

INTRUSION INC
Form 10-Q
August 13, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 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
(State or other jurisdiction of
incorporation or organization)

75-1911917
(I.R.S. Employer
Identification No.)

1101 East Arapaho Road, Richardson, Texas 75081

(Address of principal executive offices)

(Zip Code)

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(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 No

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

The number of shares outstanding of the Registrant's Common Stock, \$0.01 par value, on August 13, 2004 was 5,166,312.

INTRUSION INC.

INDEX

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Condensed Consolidated Balance Sheets as of June 30, 2004 and December 31, 2003

Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2004 and 2003.

Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and 2003

Notes to Condensed Consolidated Financial Statements

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 6. Exhibits and Reports on Form 8-K

Signature Page

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

	June 30, 2004 (Unaudited)	December 31, 2003 (Audited)
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,636	\$ 974
Short-term investments	3,100	1,705
Accounts receivable, less allowance for doubtful accounts of \$574 in 2004 and \$574 in 2003	588	972
Inventories, net	1,382	1,286
Other assets	253	449
Total current assets	6,959	5,386
Property and equipment, net	234	297
Other assets	77	77
TOTAL ASSETS	\$ 7,270	\$ 5,760
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 1,692	\$ 2,188
Deferred revenue	919	788
Total current liabilities	2,611	2,976
Stockholders Equity:		
Preferred stock, \$.01 par value, authorized shares 5,000; 1,000 shares issued and outstanding, 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	48,661	47,526
Accumulated deficit	(46,998)	(44,204)
Accumulated other comprehensive loss	(228)	(228)
Total stockholders equity	4,659	2,784
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 7,270	\$ 5,760

See accompanying notes.

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

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net product revenue	\$ 644	\$ 768	\$ 1,215	\$ 1,659
Net customer support and maintenance revenue	459	715	1,155	1,300
Total revenue	1,103	1,483	2,370	2,959
Cost of product revenue	453	712	728	1,565
Cost of customer support and maintenance revenue	124	379	485	530
Total cost of revenue	577	1,091	1,213	2,095
Gross profit	526	392	1,157	864
Operating expenses:				
Sales and marketing	1,013	1,923	1,973	3,786
Research and development	732	901	1,334	1,824
General and administrative	315	446	579	848
Severance costs	34	118	130	244
Operating loss	(1,568)	(2,996)	(2,859)	(5,838)
Other income	40	10	40	10
Interest income, net	7	53	26	114
Loss before income tax provision	(1,521)	(2,933)	(2,793)	(5,714)
Income tax provision				
Net loss	\$ (1,521)	\$ (2,933)	\$ (2,793)	\$ (5,714)
Preferred stock dividends accrued	(62)		(62)	
Beneficial conversion feature on preferred stock			(938)	
Net loss attributable to common stockholders	\$ (1,583)	\$ (2,933)	\$ (3,793)	\$ (5,714)
Net loss per share attributable to common stockholders (basic and diluted)	\$ (0.31)	\$ (0.57)	\$ (0.73)	\$ (1.11)
Weighted average common shares outstanding, basic and diluted	5,166	5,162	5,165	5,162

See accompanying notes.

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

	Six Months Ended	
	June 30, 2004	June 30, 2003
Operating Activities:		
Net loss	\$ (2,793)	\$ (5,714)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	144	850
Provision for doubtful accounts		(290)
Changes in operating assets and liabilities:		
Accounts receivable	384	1,692
Inventories	(96)	(145)
Other assets	196	423
Accounts payable and accrued expenses	(558)	(872)
Deferred revenue	131	(502)
Net cash used in operating activities	(2,592)	(4,558)
Investing Activities:		
Purchases of short-term investments	(3,100)	(2,150)
Maturities of short-term investments	1,705	4,925
Net purchases of property and equipment	(82)	(85)
Net cash provided by investing activities	(1,477)	2,690
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	662	(1,868)
Cash and cash equivalents at beginning of period	974	2,898
Cash and cash equivalents at end of period	\$ 1,636	\$ 1,030
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	\$
Preferred stock dividend accrued	\$ 62	\$

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 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 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 June 30, 2004, we had cash, cash equivalents and short-term investments in the amount of approximately \$4.7 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, 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, we expect our operating losses and net operating cash outflows to continue through 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.

