INTRUSION INC
Form 10-Q/A
August 06, 2004

QuickLinks -- Click here to rapidly navigate through this document

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q/A

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2004**

**OR**

o **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 0-20191**

# INTRUSION INC.

(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **75-1911917** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**1101 East Arapaho Road, Richardson, Texas 75081**
(Address of principal executive offices)
(Zip Code)

**(972) 234-6400**
(Registrant's telephone number, including area code)

**Not Applicable**
Former name, if changed since last report)
* * * * * * * * * *

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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

The number of shares outstanding of the Registrant's Common Stock, $0.01 par value, on April 30, 2004 was 5,166,312.

**INTRUSION INC.**

**INDEX**

## PART I FINANCIAL INFORMATION

### Item 1. FINANCIAL STATEMENTS

**INTRUSION INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(In thousands, except par value amounts)**

| | March 31, 2004 | December 31, 2003 |
|---|---|---|
| | (Unaudited) | (Audited) |
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 5,787 | $ 974 |
| Short-term investments | 505 | 1,705 |
| Accounts receivable, less allowance for doubtful accounts $574 in 2004 and $574 in 2003 | 498 | 972 |
| Inventories, net | 1,481 | 1,286 |
| Other assets | 402 | 449 |
| Total current assets | 8,673 | 5,386 |
| Property and equipment, net | 234 | 297 |
| Other assets | 77 | 77 |
| TOTAL ASSETS | $ 8,984 | $ 5,760 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current Liabilities: | | |
| Accounts payable and accrued expenses | $ 1,875 | $ 2,188 |
| Deferred revenue | 867 | 788 |
| Total current liabilities | 2,742 | 2,976 |
| Stockholders' Equity: | | |
| Preferred stock, $.01 par value, authorized shares 5,000 1,000 shares issued and outstanding, net of discount, liquidation preference $5,000 | 3,534 | |
| Common stock, $.01 par value, authorized shares 80,000; issued shares 5,176 in 2004 and 5,173 in 2003; outstanding shares 5,166 in 2004 and 5,163 in 2003 | 52 | 52 |
| Common stock held in treasury, at cost 10 shares | (362) | (362) |
| Additional paid-in capital | 48,723 | 47,526 |
| Accumulated deficit | (45,477) | (44,204) |
| Accumulated other comprehensive loss | (228) | (228) |
| Total stockholders' equity | 6,242 | 2,784 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 8,984 | $ 5,760 |

See accompanying notes.

**INTRUSION INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(In thousands, except per share amounts)**
**(Unaudited)**

| | Three Months Ended | |
|---|---|---|
| | March 31, 2004 | March 31, 2003 |
| Net product revenue | $ 905 | $ 892 |
| Net customer support and maintenance revenue | 362 | 584 |
| Total revenue | 1,267 | 1,476 |
| Cost of product revenue | 526 | 853 |
| Cost of customer support and maintenance revenue | 111 | 151 |
| Total cost of revenue | 637 | 1,004 |
| Gross profit | 630 | 472 |
| Operating expenses: | | |
| Sales and marketing | 960 | 1,863 |
| Research and development | 601 | 923 |
| General and administrative | 264 | 402 |
| Severance costs | 96 | 126 |
| Operating loss | (1,291) | (2,842) |
| Interest income, net | 18 | 61 |
| Loss before income tax provision | (1,273) | (2,781) |
| Income tax provision | | |
| Net loss | $ (1,273) | $ (2,781) |
| Beneficial conversion feature on preferred stock | (938) | |
| Net loss attributable to common stockholders | $ (2,211) | $ (2,781) |
| Net loss per share attributable to common stockholders (basic and diluted) | $ (0.43) | $ (0.54) |
| Weighted average common shares outstanding, basic and diluted | 5,163 | 5,162 |

See accompanying notes.

