INTRUSION INC
Form 10KSB
March 30, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

(Mark One)

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

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, SUITE 200 **RICHARDSON, TEXAS** (Address of principal executive offices)	**75081** (Zip Code)

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

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.01 par value
(Title of class)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 x No o

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

State the issuer s revenues for its most recent fiscal year: $5,242,000.

State the aggregate market value of the voting and non-voting equity held by non-affiliates of the Registrant computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of March 16, 2007: $3,036,659. As of March 16, 2007, 9,222,139 shares of the Registrant s Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement filed in connection with the Registrant s 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (Check One): Yes o No x

INTRUSION INC.

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PART I

Item 1. Description of Business.

In addition to the historical information contained herein, the discussion in this Form 10-KSB contains certain 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: growth and anticipated operating results; developments in our markets and strategic focus; new products and product enhancements; potential acquisitions and the integration of acquired businesses, products and technologies; strategic relationships and future economic and business conditions. The cautionary statements made in this Form 10-KSB should be read as being applicable to all related forward-looking statements whenever they appear in this Form 10-KSB. Our actual results could differ materially from the results discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the section captioned Factors That May Affect Future Results of Operations in Item 1 of this Form 10-KSB as well as those cautionary statements and other factors set forth elsewhere herein.

General

We develop, market and support a family of network intrusion prevention, intrusion detection, regulated information compliance, data privacy protection and entity identification products. Our product families include the Compliance Commander for regulated information and data privacy protection, Intrusion SpySnare for real-time inline blocking of spyware and unwanted peer-to-peer (P2P) applications, Intrusion SecureNet for network intrusion prevention and detection and TraceCop for identity identification. Intrusion s products help protect critical information assets by quickly detecting, protecting, analyzing and reporting attacks or misuse of classified, private and regulated information for government and enterprise networks.

We market and distribute our products through a direct sales force to end-users, distributors and numerous system integrators, managed service providers and value-added resellers. Our end-user customers include banks, credit unions, other financial institutions, U.S. federal government entities, foreign government entities and local government entities, high technology, e-commerce and telecommunication companies, hospital and other healthcare providers and academic institutions. Essentially, our end-users can be defined as any end-user requiring network security solutions for protecting their mission critical data .

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. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our ticker symbol from ODSI to INTZ to reflect our focus on intrusion prevention and detection solutions, along with information compliance and data privacy protection products. 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, Suite 200, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is www.intrusion.com. References to we , us , our or Intrusion Inc. refer to Intrusion Inc. and its subsidiaries Compliance Commander , SecureNet , TraceCop and SpySnare are trademarks of Intrusion Inc.

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

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

On March 28, 2005, we completed a private placement of 1,065,200 shares of our Series 2 5% Convertible Preferred Stock and warrants to purchase 532,600 shares of our common stock for gross proceeds of $2,663,000. The preferred shares may be converted into 1,065,200 shares of common stock at an initial conversion price of $2.50 per share, and the warrants may be exercised at a price of $2.77 per share during the five-year period commencing on September 28, 2005. 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 employees of our financial advisor for the private placement.

On December 2, 2005, we completed an additional private placement of 564,607 shares of our Series 3 5% Convertible Preferred Stock and warrants to purchase 282,306 shares of our common stock for gross proceeds of $1,230,843. The preferred shares may be converted into 564,607 shares of common stock at an initial conversion price of $2.18 per share, and the warrants may be exercised at a price of $0.40 per share during the five-year period commencing on June 2, 2006. In connection with the closing of this private placement, we issued warrants to purchase 27,531 shares of our common stock at an exercise price of $2.58 per share to employees of our financial advisor for the private placement.