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 June 30, 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)

	June 30, 2004	December 31, 2003
Inventories consist of:		
Finished goods	\$ 1,008	\$ 851
Work in progress	146	261
Demonstration systems	228	174
Net inventory	\$ 1,382	\$ 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 as amended by SFAS 148 had been applied for the quarters ended June 30, 2004 and June 30, 2003 (in thousands, except per share data). All stock information in this report reflects a four-for-one (4:1) reverse stock split completed on March 29, 2004:

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	Quarter Ended June 30, 2004	Quarter Ended June 30, 2003	Six Months June 30, 2004	Six Months June 30, 2003
Net loss attributable to common stockholders	\$ (1,583)	\$ (2,933)	\$ (3,793)	\$ (5,714)
Add (Deduct): Total stock-based compensation determined under fair value-based method for all awards	(46)	4	(119)	336
Pro forma net loss attributable to common stockholders	\$ (1,629)	\$ (2,929)	\$ (3,912)	\$ (5,378)
Net loss per share attributable to common stockholders:				
as reported (basic and diluted)	\$ (0.31)	\$ (0.57)	\$ (0.73)	\$ (1.11)
pro forma (basic and diluted)	\$ (0.32)	\$ (0.57)	\$ (0.76)	\$ (1.04)
Weighted-average shares used in computation:				
Basic and diluted	5,166	5,162	5,165	5,162

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.

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 and six-month periods ended June 30, 2004 and 2003 are 2,594,849 and 377,095, respectively. Our common stock equivalents are not included in the diluted loss per share for the three and six-month periods ended June 30, 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.

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 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, as amended, 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 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, 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: 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		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net product revenue	58.4%	51.8%	51.3%	56.1%
Net customer support and maintenance revenue	41.6	48.2	48.7	43.9
Total revenue	100.0	100.0	100.0	100.0
Cost of product revenue	41.1	48.0	30.7	52.9
Cost of customer support and maintenance revenue	11.2	25.6	20.5	17.9
Total cost of revenue	52.3	73.6	51.2	70.8
Gross profit	47.7	26.4	48.8	29.2
Operating expenses:				
Sales and marketing	91.8	129.7	83.2	127.9
Research and development	66.4	60.8	56.3	61.6
General and administrative	28.6	30.1	24.4	28.7
Severance costs	3.1	8.0	5.5	8.2
Operating loss	(142.2)	(202.2)	(120.6)	(197.2)
Other income	3.6	0.7	1.7	0.3
Interest income, net	0.6	3.6	1.1	3.9
Loss before income tax provision	(137.9)	(197.9)	(117.8)	(193.0)
Income tax provision				
Net loss	(137.9)%	(197.9)%	(117.8)%	(193.0)%
Preferred stock dividends accrued	(5.6)		(2.6)	
Beneficial conversion feature on preferred stock			(39.6)	
Net loss attributable to common stockholders	(143.5)%	(197.9)%	(160.0)%	(193.0)%

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	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Domestic revenues	84.6%	66.6%	73.7%	57.6%
Export revenues to:				
Europe	5.7	24.6	16.6	30.9
Canada	7.5	1.9	5.5	0.6
Asia	1.9	6.6	3.9	10.8
Latin America	0.3	0.3	0.3	0.1
Net revenues	100.0%	100.0%	100.0%	100.0%

