INTRUSION INC
Form 10QSB
November 10, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2005

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 small business issuer 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

(Issuer 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 a shell company (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 October 28, 2005 was 6,909,507.

Transitional Small Business Disclosure Format (check one): Yes o No ý

INTRUSION INC.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

	September 30, 2005	December 31, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,398	$ 2,315
Short-term investments	500	75
Accounts receivable, less allowance for doubtful accounts of $223 in 2005 and $508 in 2004	902	1,220
Inventories, net	519	950
Prepaid expenses	189	393
Total current assets	4,508	4,953
Property and equipment, net	294	299
Other assets	43	64
TOTAL ASSETS	$ 4,845	$ 5,316
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	$ 1,368	$ 1,667
Deferred revenue	713	799
Total current liabilities	2,081	2,466
Stockholders Equity:		
Preferred stock $.01 par value; authorized shares 5,000 5% shares issued and outstanding 389 in 2005 and 840 in 2004; Liquidation preference of $1,994 as of September 30, 2005	1,375	2,968
Series 2 5% shares issued and outstanding 500; Liquidation preference of $1,256 as of September 30, 2005	787	
Common stock $.01 par value; authorized shares 80,000; Issued shares 6,714 in 2005 and 5,431 in 2004; Outstanding shares 6,704 in 2005 and 5,421in 2004	67	54
Common stock held in treasury, at cost 10 shares	(362)	(362)
Additional paid-in capital	52,251	49,095
Accumulated deficit	(51,175)	(48,732)
Accumulated other comprehensive loss	(179)	(173)
Total stockholders equity	2,764	2,850
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 4,845	$ 5,316

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	Sept 30, 2005	**Sept 30, 2004**	**Sept 30, 2005**	**Sept 30, 2004**
Net product revenue	$ 1,589	$ 1,213	$ 3,783	$ 2,762
Net customer support and maintenance revenue	389	464	1,089	1,285
Total revenue	1,978	1,677	4,872	4,047
Cost of product revenue	789	726	2,010	1,705
Cost of customer support and maintenance revenue	8	117	54	351
Total cost of revenue	797	843	2,064	2,056
Gross profit	1,181	834	2,808	1,991
Operating expenses:				
Sales and marketing	797	894	2,429	2,867
Research and development	552	613	1,957	1,947
General and administrative	336	304	868	884
Severance and related costs		5	55	134
Operating loss	(504)	(982)	(2,501)	(3,841)
Other income, net		26	2	67
Interest income, net	23	9	56	34
Loss before income tax provision	(481)	(947)	(2,443)	(3,740)
Income tax provision				
Net loss	$ (481)	$ (947)	$ (2,443)	$ (3,740)
Preferred stock dividends accrued	(44)	(67)	(129)	(129)
Beneficial conversion feature on preferred stock			(919)	(938)
Net loss attributable to common stockholders	$ (525)	$ (1,014)	$ (3,491)	$ (4,807)
Net loss per share attributable to common stockholders, basic and diluted	$ (0.08)	$ (0.20)	$ (0.56)	$ (0.93)
Weighted average common shares outstanding, basic and diluted	6,586	5,166	6,270	5,166

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended	
	Sept 30, 2005	Sept 30, 2004
Operating Activities:		
Net loss	$ (2,443)	$ (3,740)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	141	164
Provision for doubtful accounts	(285)	(108)
Changes in operating assets and liabilities:		
Accounts receivable	603	30
Inventories	431	150
Other Assets		250
Prepaid expenses and other assets	227	
Accounts payable and accrued expenses	(291)	(561)
Deferred revenue	(86)	107
Net cash used in operating activities	(1,703)	(3,708)
Investing Activities:		
Purchases of short-term investments	(2,350)	(3,100)
Maturities of short-term investments	1,925	3,035
Purchases of property and equipment	(136)	(126)
Net cash used in investing activities	(561)	(191)
Financing Activities:		
Proceeds from the exercise of employee stock options		6
Dividends paid on preferred stock	(137)	
Proceeds from the issuance of preferred stock and warrants, net	2,490	4,725
Net cash provided by financing activities	2,353	4,731
Effect of foreign currency translation adjustment on cash and cash equivalents	(6)	
Net increase in cash and cash equivalents	83	832
Cash and cash equivalents at beginning of period	2,315	974
Cash and cash equivalents at end of period	$ 2,398	$ 1,806
SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES:		
Fair value of warrants issued in connection with sale of preferred stock	$ 815	$ 1,191
Amortization of preferred stock beneficial conversion feature	$ 919	$ 938
Preferred stock dividends accrued	$ 129	$ 129

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

We develop, market and support a family of regulated information compliance and data privacy protection products, entity identification systems along with network intrusion prevention and detection systems that address vital security issues facing organizations with mission critical business applications or housing classified, confidential, or customer information assets. Our products include Compliance Commander for regulated information and data privacy protection, TraceCop for entity identification and location, SpySnare for real-time inline blocking of spyware and unwanted peer-to-peer applications, and SecureNet for network intrusion prevention and detection.

We market and distribute our products through a direct sales force to end-users and 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 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 September 30, 2005, we had cash, cash equivalents and short-term investments in the amount of approximately $2.9 million, up from approximately $2.4 million as of December 31, 2004. This cash increase is primarily the result of the sale of our Series 2 5% preferred stock discussed in Note 7. Although we believe we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months, based on our internal estimates and our operating plan, 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, our operating losses and net operating cash outflows may continue through at least the fourth quarter of 2005. 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 equity financing. In addition, we believe we may need to seek additional equity financing in order to remain in compliance with Nasdaq s continued listing requirement of at least $2.5 million of stockholders equity. 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, fund our other liquidity needs or maintain our listing on The Nasdaq SmallCap Market. Moreover, any financing raised by us may restrict our business activities or future capital raising efforts or cause dilution to our current stockholders.

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-QSB and Item 310 of Regulation S-B. 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, 2004 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 and nine month periods ending September 30, 2005 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The unaudited 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-KSB for the year ended December 31, 2004.