**INTRUSION INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**
**(Unaudited)**

| | Three Months Ended | |
|---|---|---|
| | **March 31, 2004** | **March 31, 2003** |
| Operating Activities: | | |
| Net loss | $ (1,273) | $ (2,781) |
| Adjustments to reconcile net loss to net cash used in operating activities | | |
| Depreciation and amortization | 104 | 445 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 474 | 807 |
| Inventories | (195) | (315) |
| Other assets | 48 | (38) |
| Accounts payable and accrued expenses | (314) | (165) |
| Deferred revenue | 80 | (361) |
| Net cash used in operating activities | (1,076) | (2,408) |
| Investing Activities: | | |
| Purchases of short-term investments | | (1,000) |
| Maturities of short-term investments | 1,200 | 1,525 |
| Net purchases of property and equipment | (42) | (70) |
| Net cash provided by investing activities | 1,158 | 455 |
| Financing Activities: | | |
| Proceeds from the exercise of employee stock options | 6 | |
| Proceeds from the issuance of preferred stock and warrants, net | 4,725 | |
| Net cash provided by financing activities | 4,731 | |
| Net increase(decrease) in cash and cash equivalents | 4,813 | (1,953) |
| Cash and cash equivalents at beginning of period | 974 | 2,898 |
| Cash and cash equivalents at end of period | $ 5,787 | $ 945 |
| SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES: | | |
| Fair value of warrants issued in connection with sale of preferred stock | $ 1,191 | $ |
| Amortization of preferred stock beneficial conversion feature | $ 938 | $ |

See accompanying notes.

**INTRUSION INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

**1. Description of Business**

We develop, market and support a family of network intrusion prevention and detection systems and regulated information compliance systems that address vital security issues facing organizations with mission critical business applications or housing classified, confidential, or customer information assets. We currently provide network security and regulated information compliance solutions under our SecureNet family of hardware and software solutions.

We market and distribute our products through a direct sales force to end-users, distributors and by numerous domestic and international system integrators, managed service providers and value-added resellers. Our end-user customers include high technology, manufacturing, telecommunications, retail, transportation, health care, insurance, entertainment, utilities and energy companies, government entities, financial institutions, and academic institutions.

We were organized in Texas in September 1983 and reincorporated in Delaware in October 1995. For more than 15 years, we provided local area networking equipment and were known as Optical Data Systems or ODS Networks. On April 17, 2000, we announced plans to sell, or otherwise dispose of, our networking divisions, which included our Essential Communications division and our local area networking assets. In accordance with these plans, we have accounted for these businesses as discontinued operations. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our NASDAQ ticker symbol from ODSI to INTZ to reflect our focus on intrusion detection solutions. On November 1, 2001, we changed our name from Intrusion.com, Inc. to Intrusion Inc.

Our principal executive offices are located at 1101 East Arapaho Road, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is *www.intrusion.com*. Information contained in or linked to our website are not a part of this report. References to "we," "us" and "our" in this report refer to Intrusion Inc. and its subsidiaries.

As of March 31, 2004, we had cash, cash equivalents and short-term investments in the amount of approximately $6.3 million, up from approximately $2.7 million as of December 31, 2003. Although we believe we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue through at least the first half of 2004. As a result, we may not be able to achieve the revenue and gross margin objectives necessary to achieve positive cash flow or profitability without obtaining additional financing. We do not currently have any arrangements for financing and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. If our business does not generate sufficient cash flow from operations and sufficient future financings are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

On March 25, 2004, we completed a $5.0 million private placement of 5% Convertible Preferred Stock and warrants. In the private placement, we sold 1,000,000 shares of preferred stock at a price of $5.00 per share for gross proceeds of $5.0 million, less $275,000 of issuance costs. The preferred shares may be converted into 1,590,331 shares of common stock at an initial conversion price of $3.144 per share. Included in this transaction were warrants to purchase 556,619 shares of common stock at an exercise price of $3.144 per share. In connection with the closing of this private placement, we issued warrants to purchase 64,408 shares of our common stock at an exercise price of $3.144 per share to our financial advisor for assistance with the private placement.