Net Revenues. Net revenues for the quarter and six months ended June 30, 2004 were \$1.1 million and \$2.4 million, respectively, compared to \$1.5 million and \$3.0 million for the same periods in 2003. Product revenues decreased \$0.1 million and \$0.4 million for the quarter and six months ended June 30, 2004 compared to the same periods in 2003. Customer support and maintenance revenue decreased \$0.3 million and \$0.1 million for the quarter and six months ended June 30, 2004 compared to the same periods in 2003. Total revenues (including maintenance and support) for the quarter and six months ended June 30, 2004 from our SecureNet product line increased to \$1.0 million and \$2.1 million from \$0.9 million and \$1.9 million for the same periods in 2003, but were not sufficient to counteract a continued decline in sales of our hardware-based products in connection with our shift in business focus. Our first generation product sales, including PDS and SecureCom decreased for the quarter and six months ended June 30, 2004 to \$0.1 million and \$0.2 million from \$0.7 million and \$1.3 million from the same periods in 2003. In addition, continued sluggish economic conditions and delayed customer orders contributed to the decline in revenues.

Export Revenues. Export revenues for the quarter and six months ended June 30, 2004 decreased to \$0.2 million and \$0.6 million from \$0.5 million and \$1.3 million compared to the same periods in 2003 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 \$0.4 million, or 37.6% of revenues, for the quarter ended June 30, 2004 compared to \$0.2 million, or 13.6% of revenues, for the same period in 2003. Revenues from sales to Computer Science Corporation totaled \$0.1 million or 10.3% of revenue for the quarter ended June 30, 2004 compared to \$44 thousand or 3.0% of revenue for the same period in 2003. We expect our concentration of revenues to vary among customers in future quarters depending upon the timing of certain sales.

Gross Profit. Gross profit was \$0.5 million or 47.7% of net revenues for the quarter ended June 30, 2004, compared to \$0.4 million or 26.4% of net revenues for the quarter ended June 30, 2003. Gross profit was \$1.2 million or 48.8% of net revenues for the six months ended June 30, 2004, compared to \$0.9 million or 29.2% of net revenues for the six months ended June 30, 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 for the quarter ended June 30, increased from 7.3% in 2003 to 29.7% in 2004 due to the transition to our more profitable software-based products. Gross profit on customer support and maintenance revenues for the quarter ended June 30,

increased from 47.0% in 2003 to 73.0% in 2004, as less repair costs were incurred during the quarter 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 \$1.0 million for the quarter ended June 30, 2004, compared to \$1.9 million for the quarter ended June 30, 2003. Sales and marketing expenses decreased to \$2.0 million for the six months ended June 30, 2004, compared to \$3.8 million for the six months ended June 30, 2003. 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. 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 relatively constant through the end of the year.

Research and Development. Research and development expenses decreased to \$0.7 million for the quarter ended June 30, 2004, compared to \$0.9 million for the quarter ended June 30, 2003. Research and development expenses decreased to \$1.3 million for the six months ended June 30, 2004, compared to \$1.8 million for the six months ended June 30, 2003. Research and development costs are expensed in the period incurred. Research and development expenses decreased in the quarter and six months ended June 30, 2004, compared to the same periods in 2003 as we focused more of our development efforts on our core SecureNet software-based security products and our regulated information compliance products, while reducing efforts on our PDS, SecureCom and other hardware-based 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 June 30, 2004, compared to \$0.4 million for the quarter ended June 30, 2003. General and administrative expenses decreased to \$0.6 million for the six months ended June 30, 2004, compared to \$0.8 million for the six months ended June 30, 2003. This decrease was 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, as no further headcount reductions are anticipated. General and administrative expense may vary as a percentage of net sales in the future.

Severance Costs. Severance costs decreased to \$34 and \$130 thousand for the three and six-month periods ended June 30, 2004, compared to \$118 and \$244 thousand for the quarter and six months ended June 30, 2003. Severance costs during the three- and six-month periods ended June 30, 2004 consisted primarily of severance payments made during the periods as a result of reductions in force. All severance obligations were paid prior to June 30, 2004, and we were not receiving further benefit from these individuals after June 30, 2004. Severance costs for the three and six-month periods ended June 30, 2003 consisted of reductions in force made during those periods.