3. Inventories (In thousands)

		Sept 30, 2005		December 31, 2004
Inventories consist of:				
Finished goods	$	378	$	743
Work in progress		93		18
Demonstration systems		48		189
Net inventory	$	519	$	950

4. Accounting for Stock-Based Compensation

We account for employee stock-based compensation in accordance with 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 as amended by SFAS 148 had been applied the quarters and nine months ended September 30, 2005 and September 30, 2004 (in thousands, except per share data).

		Quarter Ended Sept 30, 2005		Quarter Ended Sept 30, 2004		Nine Months Sept 30, 2005		Nine Months Sept 30, 2004
Net loss attributable to common stockholders	$	(525)	$	(1,014)	$	(3,491)	$	(4,807)
Deduct: Total stock-based compensation determined under fair value-based method for all awards		(283)		(44)		(589)		(164)
Pro forma net loss attributable to common stockholders	$	(808)	$	(1,058)	$	(4,080)	$	(4,971)
Net loss per share attributable to common stockholders:								
as reported (basic and diluted)	$	(0.08)	$	(0.20)	$	(0.56)	$	(0.93)
pro forma (basic and diluted)	$	(0.12)	$	(0.20)	$	(0.65)	$	(0.96)
Weighted-average shares used in computation:								
Basic and diluted		6,586		5,166		6,270		5,166

As required, the pro forma disclosures above include options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 and SFAS 148 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.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS 123 and supersedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. For the

Company, SFAS 123R is effective for periods beginning after December 15, 2005. Early application of SFAS 123R is encouraged, but not required. We plan to adopt SFAS 123R on January 1, 2006 using the modified prospective application method described in the statement. Under the modified prospective application method, we will apply the standard to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the unvested portion of awards outstanding as of the required effective date will be recognized as compensation expense as the requisite service is rendered after the required effective date.

We are evaluating the impact of adopting SFAS 123R and expect that we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on our financial condition or cash flows but is expected to have a significant, adverse effect on our results of operations. The future impact of the adoption of SFAS 123R cannot be predicted at this time because it will depend on levels of share-based payments granted by us in the future. However, had we adopted SFAS 123R in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net loss attributable to common stockholders included above.

5. Net Loss Per Share

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 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 periods ended September 30, 2005 and 2004 are 3,247,451 and 2,607,197, respectively. Our common stock equivalents are not included in the diluted loss per share for the three and nine-month periods ended September 30, 2005 and 2004, 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 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.

7. Preferred Stock

On March 28, 2005, we completed a $2.7 million private placement of Series 2 5% preferred stock and warrants. In the private placement, we sold 1,065,200 shares of preferred stock at a price of $2.50 per share for gross proceeds of $2.7 million, less $173,000 of issuance costs. The shares of Series 2 5% preferred stock are convertible into 1,065,200 shares of common stock at an initial conversion price of $2.50 per share. Holders of the Series 2 5% preferred stock include 160,000 shares purchased by our CEO and 60,000 shares purchased by a director of the Company.

The 5% dividends accruing on the Series 2 5% preferred stock are required to be paid quarterly on the first business day in March, June, September and December of each year, beginning with June 2005. The liquidation preference for the preferred stock is an amount equal to $2.50 per share plus any accrued and unpaid dividends. Holders of our Series 2 5% preferred stock have liquidation preference rights over our 5% preferred stock holders as well as our common stock holders. The holders of the Series 2 5% preferred stock are not entitled to vote on any matter, except as otherwise required by law or with respect to certain limited matters specified in the Certificate of Designations creating the Series 2 5% preferred stock.

Included in this transaction were warrants to purchase 532,600 shares of common stock at an exercise price of $2.77 per share. Warrant holders include 80,000 held by our CEO and 30,000 held by a director of the Company. The relative fair value of these warrants was valued at $0.7 million using the Black-Scholes model and has been recorded as a discount to the Series 2 5% preferred stock and an increase in additional paid-in capital. The issuance of these warrants also resulted in a beneficial conversion feature to the Series 2 5% 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 2005, as the preferred stock does not have a stated maturity and is immediately convertible into common stock. This beneficial conversion feature is included in the net loss attributed to common stockholders. In connection with the closing of this private placement, we issued warrants to purchase 60,390 shares of our common stock at an exercise price of $2.77 per share to two affiliates of our financial advisor for assistance with the private placement. These warrants were valued at $0.1 million using the Black-Scholes model and have been recorded as a discount to the Series 2 5% preferred stock and an increase to additional paid-in capital.

The Series 2 5% preferred stock was recorded as the net of the proceeds of $2.7 million less $173,000 issuance costs and the fair value of the warrants issued in conjunction with the Series 2 5% preferred stock totaling $0.8 million.

Holders of Series 2 5% preferred stock have the right to require us to redeem any or all of the their shares upon the occurrence of certain events within the Company s control that are defined in Certificate of Designation at a price equal the sum of (1) the greater of $3.25 and the product of the volume weighted average price of our common stock on the trading day immediately preceding the event multiplied by $2.50 divided by the conversion price then in effect plus (2) any accrued but unpaid dividends on the Series 2 5% preferred stock plus (3) all liquidated damages or other amounts payable to the holders of Series 2 5% preferred stock.

8. Common Stock

During the three months ended September 30, 2005, 220,000 shares of our Series 2 5% preferred stock were converted into 220,000 shares of common stock. In addition, an employee exercised stock options to purchase 501 shares of common stock.

During the nine months ended September 30, 2005, 450,912 shares of our 5% preferred stock were converted into 717,099 shares of common stock and 565,200 shares of Series 2 5% preferred stock were converted into 565,200 shares of common stock. In addition, an employee exercised stock options to purchase 668 shares of common stock.

