon shipment or, if an acceptance period is allowed, at the later of shipment or customer acceptance. No significant obligations exist with regard to delivery or customer acceptance at the time of recognizing revenue.

Support Agreements. Support agreements generally call for the Company to provide technical support and software updates to customers. Revenue on technical support and software update rights is recognized ratably over the term of the support agreement.

Consulting and Education Services. The Company provides consulting and education services to its customers. Revenue from such services is generally recognized during the period in which the services are performed.

Non-monetary Transaction. In October 2000, the Company entered into an agreement to sell SnareWorks and Digipass products in the amount of \$2,000,000 along with support agreements and consulting services of \$450,000 to a U.S. customer. At approximately the same time, VASCO entered into an agreement with the same company to purchase products to be used internally for product development and testing in an amount of \$2,500,000. Although cash was exchanged in these transactions, the Company treated these as non-monetary (barter) transactions, in accordance with accounting principles generally accepted in the United States of America. Revenue of \$2,075,000 and deferred revenue of \$375,000 were recorded during 2000. This represented 7% of total revenues for the year and 19% of U.S. revenues. The purchased products were capitalized as software and are being amortized over 36 months.

Prepaid Royalties

On March 25, 1998, the Company entered into a license agreement with Lernout & Hauspie Speech Products N.V. pursuant to which the Company received a five-year worldwide, non-exclusive, non-transferable license to use certain speaker verification software in access control applications. For this license, the Company agreed to pay a royalty of 10% of revenue associated with the software plus royalty prepayments aggregating \$800,000. On December 31, 1998, the license was extended for an additional 5 years and the Company made royalty prepayments to reach an aggregate of \$1.7 million. Prepaid royalties amounted to \$1,700,000 and \$1,487,500 at December 31, 1999 and 2000, respectively. Amortization of the royalty prepayments commenced during the third quarter of 2000 and is being amortized over 42 months.

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets ranging from three to seven years. Additions and improvements are capitalized, while expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses resulting from sales or retirements are recorded as incurred, at which time related costs and accumulated depreciation are removed from the accounts.

Software Costs

The Company capitalizes software development costs in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed". Research and development costs, prior to the establishment of technological feasibility, determined based upon the creation of a working model, are expensed as incurred. The Company's policy is to amortize capitalized costs by the greater of (a) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product, generally two to five years, including the period being reported on.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Fair Value of Financial Instruments

The following disclosures of the estimated fair value of financial instruments are made in accordance with the requirements of SFAS No. 107, "Disclosures and Fair Value of Financial Instruments." The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The fair values of the Company's financial instruments were not materially different from their carrying amounts at December 31, 1999 and 2000, except for notes payable and long-term debt, for which the fair values were not determinable.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain amounts in the consolidated financial statements have been reclassified to conform to the 2000 presentation.

Goodwill and Other Intangibles

Goodwill is amortized on a straight-line basis over the expected period to be benefited, which is seven years. Other intangibles are amortized on a straight-line basis and consist of software and hardware technology which is being amortized over a period of four years and workforce and customer lists of approximately \$320,000 and \$542,000 which are being amortized over a period of seven years.

The Company periodically evaluates whether events and circumstances that have occurred indicate that the remaining balance of goodwill and other intangibles may not be recoverable or that the remaining estimated useful lives may warrant revision. When such factors indicate that goodwill and other intangibles should be evaluated for possible impairment, the Company uses an estimate of undiscounted future cash flows to measure whether the goodwill and other intangibles are recoverable.

Stock-Based Compensation

On January 1, 1996, the Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation," which permits entities to recognize the compensation expense associated with the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and provide pro forma disclosures as if the fair value method defined in SFAS No. 123 had been applied. The Company has elected to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosures required by SFAS No. 123.

Loss Per Common Share

Basic earnings per share is based on the weighted average number of shares outstanding and excludes the dilutive effect of unexercised common stock equivalents. Diluted earnings per share is based on the weighted average number of shares outstanding and includes the dilutive effect of unexercised common stock equivalents to the extent they are not anti-dilutive.