On March 18, 2004, we filed an amendment to our certificate of incorporation to effect a four-for-one (4:1) reverse stock split of our common stock. The reverse stock split became effective on March 29, 2004. All outstanding share numbers and related common stock numbers, such as earnings per share and outstanding options, included in this report are set forth on a post-split basis.

**2. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The December 31, 2003 balance sheet was derived from audited financial statements, but does not include all the disclosures required by accounting principles generally accepted in the United States. However, we believe that the disclosures are adequate to make the information presented not misleading. In our opinion, all the adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. The results of operations for the three months ending March 31, 2004 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2003.

**3. Inventories (In thousands)**

Inventories consist of:

| | March 31, 2004 | December 31, 2003 |
|---|---|---|
| Finished goods | $ 1,030 | $ 851 |
| Work in progress | 252 | 261 |
| Demonstration systems | 199 | 174 |
| Net inventory | $ 1,481 | $ 1,286 |

**4. Accounting for Stock-Based Compensation**

We account for employee stock-based compensation under APB 25. The following table summarizes relevant information as to the reported results under our intrinsic value method of accounting for stock awards, with supplemental information as if the fair value recognition provision of SFAS 123 had been applied for the quarters ended March 31, 2004 and March 31, 2003 (in thousands, except per share data). All such information is reported in post reverse stock split values:

| | March 31, 2004 | March 31, 2003 |
|---|---|---|
| Net loss attributable to common stockholders | $ (2,211) | $ (2,781) |
| Add (deduct): Total stock-based compensation determined under fair value-based method for all awards | (72) | 332 |
| Pro forma net loss attributable to common stockholders | $ (2,283) | $ (2,449) |
| Net loss per share attributable to common stockholders: | | |
| As reported (basic and diluted) | $ (0.43) | $ (0.54) |
| Pro forma (basic and diluted) | $ (0.44) | $ (0.47) |
| Weighted-average shares used in computation: | | |
| Basic and Diluted | 5,163 | 5,162 |

As required, the pro forma disclosures above include options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 for providing pro forma disclosures may not be representative of the effects on reported operating results for future years until all options outstanding are included in the pro forma disclosures. For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options are amortized to expense primarily over the vesting period.

**5. Net Loss Per Share**

We report two separate earnings per share ("EPS") numbers, basic EPS and diluted EPS. Basic net loss per share is computed by dividing net loss attributable to common stockholders for the period by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing the net loss attributable to common stockholders by the weighted average number of common shares and common stock equivalents outstanding for the period. Our common stock equivalents include all common stock issuable upon conversion of convertible preferred stock and the exercise of outstanding options and warrants. The aggregate number of common stock equivalents excluded from the loss per share calculation for the three-month periods ended March 31, 2004 and 2003 are 2,609,715 and 404,652, respectively. Our common stock equivalents are not included in the diluted loss per share for the three-month periods ended March 31, 2004 and 2003, as they are antidilutive.

**6. Commitments and Contingencies**

We are subject to legal proceedings and claims that arise in the ordinary course of business. We do not believe that the outcome of those matters, if any, will have a material adverse affect on our consolidated financial position, operating results or cash flows. However, there can be no assurance such legal proceedings will not have a material impact.

During the quarter, we successfully renegotiated our lease agreement for our headquarters in Richardson, Texas, which decreased the amount of square feet we lease and extended the lease term for an additional five years. In accordance with the new lease agreement, our Richardson, Texas headquarters will be located in the same building. However, we will reduce the amount of space that we lease from approximately 95,000 square feet to approximately 30,000 square feet of floor space and the term of our new lease will expire in February 2010.

**7. Preferred Stock Private Placement**

On March 25, 2004, we completed a $5.0 million private placement of 5% Convertible Preferred Stock and warrants. In the private placement, we sold 1,000,000 shares of preferred stock at a price of $5.00 per share for gross proceeds of $5.0 million, less $275,000 of issuance costs. The preferred shares may be immediately converted into 1,590,331 shares of common stock at an initial conversion price of $3.144 per share.