9. Comprehensive Loss

SFAS No. 130, Reporting Comprehensive Income, establishes standards for the reporting and display of comprehensive loss and its components. SFAS No. 130 requires, among other things, that foreign currency translation adjustments be included in other comprehensive loss. The following statement presents comprehensive loss for the three and nine months ended September 30, 2005 and 2004 (in thousands):

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Net loss attributable to common shareholders	$ (525)	$ (1,014)	$ (3,491)	$ (4,807)
Other comprehensive income (loss):				
Foreign currency translation adjustment			6	
Comprehensive loss	$ (525)	$ (1,014)	$ (3,485)	$ (4,807)

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, market acceptance of our products, the impact of sustained losses on our ability to successfully operate and grow our business, our stock price and our ongoing Nasdaq eligibility, the highly competitive market for our products, the effects of sales and implementation cycles for our new products on our quarterly results, 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-KSB 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 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 unaudited 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 we believe are 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 unaudited 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, our warranty costs should continue to decline. To the extent that they do decline, our warranty reserve from current sales will decrease. If 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 estimates 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: (1) execution of a written agreement; (2) delivery of the product has occurred; (3) the fee is fixed and determinable; and (4) 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. Our receivables are uncollateralized and we expect to continue this policy in the future. 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		Nine Months Ended	
	Sept 30, 2005	**Sept 30, 2004**	**Sept 30, 2005**	**Sept 30, 2004**
Net product revenue	80.3%	72.3%	77.6%	68.2%
Net customer support and maintenance revenue	19.7	27.7	22.4	31.8
Total revenue	100.0	100.0	100.0	100.0
Cost of product revenue	39.9	43.3	41.3	42.1
Cost of customer support and maintenance revenue	0.4	7.0	1.1	8.7
Total cost of revenue	40.3	50.3	42.4	50.8
Gross profit	59.7	49.7	57.6	49.2
Operating expenses:				
Sales and marketing	40.3	53.3	50.0	70.9
Research and development	27.9	36.6	40.2	48.1
General and administrative	17.0	18.1	17.8	21.8
Severance and related costs		0.3	1.1	3.3
Operating loss	(25.5)	(58.6)	(51.3)	(94.9)
Other income, net		1.6	0.0	1.7
Interest income, net	1.2	0.5	1.1	0.8
Loss before income tax provision	(24.3)	(56.5)	(50.2)	(92.4)
Income tax provision				
Net loss	(24.3)%	(56.5)%	(50.2)%	(92.4)%
Preferred stock dividends accrued	(2.2)	(4.0)	(2.6)	(3.2)
Beneficial conversion feature on preferred stock			(18.9)	(23.2)
Net loss attributable to common stockholders	(26.5)%	(60.5)%	(71.7)%	(118.8)%

	Three Months Ended		Nine Months Ended	
	Sept 30, 2005	**Sept 30, 2004**	**Sept 30, 2005**	**Sept 30, 2004**
Domestic revenues	91.0%	84.5%	89.4%	78.2%
Export revenues to:				
Europe	7.3	8.8	7.5	13.3
Canada	0.2	2.1	0.5	4.1
Asia	1.4	4.4	2.5	4.1
Latin America	0.1	0.2	0.1	0.3
Net revenues	100.0%	100.0%	100.0%	100.0%

Net Revenues. Net revenues for the quarter and nine months ended September 30, 2005 were $2.0 million and $4.9 million, respectively, compared to $1.7 million and $4.0 million for the same periods in 2004. Product revenues increased $0.4 million and $1.0 million for the quarter and nine months ended September 30, 2005 compared to the same periods in 2004. Customer support and maintenance revenue decreased $0.1 million and $0.2 million for the quarter and nine months ended September 30, 2005 compared to the same periods in 2004. Consistent with our strategic move to concentrate on our Intrusion Prevention/Detection, Entity Identification and Regulated Information

Compliance and Data Privacy products, total revenues (including maintenance and support) for the quarter and nine months ended September 30, 2005 from this product line increased to $1.9 million and $4.6 million from $1.4 million and $3.6 million for the same periods in 2004. Our first generation product sales, including PDS and SecureCom decreased for the quarter and nine months ended September 30, 2005 to $0.1 million and $0.2 million from $0.3 million and $0.4 million from the same periods in 2004.

Export Revenues. Export revenues for the quarter and nine months ended September 30, 2005 decreased to $0.2 million and $0.5 million from $0.3 million and $0.9 million compared to the same periods in 2004 as revenues from our PDS security appliance family decreased and we focused more of our resources domestically.

Concentration of Revenues. Revenues from sales to various U.S. government entities totaled $1.5 million, or 77.0% of revenues, for the quarter ended September 30, 2005 compared to $0.9 million, or 56.4% of revenues, for the same period in 2004. Revenues from sales to various U.S. government entities totaled $3.6 million, or 73.4% of revenues, for the nine months ended September 30, 2005 compared to $1.9 million, or 45.9% of revenues, for the same period in 2004. Although, we expect our concentration of revenues to vary among customers in future quarters depending upon the timing of certain sales, we anticipate that sales to government customers will continue to account for a significant portion of our revenues in future quarters. Sales to the government present risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including potential disruption to appropriation and spending patterns and the government s reservation of the right to cancel contracts and purchase orders for its convenience. Although we do not believe that the cancellation of any particular order would have a material adverse effect on our financial results or that any of our revenues with government customers are subject to renegotiation, a large number of cancelled or renegotiated government orders could have a material adverse effect on our financial results. Currently, we are not aware of any proposed cancellation or renegotiation of any of our existing arrangement with government entities and, historically, government entities have not cancelled or renegotiated orders which had a material adverse effect on our business.

Gross Profit. Gross profit was $1.2 million or 59.7% of net revenues for the quarter ended September 30, 2005, compared to $0.8 million or 49.7% of net revenues for the quarter ended September 30, 2004. Gross profit was $2.8 million or 57.6% of net revenues for the nine months ended September 30, 2005, compared to $2.0 million or 49.2% of net revenues for the nine months ended September 30, 2004. 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, to our more profitable software-based products. Gross profit on product revenues for the quarter and nine months ended September 30, increased from 40.1% and 38.3%, respectively, in 2004 to 50.3% and 46.9%, respectively, in 2005 due to the transition to our more profitable software-based products. Gross profit on customer support and maintenance revenues for the quarter and nine months ended September 30, increased from 74.8% and 72.7%, respectively, in 2004 to 97.9% and 95.0%, respectively, in 2005, as less repair costs associated with maintenance contracts were incurred during the quarter and nine months during 2005 in conjunction with our transition to software-based products.