Shares issuable from securities that could potentially dilute basic earnings per share in the future that were not included in the computation of earnings per share because their effect was anti-dilutive were as follows:

	<u>1998</u>	<u>1999</u>	<u>2000</u>
Stock options	1,475,500	2,377,200	2,342,217
Warrants.....	1,004,034	804,034	1,764,883
Convertible notes (June 1996).....	416,667	416,667	-
Convertible notes (August 1997)*.....	1,123,387	732,658	532,029
Convertible notes (March 1998).....	528,048	-	-
Total.....	<u>4,547,636</u>	<u>4,547,636</u>	<u>4,639,129</u>

* Due to the contingent nature of the conversion feature of these notes, a 20-day average market price was used to calculate the number of potentially dilutive shares.

Additionally, the net loss applicable to common stockholders for the years ended December 31, 1998, 1999 and 2000 would have been decreased by adding back interest expense related to the convertible notes of approximately \$1,394,000, \$704,000 and \$275,000, respectively.

Note 2 – Acquisitions

Effective May 1, 1999, the Company acquired substantially all of the assets of SecureWare SA and DMIC SA (SecureWare), as well as certain developed software licenses from the founder of SecureWare in exchange for \$738,735 in cash (of which \$151,203 was recorded in accrued liabilities at December 31, 1999) plus 174,575 shares of the Company's common stock, which had a market value based upon the trading price of the common stock on the NASD Bulletin Board ("Market Value") of approximately \$650,000 at the time of the acquisition. SecureWare, located in Bordeaux, France, is a software developer focusing on developing security solutions for a number of operating systems.

The acquisition of SecureWare was accounted for under the purchase method of accounting, and accordingly, the acquired assets have been recorded at their estimated fair values at the date of acquisition. Purchased software related to this transaction was \$889,000 and is being amortized over a period of 5 years. Goodwill related to this transaction was \$406,000 and is being amortized over a period of 7 years.

On October 6, 1999, the Company acquired all of the outstanding capital stock of IntelliSoft Corporation (IntelliSoft) in exchange for 1,812,078 shares of Common Stock which had a Market Value of approximately \$7,250,000 at the time of the acquisition. In addition, the Company paid \$751,575 to IntelliSoft dissenters to acquire their capital stock interests, which represented 9.4% of the outstanding capital stock of IntelliSoft at the date of the acquisition. The acquisition of these shares has been treated as the purchase and retirement of common stock. IntelliSoft, located in Acton, MA, specializes in developing true secure single sign-on, Web authorization, PKI, VPN, and enterprise management solutions. This transaction was accounted for under the pooling-of-interests method of accounting. Accordingly, the consolidated financial statements have been restated as if IntelliSoft had been combined for all periods presented.

At the end of August 2000, the Company acquired Invincible Data Systems (IDS) in a transaction which has been accounted for under the pooling-of-interests method. A total of 322,565 shares were issued in this transaction, which is deemed immaterial.

Note 3 - Inventories

Inventories, consisting principally of hardware and component parts, are stated at the lower of cost or market. Cost is determined using the first-in-first-out (FIFO) method.

Inventories are comprised of the following:

	December 31,	
	<u>1999</u>	<u>2000</u>
Component parts	\$ 213,909	\$ 451,487
Work-in-process and finished goods	<u>591,473</u>	<u>660,264</u>
Total.....	<u>\$ 805,382</u>	<u>\$ 1,111,751</u>

Note 4 - Accrued Expenses

Accrued expenses are comprised of the following:

	December 31,	
	<u>1999</u>	<u>2000</u>
Accrued interest	\$ 698,946	654,941
Accrued payroll	268,455	709,899
Accrued royalties	-	270,480
Other accrued expenses	<u>515,569</u>	<u>1,462,964</u>
Total.....	<u>\$ 1,482,970</u>	<u>\$ 3,098,284</u>

Note 5 - Income Taxes

At December 31, 2000, the Company has United States net operating loss carryforwards approximating \$12,500,000 and foreign net operating loss carryforwards approximating \$2,000,000. Such losses are available to offset future taxable income in the respective jurisdictions and expire in varying amounts beginning in 2002 and continuing through 2020. In addition, if certain substantial changes in the Company's ownership are deemed to have occurred, there would be an annual limitation on the amount of the U.S. carryforwards which could be utilized.