The 5% dividends related to the preferred stock are paid semi-annually on the last business day in March and September of each year, beginning with September 2004. Preferred stockholders vote together with common stockholders on an as converted to common stock basis. Based on the conversion rate of the preferred stock, holders of preferred stock will receive 1.5903 votes per share and rounded to the nearest whole number. The liquidation preference for the preferred stock is an amount equal to $5.00 per share plus any accrued and unpaid dividends. Holders of preferred stock have liquidation preference rights over common stock holders.

Included in this transaction were warrants to purchase 556,619 shares of common stock at an exercise price of $3.144 per share. In connection with the closing of this private placement, we issued warrants to purchase 64,408 shares of our common stock at an exercise price of $3.144 per share to our financial advisor for assistance with the private placement. These 621,027 shares from warrants were valued at $1.2 million using the Black-Scholes model and have been treated as a discount to the Preferred Stock and were recorded as an increase in additional paid in capital. The issuance of the warrants resulted in a beneficial conversion feature to the Preferred Stock valued at $0.9 million. In accordance with EITF 98-5, the beneficial conversion feature was fully amortized in the first quarter of 2004, as the preferred stock does not have a stated maturity and is immediately convertible into common stock. This beneficial conversion feature is added to the net loss to arrive at the net loss attributed to common stockholders.

The Preferred Stock was recorded as the net of the financing proceeds of $5.0 million less $275,000 issuance costs and the fair value of the warrants issued in conjunction with the Preferred Stock of $1.2 million.

We have the right to redeem any or all of the outstanding preferred stock at a price of $5.00 per share plus accrued dividends at any time after September 25, 2004 if certain conditions are met.

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This report contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties, such as statements concerning: the difficulties in forecasting future sales caused by current economic and market conditions, the effect of military actions on government and corporate spending on information security products, spending patterns of, and appropriations to, U.S. government departments, the impact of our cost reduction programs and our refocused product line, the difficulties and uncertainties in successfully developing and introducing new products, our ability to continue to meet operating expenses through current cash flow or additional financings, the continuance and strength of our relationship with Check Point, the highly competitive market for our products, difficulties in accurately estimating market growth, the consolidation of the information security industry, the impact of changing economic conditions, business conditions in the information security industry, our ability to manage acquisitions effectively, our ability to manage discontinued operations effectively, the impact of market peers and their products as well as risks concerning future technology and others identified in our Annual Report on Form 10-K and other Securities and Exchange Commission filings. Such forward-looking statements are generally accompanied by words such as "plan," "estimate," "expect," "believe," "should," "would," "could," "anticipate," "may" or other words that convey uncertainty of future events or outcomes. These forward-looking statements and other statements made elsewhere in this report are made in reliance on the Private Securities Litigation Reform Act of 1995. The section below entitled "Factors That May Affect Future Results of Operations" sets forth and incorporates by reference certain factors that could cause actual future results of the company to differ materially from these statements.

*Critical Accounting Policies and Estimates*

Management's discussion and analysis of financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, income taxes, warranty obligations, restructuring, maintenance contracts and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

*Revenue Recognition*

We generally recognize product revenue upon shipment of product. We accrue for estimated warranty costs and sales returns at the time of shipment based on our experience. Revenue from maintenance contracts is deferred and recognized over the contractual period the services are performed, generally one year. There is a risk that technical issues on new products could result in unexpected warranty costs and returns. However, as we migrate to more of a software-based business model, the warranty costs should continue to decline. To the extent that they do decline, our warranty reserve from current sales will decrease. To the extent that our warranty costs exceed our expectations, we will increase our warranty reserve to compensate for the additional expense expected to be incurred. We review these estimate periodically and determine the appropriate reserve percentage. However, to date, warranty costs and sales returns have not been material. Historically, our estimates for these items have not differed materially from actual results. We believe that our revenue recognition policy does not include significant or subjective estimates.