Interest. Net interest income decreased to \$7 thousand for the quarter ended June 30, 2004 compared to \$53 thousand for the same period in 2003. Net interest income decreased to \$26 thousand for the six months ended June 30, 2004 compared to \$114 thousand for the same period in 2003. The decrease in interest income was primarily due to the decrease in overall cash balances over the 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 June 30, 2004 is approximately \$1.6 million of cash and cash equivalents and \$3.1 million of short-term investments. As of June 30, 2004 working capital was \$4.3 million compared to \$5.8 million as of June 30, 2003.

Cash used in operations for the six months ended June 30, 2004 was \$2.6 million, primarily due to an operating loss of \$2.8 million, an increase in inventories of \$0.1 million and a decrease in accounts payable and accrued expenses of \$0.6 million. This cash usage was partially offset by depreciation expense of \$0.1 million, a decrease in accounts receivable of \$0.4 million, an increase in deferred revenue of \$0.1 million and a decrease in other assets of \$0.2 million. Cash used in operations of \$4.6 million for the six months ended June 30, 2003, was primarily due to an operating loss from continuing operations of \$5.7 million. This cash usage was offset by depreciation expense of \$0.9 million, recovery of accounts previously written off of \$0.3 million and decreases in accounts receivable of \$1.7 million and other assets of \$0.4 million, offset by an increase in inventories of \$0.1 million, a decrease in accounts payable and accrued liabilities of \$0.9 million and a decrease in deferred revenue of \$0.5 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 six months ended June 30, 2004 was \$1.5 million, which consisted primarily of the net purchase of short-term investments of \$1.4 million, compared to cash provided by investing activities of \$2.7 million for the six months ended June 30, 2003, which consisted primarily of the maturity of short-term investments.

Cash provided by financing activities in the six months ended June 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 June 30, 2004, the Company did not have any material commitments for capital expenditures.

During the six months ended June 30, 2004, the Company funded its operations through the use of cash and cash equivalents.

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 quarter by selling a portion of our 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, we expect our operating losses and net operating cash outflows to continue through 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 and to \$2.4 million for the six months ended June 30, 2004 from \$3.0 in the same period 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 half of 2004 are \$2.4 million as compared to \$3.0 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.

As a result of these sales, we now depend exclusively on revenues generated from the sale of our networks security products, which have received limited market acceptance. Moreover, we have only recently introduced our regulated information compliance systems, and the market for these products has only begun to emerge. Consequently, we resemble a developmental stage company and will face the following inherent risks and uncertainties:

the need for our network security products and regulated information compliance systems 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 had a net loss of \$2.8 million and an accumulated deficit of \$47.0 million as of the six months ending June 30, 2004. 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 six months ended June 30, 2004, we incurred a net loss of \$2.8 million and had an accumulated deficit of approximately \$47.0 million at June 30, 2004. In addition, our revenues have declined from \$16.7 million in 2001, to \$7.8 million in 2002, and \$6.5 million in 2003. 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., Symantec, Inc., Netscreen Technologies, Inc., Tipping Point Technologies Inc. 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 that our focus on network perimeters with market leading VPN/firewall control technology and network intrusion detection visibility technology that reduce the total cost of ownership provides us with an advantage with large organizations with complex security requirements, 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 on our products, increasing our costs and affecting our international operations.

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 or corporate spending on network security 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 agencies 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 cash, cash equivalents, and investments have increased approximately \$2.1 million in the last six 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.

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During the six months ended June 30, 2004, our cash, cash equivalents and short-term investments increased to approximately \$4.7 million from approximately \$2.7 million as of December 31, 2003, primarily as a result of a private placement of our preferred stock and warrants we completed on March 25, 2004. As of December 31, 2003, we had cash, cash equivalents and investments in the amount of approximately \$2.7 million, down from approximately \$10.7 million as of December 31, 2002. Although we believe the proceeds we received in connection with the private placement 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,

we expect our net operating losses and net operating cash outflows to continue through 2004. We do not currently have any further arrangements for financing, and we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, at the time when we need this financing. 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 or fund our other liquidity needs.

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

During the first half of 2004, we continued a restructuring plan and cost reduction efforts, which resulted in \$0.1 million in severance costs. Since we began restructuring in 2002, we have incurred approximately \$0.8 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 industry may limit market acceptance of our products.