Pretax loss from continuing operations was taxed in the following jurisdictions:

	For the Year Ended December 31,		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
Domestic	\$ (3,165,857)	\$ (1,809,920)	\$ (4,293,166)
Foreign	<u>70,847</u>	<u>(80,254)</u>	<u>526,640</u>
Total	<u>\$ (3,095,010)</u>	<u>\$ (1,890,174)</u>	<u>\$ (3,766,526)</u>

The provision for income taxes consists of the following:

	For the Year Ended December 31,		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
Current:			
Federal.....	\$ -	\$ -	\$ -
State.....	(2,514)		2,632
Foreign	689,516	322,310	392,614
Deferred:			
Federal.....	\$ -	\$ -	\$ -
State.....	-	-	-
Foreign	-	-	-
Total	<u>\$ 687,002</u>	<u>\$ 322,310</u>	<u>\$ 395,246</u>

The differences between income taxes computed using the statutory federal income tax rate of 34% and the provisions for income taxes reported in the consolidated statements of operations are as follows:

	For the Year Ended December 31,		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
Expected tax benefit at the statutory rate	\$ (1,052,303)	\$ (642,659)	\$ (1,231,023)
Increase (decrease) in income taxes resulting from:			
Foreign taxes at rates other than 34%	665,000	205,916	(4,243)
Change in valuation allowance primarily related to NOL.....	1,035,000	676,000	1,739,000
Nondeductible expenses	100,000	155,938	34,420
Other, net	(60,695)	(72,885)	(142,908)
Total	<u>\$ 687,002</u>	<u>\$ 322,310</u>	<u>\$ 395,246</u>

The deferred income tax balances are comprised of the following:

	December 31,	
	<u>1999</u>	<u>2000</u>
Deferred tax assets:		
U.S. net operating loss carryforwards	\$ 3,519,000	\$ 4,832,000
Foreign net operating loss carryforwards	582,000	800,000
Accounts receivable	35,000	89,000
Accrued expenses.....	16,000	12,000
Deferred revenue	43,000	257,000
Fixed assets	17,000	-
Other	5,000	-
Total gross deferred income tax assets.....	4,217,000	5,990,000
Less valuation allowance.....	(4,121,000)	(5,860,000)
	96,000	130,000
Deferred tax liabilities:		
Fixed assets	(13,000)	(47,000)
Net deferred income taxes.....	<u>\$ 83,000</u>	<u>\$ 83,000</u>

The net change in the total valuation allowance for the years ended December 31, 1998, 1999 and 2000 was an increase of \$1,035,000, \$676,000 and \$1,739,000, respectively. In assessing the realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the period in which these temporary differences become deductible. This assessment was performed considering the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies. The Company has determined that it is more likely than not that \$83,000 of deferred tax assets will be realized. The remaining valuation allowance of \$5,860,000 is maintained on deferred tax assets which the Company has not determined to be more likely than not realizable as of December 31, 2000. This valuation allowance will be reviewed on a regular basis and adjustments made as appropriate.

Note 6 - Debt

Debt consists of the following:

	December 31,	
	<u>1999</u>	<u>2000</u>
Convertible stockholder note, interest payable at 9% (see Note 8)	\$ 5,000,000	\$ -
Convertible note, interest payable at 3.25%	3,400,000	3,400,000
Installment notes payable	648,184	726,108
	<u>9,048,184</u>	<u>4,126,108</u>
Less current maturities	(639,322)	(362,250)
Long-term debt	<u>\$ 8,408,862</u>	<u>\$ 3,763,858</u>

In August 1997, the Company renegotiated the guarantee related to the final payment for the 1996 acquisition of Digipass into a term loan in the amount of \$3.4 million. The note matures on September 30, 2002 and bears interest at a rate of 3.25%. In the event a public offering is completed, the lender may at its option require the principal amount of the loan to be repaid in cash, in which case the Company must pay additional special interest in the amount of \$680,000 which is accrued at December 31, 2000.