Gross profit as a percentage of net revenues is impacted by several factors, including shifts in product mix, changes in channels of distribution, revenue 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 $0.8 million for the quarter ended September 30, 2005, compared to $0.9 million for the quarter ended September 30, 2004. Sales and marketing expenses decreased to $2.4 million for the nine months ended September 30, 2005, compared to $2.9 million for the nine months ended September 30, 2004. This cost reduction was primarily due to the reorganization of our sales and marketing departments, including a reduction in headcount, and other cost reduction initiatives. Sales and marketing expenses may vary in the future. However, we believe that these costs will remain relatively constant through the end of 2005.

Research and Development. Research and development expenses remained constant at $0.6 million for the quarters ended September 30, 2005 and 2004. Research and development expenses increased to $2.0 million for the nine months ended September 30, 2005, compared to $1.9 million for the nine months ended September 30, 2004.

Research and development costs are expensed in the period incurred. Research and development expenses increased slightly in the nine months ended September 30, 2005, compared to the same periods in 2004 as we incurred slightly more material-related development costs during the period. Research and development expenses may vary in the future; however, we believe that these costs will remain relatively constant through the end of 2005.

General and Administrative. General and administrative expenses remained constant at $0.3 million for the quarters ended September 30, 2005 and 2004. General and administrative expenses remained constant at $0.9 million for the nine months ended September 30, 2005 and 2004. It is expected that general and administrative expenses will remain relatively constant throughout the remainder of 2005, as no further headcount reductions are anticipated. General and administrative expense may vary in the future.

Severance and Related Costs. We did not incur severance and related costs during the quarter ended September 30, 2005 compared to $5 thousand for the same period in 2004. Severance costs decreased to $55 thousand for the nine-month period ended September 30, 2005, compared to $134 thousand for the nine-month period ended September 30, 2004. Severance and related costs during the nine-month period ended September 30, 2005 consisted primarily of payments made during the periods as a result of prior reductions in force. Severance and related costs for the nine-month period ended September 30, 2004 consisted of reductions in force made during those periods.

Interest. Net interest income increased to $23 thousand for the quarter ended September 30, 2005 compared to $9 thousand for the same period in 2004. Net interest income increased to $56 thousand for the nine months ended September 30, 2005 compared to $34 thousand for the same period in 2004. The increase in interest income was primarily due to better returns over prior year and relatively constant cash and short-term investment balances when compared to prior year. 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 September 30, 2005 is approximately $2.4 million of cash and cash equivalents and $0.5 million of short-term investments. At September 30, 2005 working capital was $2.4 million compared to $3.3 million at September 30, 2004.

Cash used in operations for the nine months ended September 30, 2005 was $1.7 million, primarily due to a net loss of $2.4 million, a decrease in accounts payable and accrued expenses of $0.3 million, a reduction in the provision for doubtful accounts of $0.3 million and a reduction in deferred revenue of $0.1 million. This cash decrease was partially offset by depreciation expense of $0.1 million, a decrease in accounts receivable of $0.6 million, a decrease in inventories of $0.4 million and a decrease in prepaid expenses and other assets of $0.2 million. Cash used in operations for the nine months ended September 30, 2004 was $3.7 million, primarily due to an operating loss of $3.7 million, a decrease in accounts payable and accrued expenses of $0.6 million and a decrease in the provision for doubtful accounts of $0.1 million. This cash usage was partially offset by depreciation and amortization of $0.2 million, a decrease in inventories of $0.2 million, an increase in deferred revenue of $0.1 million and a decrease in other assets of $0.3 million. 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 used in investing activities in the nine months ended September 30, 2005 was $0.6 million, which consisted primarily of the purchase of short-term investments of $2.4 million and net purchases of property and equipment of $0.1 million, which was offset partially by maturities of short-term investments of $1.9 million, compared to cash used in investing activities in the nine months ended September 30, 2004 of $0.2 million, which consisted primarily of the net purchase of short-term investments of $0.1 million and net purchases of property and equipment of $0.1 million.

Cash provided by financing activities in the nine months ended September 30, 2005 was $2.4 million, consisting of net financing proceeds from a private placement of $2.5 million, partially offset by payment of dividends on preferred stock of $137 thousand, compared to cash provided by financing activities in the nine months ended September 30, 2004 was $4.7 million, consisting of net financing proceeds from a private placement of $4.7 million and the exercise of employee stock options of $6 thousand.

At September 30, 2005, the Company did not have any material commitments for capital expenditures.

During the nine months ended September 30, 2005, the Company funded its operations through financing proceeds raised during the first quarter of 2005 as well as the use of cash, cash equivalents and sales of short-term investments.

Based on our financial projections, we expect that our cash on hand, along with our short-term investments, and cash from our operations will be sufficient to fund our operations for the next 12 months. However, our projections are dependent upon our ability to meet our revenue and gross profit targets. We funded our operations and met our cash requirements during the nine months ended September 30, 2005 through financing proceeds on preferred stock and the use of cash, cash equivalents and sales of short-term investments. Although we believe we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months, based on our internal estimates and our operating plan, 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, our operating losses and net operating cash outflows may continue through at least the fourth quarter of 2005. 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 equity financing. In addition, we believe we may need to seek additional equity financing in order to remain in compliance with Nasdaq s continued listing requirement of at least $2.5 million of stockholders equity. 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, fund our other liquidity needs or maintain our listing on The Nasdaq SmallCap Market. Moreover, any financing raised by us may restrict our business activities or future capital raising efforts or cause dilution to our current stockholders.

We may 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 may 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.

Off-Balance Sheet Arrangements.

As of September 30, 2005, we did not have any significant off-balance sheet arrangements, as defined by Item 303(c)(2) of Regulation S-B.

Factors That May Affect Future Results of Operations

Numerous factors may affect our business and future results of operations. These factors include 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-KSB for the year ended December 31, 2004.