We recognize software revenue from the licensing of our software products in accordance with Statement of Position ("SOP") No. 97-2 "Software Revenue Recognition", SOP 98-9 "Modification of 97-2, Software Revenue Recognition, with respect to certain transactions" and Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition" whereby revenue from the licensing of our products is not recognized until all four of the following have been met: i) execution of a written agreement; ii) delivery of the product has occurred; iii) the fee is fixed and determinable; and iv) collectibility is probable. Bundled hardware and perpetual software product sales are recognized at time of delivery, as our licenses are not sold on a subscription basis. In the case of multiple product and service sales, we perform a Vendor Specific Objective Evidence analysis to appropriately determine the amount of revenue derived from each deliverable. If our license strategy changes and we begin to offer licenses on a subscription basis, we would perform this analysis in a similar manner. Under these circumstances, the revenue related to the license would be recognized ratably over the subscription period. Market values are easily obtained for all of our product offerings, as we have historical sales information on our product offerings. We defer and recognize maintenance and support revenue over the term of the contract period, which is generally one year.

We have signed distribution agreements with distributors in the United States, Europe and Asia. In general, these relationships are non-exclusive. Distributors typically maintain an inventory of our products. Under these agreements, we provide certain protection to the distributors for their inventory of our products for price reductions as well as products that are slow moving or have been discontinued by us. Historically, returns from our distributors and charges related to price reductions on inventory held by distributors have not been material. Recognition of sales to distributors and related gross profits are deferred until the distributors resell the merchandise. However, since we have legally sold the inventory to the distributor and we no longer have care, custody or control over the inventory, we recognize the trade accounts receivable and reduce inventory related to the sale at the time of shipment to the distributor. Revenue, offset by deferred cost of sales, is included in deferred revenue in the accompanying financial statements. Since the net balance in Deferred Revenue represents the sales price less the cost of the product maintained by the distributors, the deferred costs of these products are included in our obsolescence and slow-moving analysis and are written down according to their current value. This transaction, effectively recognizes expense for the write-down, if any, and increases the net liability in the deferred revenue account.

We generally recognize service revenue upon delivery of the contracted service. Service revenue, primarily including maintenance, training and installation are recognized upon delivery of the service and typically are unrelated to product sales. These services are not essential to the functionality of the delivered product. To date, training and installation revenue has not been material.

*Allowance for Doubtful Accounts and Returns*

Trade accounts receivable are stated at the amount we expect to collect. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Management considers the following factors when determining the collectibility of specific customer accounts: customer credit-worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If the financial condition of our customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, we provide for estimated uncollectible amounts through a charge to earnings and a credit to a valuation allowance. Balances that remain outstanding after we have used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. Historically, our estimates for sales returns and doubtful accounts have not materially differed from actual results.

*Inventory*

We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Historically, our estimates for inventory obsolescence have not differed materially from actual results.

*Results of Operations*

The following table sets forth, for the periods indicated, certain financial data as a percentage of net revenues. The period-to-period comparison of financial results is not necessarily indicative of future results.

| | Three Months Ended | |
|---|---|---|
| | March 31, 2004 | March 31, 2003 |
| Net product revenue | 71.4% | 60.4% |
| Net customer support and maintenance revenue | 28.6 | 39.6 |
| Total revenue | 100.0 | 100.0 |
| Cost of product revenue | 41.5 | 57.8 |
| Cost of customer support and maintenance revenue | 8.8 | 10.2 |
| Total cost of revenue | 50.3 | 68.0 |
| Gross profit | 49.7 | 32.0 |
| Operating expenses: | | |
| Sales and marketing | 75.8 | 126.2 |
| Research and development | 47.4 | 62.5 |
| General and administrative | 20.8 | 27.2 |
| Severance costs | 7.6 | 8.5 |
| Operating loss | (101.9) | (192.4) |
| Interest income, net | 1.4 | 4.1 |
| Loss before income tax provision | (100.5) | (188.3) |
| Income tax provision | | |
| Net loss | (100.5)% | (188.3)% |
| Beneficial conversion feature on preferred stock | (74.0) | |
| Net loss attributable to common stockholders | (174.5)% | (188.3)% |