Aggregate maturities of debt at December 31, 2000 are as follows:

2001	\$ 362,250
2002	3,763,858
Total	<u>\$ 4,126,108</u>

Interest expense to stockholders was \$497,795, \$450,000 and \$165,000 for the years ended December 31, 1998, 1999 and 2000, respectively.

Note 7 - Stockholders' Equity

Preferred Stock

In July 2000, the Company issued 150,000 shares of preferred stock for cash of \$15,000,000. The preferred stock is convertible into 1,052,632 shares of common stock at any time over the next 48 months. In conjunction with this financing, the company issued warrants to purchase 789,474 common shares at \$15 per share with an estimated imputed value using the Black-Scholes pricing-model of approximately \$4.1 million and warrants to purchase 480,000 shares at \$4.25 per share with an estimated imputed value using the Black-Scholes pricing-model of approximately \$4.7 million. The warrants issued at \$15 per share are immediately exercisable. The warrants issued at \$4.25 are exercisable over 48 months and the related imputed value is being accreted reducing earnings available to common stockholders. In September 2000, 30,000 warrants at \$4.25 per share were exercised.

Common Stock

In 2000, the Company issued 435,910 shares of common stock to convert a \$5,000,000 note and related accrued interest. In September, the Company issued 322,565 shares of common stock as part of the acquisition of Invincible Data Systems.

Also in 2000, the Company issued 342,400 shares of common stock as a result of the exercise of options under the Company's stock compensation plan (see Note 8) generating total proceeds of \$557,213; 303,625 shares of common stock were issued as a result of the exercise of the warrants, generating total proceeds of \$1,724,717.

During 1999, the Company issued 158,000 shares of common stock as a result of the exercise of options under the Company's stock option plan (see Note 8) generating total proceeds of \$44,225; 200,000 shares of common stock were issued as a result of the exercise of the warrants generating total proceeds of \$50,000.

Warrants

Warrant activity for the years ended December 31, 1998, 1999 and 2000 are summarized below:

	Number of Shares	Weighted average <u>Exercise Price</u>	<u>Exercise Price</u>
Outstanding at January 31, 1997	1,056,922	\$ 4.85	\$.25 – 10.00
Granted	5,000	5.19	5.19
Exercised	(57,888)	5.19	5.19
Canceled	-	-	-
Outstanding at December 31, 1998	1,004,034	4.83	.25 – 10.00
Granted	-	-	-
Exercised	(200,000)	.25	.25
Canceled	-	-	-
Outstanding at December 31, 1999	804,034	5.97	4.00 – 10.00
Granted	1,269,474	10.94	4.25 – 15.00
Exercised	(303,625)	5.68	4.00 – 10.00
Canceled	(5,000)	5.19	
Outstanding at December 31, 2000.....	1,764,833	\$ 9.59	\$ 4.25 – 15.00
Exercisable at December 31, 2000	1,344,833	\$ 9.59	\$ 4.25 – 15.00

Note 8 - Stock Compensation Plan

The Company's 1997 Stock Compensation Plan, as amended, ("Compensation Plan") is designed and intended as a performance incentive. The Compensation Plan is administered by the Compensation Committee as appointed by the Board of Directors of the Company (Compensation Committee).

The Compensation Plan permits the grant of options to employees of the Company to purchase shares of common stock and is intended to be a nonqualified plan. All options granted to employees are for a period of ten years, are granted at a price equal to the fair market value of the common stock on the date of the grant and are typically vested 20% on the first anniversary of the grant, with an additional 20% vesting on each subsequent anniversary of the grant. Alternative vesting schedules include either date or event-based vesting.