Several of our competitors have acquired security companies with complementary technologies in the past, and we expect consolidation in the network security industry 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 agencies accounted for 38.5% of our revenues the six months ended June 30, 2004 and 17% of our revenues for the year ended December 31, 2003. Sales to government customers involve unique risks, which could adversely impact our revenues.

We derived 38.5% of our revenues from sales to various U.S. government entities for the six months ended June 30, 2004, and 17.0% of our revenues from these sales for the year ended December 31, 2003. 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 26.3% of our revenues from international sales in the six months ended June 30, 2004, and 31.4% of our revenues from these sales for the year ended December 31, 2003. Our ability to sell our products internationally are subject to certain risks which could harm our business.

Sales to foreign customers accounted for approximately 31.4% of our revenues for the year ended December 31, 2003, and 26.3% of our revenues for the six months ended June 30, 2004. Although export sales decreased for the three and six month periods ended June 30, 2004 when compared to the same periods in 2003, 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 30.4% of our revenues for the six months ended June 30, 2004 and 57% of our revenue for the year ended December 31, 2003. 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 30.4% of our revenues for the six months ended June 30, 2004, and 57% of our revenue for the year ended December 31, 2003 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 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, since August 1, 2003, the market price of our common stock on The Nasdaq SmallCap Market has fluctuated between \$0.91 and \$5.52 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 recent reductions in our work force may make it more difficult for us to attract and retain the personnel necessary to successfully operate our business.

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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. We have employment agreements with relatively few of our key technical, sales and senior management 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 5% convertible 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 preferred or incur certain indebtedness without the approval of at least a majority of the holders of our 5% convertible preferred stock. In addition, holders of the 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 of the shares of preferred stock and exercise of warrants that we issued in a private placement.

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% Convertible 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 a result, we expect the private placement to result in dilution to holders of our common stock upon conversion of the preferred stock and exercise of the warrants of 2,221,358 shares of common stock, or an approximately 43% increase in the number of shares of our common stock outstanding.

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

Upon the effectiveness of the registration statement related to this prospectus, the holders of preferred stock and warrants we issued in the private placement will be able to freely convert their shares of preferred stock and exercise their warrants and sell their underlying shares of common stock. For the four weeks ended on July 30, 2004, the average daily trading volume of our common stock on The Nasdaq SmallCap Market was 7,505 shares. Consequently, if holders of preferred stock or warrants elect to convert their 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.

The percentage of our revenues attributable to sales of PDS products integrated with software of Check Point Software Technologies decreased from 29.1% in 2002 to 16.7% in 2003 and from 24.7% for the first half of 2003 to 9.5% for the first half of 2004. Because sales of our newer products may not offset the reduced sales of our PDS products, a change in our relationship with Check Point could have a negative effect on our operating results.

Our PDS family of security appliances, which are integrated with Check Point Software Technologies' market-leading VPN-1®/FireWall-1® software, represented % of our revenues for the six months ended June 30, 2004, and 16.7% of our revenues for the year ended December 31, 2003. These percentages are down from % of our revenues for the six months ended June 30, 2003, and 29.1% of our revenues for the year ended December 31, 2002. We expect the percentage of our sales attributable to our PDS products to decline in the future; however, our reliance on newer product sales may not replace the anticipated decline in revenue from sales of our PDS products. Although we are a certified appliance partner of Check Point and our PDS products have received Check Point certification, we have no long-term agreement or exclusive relationship with Check Point. As a result, the loss or significant change in our relationship with Check Point, the failure of our PDS products to maintain or receive Check Point certification, the business failure of Check Point or its acquisition by or of one of our competitors and the loss of market share of Check Point or market acceptance of its products could each have a material adverse effect on our business, financial condition and results of operations.

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 5% convertible preferred stock may strain our cash resources.