Our cash, cash equivalents, and investments have increased approximately $0.5 million in the last nine months but have generally declined since 2003. As a result of our expected continuing net cash outflows, we may not have sufficient cash to operate our business, and we may need to raise additional equity financing to maintain our Nasdaq listing.

During the nine months ended September 30, 2005, our cash, cash equivalents and short-term investments increased approximately $0.5 million from approximately $2.4 million as of December 31, 2004 to approximately $2.9 million at September 30, 2005, primarily as a result of a private placement of our preferred stock and warrants, that yielded net proceeds of $2.5 million, which we completed on March 28, 2005. As of December 31, 2004, we had cash, cash equivalents and short-term investments in the amount of approximately $2.4 million, down from approximately $2.7 million as of December 31, 2003. Although we believe the proceeds we received in connection with the private placement in March 2005 will provide us with sufficient cash resources to finance our operations for the next twelve months, based on our internal estimates and our operating plan, 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 our actions to reduce costs and improve profitability, our net operating losses and net operating cash outflows may continue through at least the fourth quarter of 2005. As a result, we believe our stockholders equity could fall below $2.5 million. If this occurs, we would not be in compliance with the Nasdaq listing requirements, and we would need to raise additional equity financing to avoid delisting. Although we may need to secure this financing to maintain our listing on Nasdaq, we do not currently have any arrangements for equity financing. Furthermore, we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, on a timely basis. Therefore, if our business does not generate sufficient cash flow from operations and sufficient financing resources are not available, we may not be able to operate or grow our business, pay our expenses when due, fund our other liquidity needs or maintain our listing on The Nasdaq SmallCap Market.

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If we fail to respond to rapid technological changes in the network security, data protection, regulated information compliance and spyware prevention industries, we may lose customers or our products may become obsolete.

The network security, data protection, regulated information compliance and spyware prevention industries are characterized by frequent product introductions, rapidly changing technology and continued evolution of industry standards. We must introduce upgrades to our products rapidly in response to customer needs, such as new computer viruses or other novel external attacks on computer networks as well as the adoption privacy and data protection laws. In addition, the nature of the network security, data protection, regulated information compliance and spyware prevention industries 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 products that meet changing customer requirements and evolving industry and legal standards. The development of technologically advanced network security, data protection, regulated information compliance and spyware prevention 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, the introduction of new products or product enhancements by us or our competitors or the adoption of new or amended privacy or data protection laws may shorten the life cycle of our existing products or cause our existing products to become obsolete.

Although our revenues have increased to $4.9 million for the first nine months of 2005 from $4.0 for the same period in 2004, our overall revenues have declined from $7.8 million in 2002 to $6.0 million in 2004 in connection with a shift to sales of our newer product lines. If our network intrusion detection, regulated information compliance system, data privacy system and spyware prevention 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 network intrusion detection, regulated information compliance system, data privacy protection and spyware prevention 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, although our revenues for the nine months ended September 30, 2005 increased to $4.9 million from $4.0 million for the same period in 2004, our overall net revenues have declined from approximately $7.8 million in 2002, to approximately $6.5 million in 2003 and approximately $6.0 million in 2004.

Our new network security products, regulated information compliance systems, data privacy protection systems and spyware prevention products 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 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, we sold our local area networking assets and related networking divisions in a series of sales from 2000 to 2002.

As a result of these sales, we now depend exclusively on revenues generated from the sale of our network security products, which have received limited market acceptance. Moreover, we have only recently introduced our regulated compliance and data privacy systems and our spyware prevention products. Although initial response to these products has been positive, the market for these products has only begun to emerge and sales of these products may not occur as quickly as we expect. Consequently, we resemble a developmental stage company and will face the following inherent risks and uncertainties:

the need for our network security products, regulated information compliance systems, data privacy protection systems and spyware prevention products to achieve market acceptance and produce a sustainable revenue stream;

our ability to manage costs and expenses;

our dependence on key personnel;

our ability to obtain financing on acceptable terms; and

our ability to offer greater value than our competitors.

Our business strategy may not successfully address these risks. If we fail to recognize significant revenues from the sales of our network security products and regulated information compliance systems, our business, financial condition and operating results would be materially adversely affected.

We incurred a net loss of $2.4 million for the nine months ended September 30, 2005 and have an accumulated deficit of $51.2 million as of September 30, 2005. As a result, we must generate substantially greater revenues from sales in order to achieve profitability.

We have incurred significant operating losses and are uncertain about our future operating results. For the nine months ended September 30, 2005, we incurred a net loss of $2.4 million and had an accumulated deficit of approximately $51.2 million as of September 30, 2005. We need to generate and sustain substantially greater revenues from the sales of our products if we are to achieve profitability. If we are unable to achieve these greater revenues, our losses will continue indefinitely, and we may never achieve or sustain profitability or generate positive cash flow.

We face intense competition from both start-up and established companies that may have significant advantages over us and our products.

The market for network security solutions is intensely competitive. There are numerous companies competing with us in various segments of the data security markets, and their products may have advantages over our products in areas such as conformity to existing and emerging industry standards, interoperability with networking and other security products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support.

Our principle competitors in the network intrusion and detection market include Internet Security Systems, Inc., Cisco Systems, Inc., MicroSoft, Symantec, Inc., Netscreen Technologies, Inc., McAfee, Inc., Tipping Point Technologies, a division of 3COM Corporation, and NFR Security, Inc. The market for regulated information compliance systems is relatively new. Our competitors in this market include a number of start-up companies that have entered the market in the last two years. However, as this market develops, we expect increased competition from both start-up and established companies. Our current and potential competitors may have one or more of the following significant advantages over us:

greater financial, technical and marketing resources;

better name recognition;

more comprehensive security solutions;

better or more extensive cooperative relationships; and

larger customer base.

Although we believe our network security products and regulated information compliance systems compare favorably to our competitors products and create a sustainable business model, we cannot assure you that our products will achieve market acceptance or that we will be able to compete successfully with our existing or new competitors.

Military actions may disrupt our business by reducing spending our products, increasing our costs and affecting our international operations.