The Compensation Plan further permits the grant of options to directors, consultants and other key persons (non-employees) to purchase shares of common stock. All options granted to non-employees are granted at a price equal to the fair market value of the common stock on the date of the grant, and may contain vesting requirements and/or restrictions as determined by the Compensation Committee at the time of grant. Non-cash compensation expense of \$501,743 was recognized in 2000 in accordance with FIN 44, "Accounting for Certain Transactions Involving Stock Compensation", an interpretation of Accounting Principles Board Opinion No. 25. This charge was attributed to stock options issued to officers of the Company who are located outside the U.S. and whose services are rendered under consulting agreements.

As of December 31, 2000, the Compensation Plan was authorized to issue options representing up to 5,573,317 shares of the Company's common stock. The authorized shares under the Compensation Plan represent 20% of the issued and outstanding shares of the Company.

The Company applies APB Opinion No. 25 and related interpretations in accounting for the Compensation Plan. Had compensation cost for the Compensation Plan been determined consistent with SFAS No. 123, the Company's net loss available to common stockholders and net loss per common share would have been the pro forma amounts indicated below:

	For the Year Ended December 31,		
	1998	1999	2000
Net loss available to common stockholders:			
As reported	\$ (3,782,012)	\$ (2,212,484)	\$ (4,743,764)
Pro forma.....	(4,126,931)	(2,789,233)	(5,261,025)
Net loss per common share-basic and diluted:			
As reported	\$ (0.17)	\$ (0.09)	\$ (0.17)
Pro forma.....	(0.18)	(0.11)	(0.19)

For purposes of calculating the compensation cost consistent with SFAS No. 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1998, 1999 and 2000: dividend yield of 0%; expected volatility of 50%; risk free interest rates ranging from 4.00% to 6.80%; and expected lives of five years.

The following is a summary of activity under the Compensation Plan:

	Options Outstanding		Options Exercisable		Weighted Average Fair Value of Options Granted
	Number of Shares	Weighted Average Price	Number of Shares	Weighted Average Price	
Outstanding at December 31, 1997	1,945,257	\$ 1.85	1,460,629	\$ 1.29	
Granted.....	245,250	5.09			\$ 2.55
Exercised.....	(658,257)	0.18			
Forfeited.....	(56,750)	4.25			
Outstanding at December 31, 1998	1,475,500	3.05	1,088,375	2.48	
Granted.....	1,174,000	3.13			\$ 1.58
Exercised.....	(158,000)	0.28			
Forfeited.....	(114,300)	4.01			
Outstanding at December 31, 1999	2,377,200	3.23	1,074,138	3.04	
Granted.....	560,000	11.29			\$ 5.82
Exercised.....	(342,400)	1.63			
Forfeited.....	(252,583)	5.08			
Outstanding at December 31, 2000	2,342,217	\$ 5.30	984,775	\$ 3.71	

The following table summarizes information about stock options outstanding at December 31, 2000:

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number of Shares</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
\$8.50 – 23.00.....	541,250	9.36 years	\$ 11.22	-	-
\$2.50 - 7.25	1,698,467	7.27 years	\$ 3.73	882,275	\$ 4.12
\$0.1875 - 0.25	102,500	2.27 years	\$ 0.20	102,500	\$ 0.20
	<u>2,342,217</u>			<u>984,775</u>	

Note 9 - Employee Benefit Plan

The Company maintains a contributory profit sharing plan established pursuant to the provisions of Section 401(k) of the Internal Revenue Code, which provides benefits for eligible employees of the Company. The Company made no contributions to the plan during the years ended December 31, 1998, 1999 and 2000.

Note 10 - Geographic and Customer Information

During 1998, 1999 and 2000, sales to one customer from the Company's United States operations (a reseller of the Company's product in the Netherlands) aggregated approximately \$1,950,000, \$3,533,000 and \$2,844,616 respectively, representing 12%, 18% and 10% of the total revenues, respectively. Accounts receivable from this customer represented 30% and 18% of the Company's gross accounts receivable balance at December 31, 1999 and 2000, respectively.