Shares of our 5% convertible preferred stock accrue cash dividends equal to \$0.25 per share per annum. These dividends are payable in arrears on March 31 and September 30 of each year, commencing on September 30, 2004. 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, and as of June 30, 2004 our capital surplus, defined as the amount by which our net assets exceed our stated capital, was approximately \$3.7 million. Therefore, we have only limited resources to pay these dividends. In addition, the payment of these dividends could strain our available cash resources, which could adversely affect our ability to operate or grow our business.

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

As of June 30, 2004, our executive officers, directors and 5% stockholders beneficially own approximately 38.5% 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 approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us. These stockholders may use their influence to approve or take actions that may be adverse to your interests.

Item 3. **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Foreign Exchange. Revenue originating outside the U.S. in the quarters ended June 30, 2004 and 2003 was 15.4% and 33.4 % of total revenues, respectively. Revenue originating outside the U.S. in the six months ended June 30, 2004 and 2003 was 26.3% and 42.4% of total revenues, respectively. International sales are made mostly from our foreign sales subsidiaries in the local countries and are typically denominated in U.S. dollars. These subsidiaries incur most of their expenses in the local currency.

Our international business is subject to risks typical of an international business, including, but not limited to: differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign exchange rate volatility. Accordingly, our future results could be materially adversely affected by changes in these or other factors. The effect of foreign exchange rate fluctuations on us in 2004 and 2003 was not material.

On January 1, 2003, the Company elected to change the functional currency of its foreign operations to the United States dollar. This change in functional currency is supported by the fact that all foreign operations are funded monthly in United States dollars and the majority of a revenue contracts are denominated in United States dollars. Under United States dollar functional currency, the financial statements of foreign locations are remeasured from the recording currency to the United States dollar. The resulting remeasurement adjustment is recorded as foreign exchange gain or loss in the statement of operations. There is no translation adjustment to the separate component of stockholders' equity or adjustment to comprehensive income. The effect of the change in functional currency had no material impact on results of operations. The accumulation of prior years' translation adjustments remains on the balance sheet as a separate component of stockholders' equity until part, or all, of the respective entities are disposed.

Interest Rates. We invest our cash in a variety of financial instruments, including bank time deposits, fixed rate obligations of corporations, municipalities, and state and national governmental entities and agencies. These investments are denominated in U.S. dollars. Cash balances in foreign currencies overseas are operating balances and are invested in short-term time deposits of the local operating bank.

Interest income on our investments is carried in Interest income, net . We account for our investment instruments in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities . All of the cash equivalents and short-term investments are treated as available-for-sale under SFAS 115.

Investments in fixed rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have seen a decline in market value due to changes in interest rates. Our investment securities are held for purposes other than trading. The weighted-average of the stated coupon interest rate on investment securities at June 30, 2004 was 6.0%. Due to the amortization of premiums and discounts paid, the actual rate of return will vary from the weighted-average of the stated coupon interest rate. The fair value of investments held at June 30, 2004 approximated amortized cost.

Item 4. **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 June 30, 2004, 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 June 30, 2004, and our Chief Executive Officer and Chief Financial Officer have concluded that there was no change during the quarterly period ended June 30, 2004 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 4. **SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The Annual Meeting of Stockholders was held on May 29, 2004, at the Radisson Hotel, Dallas North in Richardson, Texas. The following is a brief description of each matter voted upon by stockholders, including a number of votes cast for, against, or withheld with regard to each matter of nominee.

(1) Election of five (5) directors to serve until the next Annual Meeting of Stockholders and until their respective successors are duly elected and qualified.

	FOR	WITHHELD
G. Ward Paxton	6,631,093	12,839
T. Joe Head	6,631,545	12,387
James F. Gero	6,609,921	34,011
J. Fred Bucy, Jr.	6,609,361	34,571
Donald M. Johnston	6,609,771	34,161

(2) Ratification and approval of selection by the Board of Directors of KBA Group LLP as independent auditors of the Registrant for the fiscal year ending December 31, 2004.

FOR	AGAINST	ABSTAIN
6,577,411	29,879	36,642

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

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

- 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 June 30, 2004, 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: August 13, 2004

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