We derive a substantial portion of our revenue from sales to United States government entities, including sales to various Army and other armed services bases. As a result, United States military actions or other events occurring in response to or in connection with them, including future terrorist attacks, actual conflicts involving the United States or its allies or military or trade disruptions could impact our operations by:

reducing or delaying government, armed service or corporate spending on our products;

increasing the cost and difficulty in obtaining materials or shipping products; and

affecting our ability to conduct business internationally.

Should these events occur, our business, operating results and financial condition could be materially and adversely affected.

Our products can have long sales and implementation cycles, which may result in us incurring substantial expenses before realizing any associated revenues.

The sale and implementation of our products to large companies and government entities typically involves a lengthy education process and a significant technical evaluation and commitment of capital and other resources. This process is also subject to the risk of delays associated with customers internal budgeting and other procedures for approving capital expenditures, deploying new technologies within their networks and testing and accepting new technologies that affect key operations. As a result, sales and implementation cycles for our products can be lengthy, and we may expend significant time and resources before we receive any revenues from a customer or potential customer. Our quarterly and annual operating results could be materially harmed if orders forecasted for a specific customer for a particular period are not realized.

Our failure to realize the expected benefits of our recent restructuring efforts could adversely affect our operating results.

During the first nine months of 2005, we incurred $55 thousand in severance related costs. Since we began restructuring in 2002, we have incurred approximately $1.1 million in restructuring charges, severance, and related expenses. The objective of our restructuring plan was to reduce our cost structure to a sustainable level that is consistent with our current cash resources and the general economic climate. We have also implemented other strategic initiatives to strengthen our operations, such as reductions in our work force and facilities and aligning our organization around our business objectives. Any further work force reductions could result in temporary reduced productivity of our remaining employees. Additionally, our customers and prospects may delay or forgo purchasing our products due to a perceived uncertainty caused by our restructuring and other changes. Failure to achieve the desired results of our initiatives could seriously harm our business, results of operations and financial condition.

Consolidation in the network security data protection and spyware prevention industries may limit market acceptance of our products.

Several of our competitors have acquired security companies with complementary technologies in the past. We expect consolidation in the network security, data protection and spyware prevention industries to continue in the future. These acquisitions may permit our competitors to accelerate the development and commercialization of broader product lines and more comprehensive solutions than we currently offer. Acquisitions of vendors or other companies with which we have a strategic relationship by our competitors may limit our access to commercially significant technologies. Further, business combinations in the network security industry are creating companies with larger market share, customer bases, sales forces, product offerings and technology and marketing expertise, which may make it more difficult for us to compete.

Sales to government entities accounted for 73.4% of our revenues the nine months ended September 30, 2005 and 53.6% of our revenues for the year ended December 31, 2004. Sales to government customers involve unique risks, which could adversely impact our revenues.

We derived 73.4% of our revenues from sales to various U.S. government entities for the nine months ended September 30, 2005, and 53.6% of our revenues from these sales for the year ended December 31, 2004. We expect to continue to derive a substantial portion of our revenues from U.S. government customers in the future. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruption due to appropriation and spending patterns and the government s right to cancel contracts and purchase orders for its convenience. General political and economic conditions, which we cannot accurately predict, directly and indirectly may affect the quantity and allocation of expenditures by federal departments. In addition, obtaining government contracts may involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, budgetary constraints, political agendas, extensive specification development and price negotiations and milestone requirements. Each government entity also maintains its own rules and regulations with which we must comply and which can vary significantly among departments. As a result, cutbacks or re-allocations in the federal budget or losses of government sales due to other factors could have a material adverse effect on our revenues and operating results.

We derived 10.6% of our revenues from international sales in the nine months ended September 30, 2005, and 19.2% of our revenues from these sales for the year ended December 31, 2004. Our ability to sell our products internationally is subject to certain risks which could harm our business.

Sales to foreign customers accounted for approximately 19.2% of our revenues for the year ended December 31, 2004, and 10.6% of our revenues for the nine months ended September 30, 2005. We expect sales to foreign customers to continue to represent a significant portion of our revenues in the future. Our international operations are subject to many inherent risks that may adversely affect our business, financial condition and operating results, including:

- political, social and economic instability;
- trade restrictions;
- increases in duty rates and other potentially adverse tax consequences;
- exposure to different legal standards, particularly with respect to the protection of intellectual property;
- burdens of complying with a variety of foreign laws;
- unexpected changes in regulatory requirements;

import and export license requirements and restrictions of the United States and each other country where we operate;

fluctuations in currency exchange rates; and

changes in local purchasing practices, including seasonal fluctuations in demand.

Sales through indirect channels accounted for 39.6% of our revenues for the nine months ended September 30, 2005 and 36.9% of our revenue for the year ended December 31, 2004. Our revenues will suffer if we do not expand our sales through, or receive the anticipated benefits from our sales through, indirect sales channels.

We derived 39.6% of our revenues for the nine months ended September 30, 2005, and 36.9% of our revenue for the year ended December 31, 2004, from sales through indirect sales channels, such as distributors, value added resellers, system integrators, original equipment manufacturers and managed service providers. We believe we must expand our sales through these indirect channels in order to increase our revenues. Although we are actively pursuing a strategy to increase the percentage of our revenues generated through these indirect sales channels, we cannot assure you that our products will gain market acceptance in these indirect sales channels or that sales through these indirect sales channels will increase our revenues as expected. Further, many of our competitors are also trying to sell their products through these indirect sales channels, which could result in lower prices and reduced profit margins for sales of our products.

We must adequately protect our intellectual property in order to prevent loss of valuable proprietary information.

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and non-disclosure agreements to protect our proprietary technology. However, unauthorized parties may attempt to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our intellectual property. This is particularly true in foreign countries where the laws may not protect proprietary rights to the same extent as the laws of the United States and may not provide us with an effective remedy against unauthorized use. If our protection of our intellectual property proves to be inadequate or unenforceable, others may be able to use our proprietary developments without compensation to us, resulting in potential cost advantages to our competitors.

We may incur substantial expenses defending ourselves against claims of infringement.