The Company allocates revenue based on the location of the country which initiates the sale. Information regarding geographic areas for the year ended December 31, 1998 is as follows:

	<u>United States</u>	<u>Belgium</u>	<u>Total</u>
Revenue	\$ 4,269,000	\$ 12,231,000	\$ 16,500,000
Gross profit	2,870,000	6,421,000	9,291,000
Long-lived assets	207,000	183,000	390,000

Information regarding geographic areas for the year ended December 31, 1999 is as follows:

	<u>United States</u>	<u>Belgium</u>	<u>France</u>	<u>Total</u>
Revenue	\$ 7,188,000	\$ 12,015,000	\$ 194,000	\$ 19,397,000
Gross profit	5,081,000	6,899,000	111,000	12,091,000
Long-lived assets	331,000	810,000	49,000	1,190,000

Information regarding geographic areas for the year ended December 31, 2000 is as follows:

	<u>United States</u>	<u>Belgium</u>	<u>France</u>	<u>Total</u>
Revenue	\$ 11,065,000	\$ 16,831,000	\$ 170,000	\$ 28,066,000
Gross profit	8,846,000	9,060,000	91,000	17,997,000
Long-lived assets	2,906,000	836,000	56,000	3,798,000

Note 11 - Commitments and Contingencies

The Company leases office space and equipment under operating lease agreements expiring at various times thru 2010.

Future minimum rental payments required under noncancelable leases are as follows:

<u>Year</u>	<u>Amount</u>
2001.....	\$ 715,260
2002.....	683,907
2003.....	599,543
2004.....	562,536
2005.....	345,200
Thereafter	411,453
	<u>\$ 3,317,899</u>

Rent expense under operating leases aggregated approximately \$357,000, \$434,000 and \$693,344 for the years ended December 31, 1998, 1999 and 2000, respectively.

From time to time, the Company has been involved in litigation incidental to the conduct of its business. Currently, the Company is not a party to any lawsuit or proceeding which, in management's opinion, is likely to have a material adverse effect on its business, financial condition or results of operations.

Note 12 – Subsequent Events

On February 2, 2001, the Company entered into a Letter of Intent to purchase all of the outstanding stock of Identikey, Ltd., a software company headquartered in Brisbane, Australia. The terms of the agreement provide for an initial purchase price of 406,667 shares of common stock and a contingent purchase price of additional shares of common stock based on targeted sales over a 15 month period. The maximum number of additional shares that can be earned is based upon \$12,750,000 and a price of the greater of 80% of the average closing price of the stock for the 10 days preceding the end of the measurement period, or \$7.50 per share. The revenues of Identikey, Ltd., for the year 2000 were immaterial in relation to the Company's revenues. The transaction is expected to close by April 2001 and will be accounted for under the purchase method.

SCHEDULE II

VASCO DATA SECURITY INTERNATIONAL, INC.

VALUATION AND QUALIFYING ACCOUNTS

<u>Allowance for Doubtful Accounts For Trade Accounts Receivable</u>	<u>Beginning Balance</u>	<u>Bad Debt Expense (Recovery)</u>	<u>Accounts Written Off</u>	<u>Ending Balance</u>
Year ended December 31, 1998	\$ 429,000	\$ (272,000)	\$ (102,000)	\$ 55,000
Year ended December 31, 1999	55,000	65,216	-	120,216
Year ended December 31, 2000	120,216	195,161	(29,000)	286,377

<u>Reserve for Obsolete Inventories</u>	<u>Beginning Balance</u>	<u>Obsolescence Expense (Recovery)</u>	<u>Inventory Written Off</u>	<u>Ending Balance</u>
Year ended December 31, 1998	\$ 164,000	\$ 35,000	\$ (70,000)	\$ 129,000
Year ended December 31, 1999	129,000	(36,000)	(93,000)	-
Year ended December 31, 2000	-	109,000	(109,000)	-