| | Three Months Ended | |
|---|---|---|
| | March 31, 2004 | March 31, 2003 |
| Domestic revenues | 67.5% | 48.4% |
| Export revenues to: | | |
| Europe | 24.8 | 37.3 |
| Canada | 2.6 | (0.7) |
| Asia | 5.1 | 15.0 |
| Net revenues | 100.0% | 100.0% |

**Net Revenues.** Net revenues for the quarter ended March 31, 2003 decreased 14.2% to $1.3 million compared to $1.5 million for the same period of 2003 as revenues from our first generation security products decreased. Product revenue remained constant at $0.9 million when compared to the same period in 2003. Customer support and maintenance revenue decreased 38.0% from $0.6 million in 2003 to $0.4 million in 2004 due to the expiration of maintenance contracts on some of our legacy products. Total revenues (including maintenance and support) from our SecureNet product line increased slightly over the same period in 2003 from $1.1 million to $1.2 million in 2004. Our first generation product sales, including PDS and SecureCom decreased from the same period in 2003 from $0.4 million to $0.1 million in 2004. In addition, continued sluggish economic conditions and delayed customer orders contributed to the decline in revenues.

**Export Revenues.** Export revenues for the quarter ended March 31, 2004 decreased to $0.4 million compared to $0.8 million for the same period of 2003 as revenues from our PDS security appliance family decreased and we focused more of our resources domestically.

**Concentration of Revenues.** Revenues from Concurrent Technologies Corporation were 20.0% of revenues for the quarter ended March 31, 2004, compared to 0.0% for the same period of 2003. Revenues from Expedia Inc. were 11.5% of revenues for the quarter ended March 31, 2004, compared to 0.0% for the same period of 2003. Revenues from the U.K. Government were 1.5% of total revenues for the quarter ended March 31, 2004, compared to 11.4% for the same period of 2003. We expect the concentration of revenues to continue with various customers, but that the particular customers will vary depending upon the timing of certain revenues in future quarters.

**Gross Profit.** Gross profit was $0.6 million or 49.7% of net revenues for the quarter ended March 31, 2004, compared to $0.5 million or 32.0% of net revenues for the quarter ended March 31, 2003. Gross profit margins as a percentage of net revenues increased from the same period in the prior year due to a continued shift in product mix, which resulted in an increase as a percentage of revenues of our more profitable SecureNet product line. Gross profit on product revenues increased from 4.4% in 2003 to 42.0% in 2004 due to the transition to our more profitable software-based products. Gross profit on customer support and maintenance revenue decreased from 74.1% in 2003 to 69.2% in 2004, as more repair costs were incurred during the quarter.

Gross profit as a percentage of net revenues is impacted by several factors, including shifts in product mix, changes in channels of distribution, revenues volume, fluctuations in third-party assembly costs, pricing strategies, and fluctuations in revenues of integrated third-party products.

**Sales and Marketing.** Sales and marketing expenses decreased to $1.0 million for the quarter ended March 31, 2004, compared to $1.9 million for the quarter ended March 31, 2003, primarily due to the reorganization of our sales and marketing departments, including a reduction in headcount, and other cost reduction initiatives. We expect to continue to realize the impact of our cost reduction initiatives throughout 2004. Sales and marketing expenses may vary as a percentage of net sales in the future. However, we believe that these costs will remain constant through the end of the year.