There are numerous patents held by many companies relating to the design and manufacture of network security systems. Although we are not aware of any instances in which our products violate the intellectual property rights of others or inappropriately use their technology, it is possible that third parties in the future may claim that our products infringe on their intellectual property rights. Any claim, with or without merit, could consume our management s time, result in costly litigation, cause delays in sales or implementations of our products or require us to enter into royalty or licensing agreements. Royalty and licensing agreements, if required and available, may be on terms unacceptable to us or detrimental to our business. Moreover, a successful claim of product infringement against us or our failure or inability to license the infringed or similar technology on commercially reasonable terms could seriously harm our business.

Fluctuations in our quarterly revenues may cause the price of our common stock to decline.

Our operating results have varied significantly from quarter to quarter in the past, and we expect our operating results to vary from quarter to quarter in the future due to a variety of factors, many of which are outside of our control. Although our revenues are subject to fluctuation, significant portions of our expenses are not variable in the short term, and we cannot reduce them quickly to respond to decreases in revenues. Therefore, if revenues are below our expectations, this shortfall is likely to adversely and disproportionately affect our operating results. Accordingly we may not attain positive operating margins in future quarters. Any of these factors could cause our operating results to be below the expectations of securities analysts and investors, which likely would negatively affect the price of our common stock.

The price of our common stock has been volatile in the past and may continue to be volatile in the future due to factors outside of our control.

The market price of our common stock has been highly volatile in the past and may continue to be volatile in the future. For example, for the nine-month period ending September 30, 2005, the market price of our common stock on The Nasdaq SmallCap Market fluctuated between $2.01 and $6.20 per share. The market price of our common stock may fluctuate significantly in response to a number of factors, many of which are outside our control, including:

- variations in our quarterly operating results;

changes in estimates of our financial performance by securities analysts;

changes in market valuations of our competitors;

announcements by us or our competitors of new products, significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;

product or design flaws, product recalls or similar occurrences;

additions or departures of key personnel;

sales of common stock in the future; and

fluctuations in stock market prices and volume, which can be particularly common among network security and other high technology companies.

Our reductions in our work force may make it more difficult for us to attract and retain the personnel necessary to successfully operate our business.

We rely upon the continued service of a relatively small number of key technical, sales and senior management personnel. Our future success depends on retaining our key employees and our continuing ability to attract, train and retain other highly qualified technical, sales and managerial personnel. As a result, our employees could resign with little or no prior notice. We may not be able to attract, assimilate or retain other highly qualified technical, sales and managerial personnel in the future, especially given our recent reductions in force. The loss of any of our key technical, sales and senior management personnel or our inability to attract, train and retain additional qualified personnel could seriously harm our business.

Certain rights of the holders of our preferred stock may hinder our ability to raise additional financing.

We cannot issue shares of capital stock with rights senior to those of our existing 5% preferred stock or Series 2 5% preferred stock without the approval of at least a majority of the holders of our 5% preferred stock and all of the holders of our Series 2 5% preferred stock, voting or acting as separate classes. We also cannot incur certain indebtedness without the approval of at least a majority of the holders of our 5% preferred stock. In addition, holders of the Series 2 5% preferred stock who are not executive officers or directors have the right to purchase a pro rata portion of certain future issuances of securities by us. The combination of these provisions could hinder or delay our ability to raise additional debt or equity financing.

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock and exercise of warrants that we issued in recent private placements.

On March 25, 2004, we completed a $5,000,000 private placement in connection with which we issued 1,000,000 shares of our 5% preferred stock and warrants to acquire 556,619 shares of our common stock. The conversion price for the preferred stock and the exercise price of the warrants is $3.144 per share. We also issued our placement agent a warrant for 64,408 shares of our common stock at an exercise price of $3.144 per share. As of October 31, 2005, there were 259,696 shares of 5% preferred stock, representing 413,003 shares of common stock upon conversion, and warrants to purchase 556,619 shares of common stock outstanding.

In addition, on March 28, 2005, we completed a $2,663,000 private placement in connection with which we issued 1,065,200 shares of our Series 2 5% preferred stock and warrants to acquire 532,600 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 60,390 shares of common stock. The conversion price for the preferred stock is $2.50 per share and the exercise price of the warrants is $2.77 per share. As of October 31, 2005, there were 500,000 shares of Series 2 5% preferred stock, representing 500,000 shares of common stock upon conversion, and warrants to purchase 532,600 shares of common stock outstanding.

On October 31, 2005, we had 6,909,507 shares of common stock outstanding. As a result, we expect the private placements to result in a further dilution to holders of our common stock upon conversion of the preferred stock and exercise of the warrants of 2,127,020 shares of common stock, or an approximately 30.8% increase in the number of shares of our common stock outstanding.

Further, the occurrence of certain specified events controlled by the Company may entitle holders of our Series 2 5% preferred stock to require us to redeem their shares for a number of shares of our common stock equal to the redemption price divided by 75% of the ten-day average of the volume weighted average price of our common stock ending on the day immediately preceding the holder s election to redeem. The redemption price for the shares of Series 2 5% preferred stock equals the sum of (1) the greater of $3.25 and the volume weighted average price of our common stock on the trading day immediately preceding the redemption event multiplied by $2.50 divided by the conversion price of the Series 2 5% preferred stock then in effect plus (2) any accrued but unpaid dividends on the Series 2 5% preferred stock plus (3) any unpaid liquidated damages or other amounts payable to the holders of the Series 2 5% preferred stock. As a result, assuming we have paid all liquidated damages and other amounts to the holders, accrued but unpaid dividends on October 31, 2005 of $6 thousand, a volume weighted average price of $3.01, which was the ten-day volume weighted average closing price of our common stock for the ten days ending October 31, 2005, and our 6,909,507 shares of common stock outstanding on October 31, 2005, we would issue approximately 722,481 shares of our common stock if a specified redemption event occurs and all holders of Series 2 5% preferred stock elected to redeem their shares for common stock. This would represent an increase of approximately 10.5% of the number of outstanding shares of our common stock as of October 31, 2005.