**Research and Development.** Research and development expenses decreased to $0.6 million for the quarter ended March 31, 2004, compared to $0.9 million for the quarter ended March 31, 2003. Research and development costs are expensed in the period incurred. Research and development expenses decreased in the quarter ended March 31, 2004, compared to the same period in 2003 as we focused more of our development efforts on our core security products, SecureNet and our Information Compliance products, while reducing efforts on our other security products. Research and development expenses may vary as a percentage of net sales in the future.

**General and Administrative.** General and administrative expenses decreased to $0.3 million for the quarter ended March 31, 2004, compared to $0.4 million for the quarter ended March 31, 2003, primarily due to the restructuring done in 2003, including a reduction in headcount, and other cost reduction initiatives. It is expected that general and administrative expenses will remain relatively constant throughout the remainder of the year. General and administrative expense may vary as a percentage of net sales in the future.

**Severance Costs.** Severance costs of $0.1 million for the three-month period ended March 31, 2004 consists primarily of severance payments made after year-end as a result of reductions in force. All severance obligations were paid prior to March 31, 2004, and we were not receiving further benefit from the severed individuals after March 31, 2004. Severance costs of $0.1 million for the three-month period ended March 31, 2003 consisted of reductions in force made during that period.

**Interest.** Net interest income decreased to $18 thousand for the quarter ended March 31, 2004 compared to $61 thousand for the same period in 2003. The slight decrease in interest income was primarily due to the reduced overall cash balances resulting from operating losses. Net interest income may vary in the future based on our cash flow and rate of return on investments.

*Liquidity and Capital Resources*

Our principal source of liquidity at March 31, 2004 is approximately $5.8 million of cash and cash equivalents and $0.5 million of short-term investments. As of March 31, 2004 working capital was $5.9 million compared to $8.3 million as of March 31, 2003.

On March 25, 2004, we completed a $5.0 million private placement of 5% Convertible Preferred Stock and warrants. In the private placement, the Company sold 1,000,000 shares of preferred stock at a price of $5.00 per share, which may be converted into 1,590,331 shares of common stock at an initial conversion price of $3.144 per share, and warrants to purchase 556,615 shares of common stock at an exercise price of $3.144 per share. In connection with the closing of this private placement, we issued warrants to purchase 64,409 shares of our common stock at an exercise price of $3.144 per share to our financial advisor for the private placement.

Cash used in operations for the three months ended March 31, 2004 was $1.1 million, primarily due to an operating loss of $1.3 million, an increase in inventories of $0.2 million and a decrease in accounts payable and accrued expenses of $0.3 million, which is offset by depreciation expense of $0.1 million and a decrease in accounts receivable of $0.5 million and an increase in deferred revenue of $0.1 million and a decrease in other assets of $0.0 million, compared to cash used in operations of $2.4 million for the three months ended March 31, 2003, primarily due to an operating loss from continuing operations of $2.8 million, which is offset by depreciation expense and a decrease in accounts receivable. Future fluctuations in inventory balances, accounts receivable and accounts payable will be dependent upon several factors, including, but not limited to, quarterly sales, our strategy in building inventory in advance of receiving orders from customers, and the accuracy of our forecasts of product demand and component requirements.

Cash provided in investing activities in the three months ended March 31, 2004 was $1.2 million, which consisted primarily of the net maturity of short-term investments, compared to cash provided by investing activities of $0.5 million for the three months ended March 31, 2003, which also consisted primarily of the maturity of short-term investments.

Cash provided by financing activities in the three months ended March 31, 2004 was $4.7 million, consisting of net financing proceeds from a private placement and the exercise of employee stock options, compared to $0.0 million during the three months ended March 31, 2003.

At March 31, 2004, the Company did not have any material commitments for capital expenditures.

During the three months ended March 31, 2004, the Company funded its operations through the use of cash and cash equivalents.

Although we believe we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue at least through the first half of 2004. As a result, we may not be able to achieve the revenue and gross margin objectives necessary to achieve positive cash flow or profitability without obtaining additional financing. We do not currently have any arrangements for financing, and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. If our business does not generate sufficient cash flow from operations and sufficient future financings are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

We intend to explore the possible acquisitions of businesses, products and technologies that are complementary to our existing business. We are continuing to identify and prioritize additional security technologies which we may wish to develop, either internally or through the licensing or acquisition of products from third parties. While we engage from time to time in discussions with respect to potential acquisitions, there can be no assurances that any such acquisitions will be made or that we will be able to successfully integrate any acquired business. In order to finance such acquisitions and working capital it may be necessary for us to raise additional funds through public or private financings. Any equity or debt financings, if available at all, may be on terms, which are not favorable to us and, in the case of equity financings, may result in dilution to our stockholders.

*Factors That May Affect Future Results of Operations*

Numerous factors may affect our business and future results of operations. These factors include, but are not limited to, current economic and market conditions, the effect of military actions on government and corporate spending on information security products, spending patterns of, and appropriations to, U.S. government departments, technological changes, competition and market acceptance, acquisitions, product transitions, timing of orders, manufacturing and suppliers, reliance on outsourcing vendors and other partners, intellectual property and licenses, third-party products, dependence on government customers, international operations, intellectual property issues, liquidity and cash resources and effects of restructuring plans and cost reductions. The discussion below addresses some of these and other factors. For a more thorough discussion of these and other factors that may affect our business and future results, see the discussion under the caption "Factors That May Affect Future Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2003.

***If we fail to respond to rapid technological changes in the network security industry, we may lose customers or our products may become obsolete.***

The network security industry is characterized by frequent product introductions, rapidly changing technology and continued evolution of new industry standards. We must also introduce upgrades to our products rapidly in response to customer needs such as new computer viruses or other novel external attacks on computer networks. In addition, the nature of the network security industry requires our products to be compatible and interoperable with numerous security products, networking products, workstation and personal computer architectures and computer and network operating systems offered by various vendors, including our competitors. As a result, our success depends upon our ability to develop and introduce in a timely manner new products and enhancements to our existing products that meet changing customer requirements and evolving industry standards. The development of technologically advanced network security products is a complex and uncertain process requiring high levels of innovation, rapid response and accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully in a timely manner. Further, we or our competitors may introduce new products or product enhancements that shorten the life cycle of our existing products or cause our existing products to become obsolete.

***Our revenues have declined from $16.7 million in 2001 to $6.5 million in 2003 in connection with a shift to sales of our newer product lines. If our network intrusion detection and regulated information compliance system products do not achieve market acceptance, our revenues will suffer.***

Over the past three years, we have transitioned our sales strategy from our lower margin SecureCom and PDS security appliance products to the development and sales of our higher margin SecureNet network intrusion detection products. During this transition, sales of our new products were not enough to counteract the loss in sales associated with our older products. As a result, our net revenues have declined from approximately $16.7 million in 2001, to approximately $7.8 million in 2002 and approximately $6.5 million in 2003. In addition, our revenues for the first quarter of 2004 are $1.3 million as compared to $1.5 million for the same period in 2003.

Our new network security products and regulated information compliance systems have only been in the market place for a limited period of time and may have longer sales cycles than our previous products. Although response to our products has been positive, we have not yet received broad market acceptance. We cannot assure you that our present or future products will achieve market acceptance on a sustained basis.

In order to achieve market acceptance and achieve future revenue growth, we must introduce complementary security products, incorporate new technologies into our existing product lines and design, develop and successfully commercialize higher performance products in a timely manner. We cannot assure you that we will be able to offer new or complementary products that gain market acceptance quickly enough to avoid decreased revenues during current or future product introductions or transitions.

***We resemble a developmental stage company and our business strategy may not be successful.***

From our founding in 1983 until 2000, we derived substantially all of our revenue from the design, manufacture and sale of local area networking equipment. In order to permit us to focus our resources solely on developing and marketing our network security products, on April 17, 2000, we announced our plans to sell our local area networking assets and related networking divisions.

&nbs