The conversion of preferred stock or exercise of warrants we issued in our recent private placement may cause the price of our common stock to decline.

The holders of the shares of 5% preferred stock and warrants we issued on March 25, 2004 and the holders of the shares of Series 2 5% preferred stock and warrants we issued on March 28, 2005, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to effective registration statements we filed the SEC. As of October 31, 2005, 740,304 shares of preferred stock had converted into 1,177,327 shares of common stock, and 565,200 shares of Series 2 5% preferred stock had converted into 565,200 shares of common stock.

For the four weeks ended on October 28, 2005, the average daily trading volume of our common stock on The Nasdaq SmallCap Market was 10,975 shares. Consequently, if holders of preferred stock or warrants elect to convert their remaining shares or exercise their warrants and sell a material amount of their underlying shares of common stock on the open market, the increase in selling activity could cause a decline in the market price of our common stock. Furthermore, these sales, or the potential for these sales, could encourage short sales, causing additional downward pressure on the market price of our common stock.

Our acquisition of complementary products or businesses may adversely affect our financial condition.

We have made acquisitions in the past, and, in the future, we may acquire or invest in additional companies, business units, product lines or technologies to accelerate the development of products and sales channels complementary to our existing products and sales channels. Negotiation of potential acquisitions and integration of acquired products, technologies or businesses could divert our management s time and resources. Future acquisitions could cause us to issue equity securities that would dilute your ownership of us, incur debt or contingent liabilities, amortize intangible assets or write off in-process research and development, goodwill and other acquisition-related expenses that could seriously harm our financial condition and operating results. Further, if we are not able to properly integrate acquired products, technologies or businesses with our existing products and operations, train, retain and motivate personnel from the acquired business or combine potentially different corporate cultures, we may not receive the intended benefits of our acquisitions, which could adversely affect our business, operating results and financial condition.

The payment of accrued dividends on our preferred stock may strain our cash resources, and our inability to pay these dividends could cause our stock price to decline or could adversely affect our ability to raise additional financing .

Shares of our 5% preferred stock accrue cash dividends equal to $0.25 per share per annum, payable in arrears on March 31 and September 30 of each year, and shares of our Series 2 5% preferred stock accrue cash dividends equal to $0.125 per share per annum, payable in arrears on the first business day of March, June, September and December of each year. The amount of the dividends on our Series 2 5% preferred stock may increase to $0.45 per share per annum upon the occurrence of certain event entitling the holders of these shares to redemption.

During 2004 we paid $129 thousand in dividends related to our 5% preferred stock. During 2005, we paid $90 thousand and $47 thousand in dividends related to our 5% and Series 2 5% preferred stock, respectively and at September 30, 2005, we have dividends accrued of $49 thousand related to our 5% preferred stock and $6 thousand related to our Series 2 5% preferred stock.

Delaware law provides that we may only pay dividends out of our capital surplus or, if no surplus is available, out of our net profits for the fiscal year the dividend is declared and/or the preceding fiscal year. We have not had net profits for the last two fiscal years ended December 31, 2004. However, we did have sufficient capital surplus, defined as the amount by which our net assets exceed our stated capital, based on par value of our outstanding shares as provided by Delaware law. Although we are currently able to pay accrued dividends on our outstanding shares of preferred stock, we cannot assure you that our net assets will continue to exceed our stated capital or that we will have net profits in order to pay these dividends in the future. These dividends continue to accrue on our outstanding shares of preferred stock, regardless of whether we are legally able to pay them. The accrual of these dividends may adversely affect our operating results. Moreover, the payment of these dividends could strain our available cash resources, which could adversely affect our ability to operate or grow our business.

In addition, our inability to pay dividends could require us to redeem outstanding shares of Series 2 5% preferred stock in exchange for shares of our common stock issued at a price equal to 75% of the average of volume weighted average price of our common stock for the ten days ending on the day immediately preceding an election to redeem. As a result, the issuance, or potential issuance, of these additional shares of our common stock could cause our stock price to decline. Furthermore, our inability to pay these dividends in cash could adversely affect our ability to raise equity financing in the future if required.

Compliance with export regulations may hinder our sales to foreign customers.

Certain of our data security products incorporate encryption and other technology that may require clearance and export licenses from the U.S. Department of Commerce under United States export regulations. Any inability to obtain these clearances or licenses or any foreign regulatory approvals, if required, on a timely basis could delay sales and have a material adverse effect on our operating results.

Provisions of our charter documents and Delaware law may have anti-takeover effects.

Certain provisions of our certificate of incorporation and bylaws, such as our ability to offer blank check preferred stock and the inability of our stockholders to act by written consent, could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. We are also subject to the provisions of Section 203 of the Delaware General Corporation Law, which restricts certain business combinations with interested stockholders and could inhibit a non-negotiated merger or other business combination.

Our management and preferred stockholders exercise significant control over our company and may approve or take actions that may be adverse to your interests.

As of October 31, 2005, our executive officers, directors and preferred stockholders beneficially own approximately 23.7% of our voting power. As a result, these stockholders will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and the approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us or providing us with additional financing if required. These stockholders may use their influence to approve or take actions that may be adverse to your interests.

Item 3. CONTROLS AND PROCEDURES

We have carried out an evaluation, under the supervision and the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of September 30, 2005, pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed is recorded, processed, summarized and reported in a timely manner.

We have carried out an evaluation, under the supervision and participation of our management, including our Chief Executive Officer and Chief Financial Officer, of any changes in our internal controls over financial reporting that occurred during the quarterly period ended September 30, 2005, and our Chief Executive Officer and Chief Financial Officer have concluded that there was no change during the quarterly period ended September 30, 2005 that has materially affected or is reasonably expected to materially affect our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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 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.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following Exhibits are filed with this report form 10-QSB:

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
32.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) During the quarter ended September 30, 2005, we did not file any reports on Form 8-K.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

INTRUSION INC.

Date: November 10, 2005

/s/ Michael L. Paxton
Michael L. Paxton
Vice President, Chief Financial Officer,
Treasurer & Secretary
(Principal Financial & Accounting Officer)