On March 29, 2006, we established a $1,000,000 line of credit with Silicon Valley Bank which may increase to $2,000,000 if we have EBITDA of at least $200,000 for two consecutive quarters. Under the terms of this agreement, we may borrow an amount equal up to 80% of eligible accounts receivable balances. In addition, we may obtain inventory advances equal to 35% of finished goods inventory, capped at the lesser of the inventory availability, $300,000 or 35% of our total borrowing base. If our credit line increases to $2,000,000, inventory advances will be capped at the lesser of the inventory availability, $600,000 or 35% of our borrowing base. Amounts we borrow under the credit line accrue interest at an annual rate of prime plus 1% and are secured by a lien on all of our assets. The line of credit was renewed on March 29, 2007, accrued interest on all outstanding amounts is payable monthly in arrears and all outstanding principal and accrued but unpaid interest on the amounts we borrow are due on March 28, 2008.

On December 28, 2006, we completed a private placement of 1,250,000 shares of our Common Stock for gross proceeds of $500,000.

On March 15, 2007, we completed an additional private placement of 925,926 shares of our Common Stock for gross proceeds of $500,000.

Government Sales

In December 2002, our SecureNet network security products became the first product of their kind to receive Common Criteria Certification under the National Information Assurance Partnership (NIAP) Common Criteria Evaluation and Validation Scheme, which is designed to further the goals of the government and commercial sectors to improve security in commercial products. This government initiated partnership of the National Institute of Standards and Technology and the National Security Agency establishes and verifies information technology standards and certifies products that meet their standards, in an effort to promote the development and use of evaluated information technology products and systems. This organization also develops national and international standards for information technology security, in an effort to increase the level of trust government and commercial consumers have in information systems and related networking products.

Sales to U.S. government customers accounted for 73.6% of our revenues for the year ended December 31, 2006, compared to 70.7% of our revenue in 2005. We expect to continue to derive a substantial portion of our revenues from sales to governmental entities in the future as we continue to market our entity identification products, our regulated compliance and data leakage prevention products, our network intrusion prevention products and our spyware prevention products to the government. Sales to the government presents risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including potential disruption due to irregularities in or interruptions to appropriation and spending patterns, delays in approving a federal budget and the government s reservation of the right to cancel contracts and purchase orders for its convenience.

Generally, we make our sales under purchase orders and contracts. Our customers, including government customers, may cancel their orders or contracts with little or no prior notice and without penalty. Although we transact business with various government entities, we believe that the cancellation of any particular order in itself could have a material effect on our financial results. In addition, we do not believe that any of our revenues with government customers are subject to renegotiation of profits. However, because we derive and expect to continue to derive a substantial portion of our revenue from sales to government entities, a large number of cancelled or renegotiated government orders or contracts 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 arrangements with government entities, and, historically, government entities have not cancelled or renegotiated orders which had a material adverse effect on our business.

Industry Background

With the permeation of the Internet as a business enabler over the last decade, network security has changed from being a technology deployed only by the government and the most sophisticated or most paranoid of companies, to technology employed by all sizes of business and a critical component of all mission critical systems. Today, email, instant messengers, World Wide Web access, web sites, web-based applications and e-commerce are integral components of communications and operations for business and government, and the protection of the information communicated through or stored in these applications is crucial. Although the Internet has many business advantages, its openness and accessibility makes it a potential threat to the networks and systems that are attached to it. Computer hackers, curious or disgruntled employees, competitors and innocent mistakes may compromise or destroy information assets or disrupt the normal operations and brand equity of the enterprise. In addition, new regulations and mandates by the government to protect Personally Identifiable Information (PII) have made it imperative that companies have real-time data security products and processes in place.

As a result, enterprises are adopting a variety of security solutions to meet the challenge posed by external and internal threats. To be effective, organizations require enterprise-wide information risk management solutions that are broadly deployed and centrally managed. Organizations seek systems with the optimal combination of best-of-breed capabilities and total cost of ownership. It is our belief that securing the enterprise network requires two key elements:

- Control: the ability to affect network traffic including access to the network or parts thereof in order to enforce a security policy.

- Visibility: the ability to see and understand the nature of the network and the traffic on the network, which assists in decision making as well as crafting and constant improvement of a security policy.

We focus on providing these two primary ingredients of network security within a single device for overall network security and for the protection of specific classified, confidential or customer information assets.

Products

The Intrusion SecureNet, Compliance Commander, SpySnare and TraceCop systems can operate standalone or with our Provider Management System.

Sensors are appliances or software components that are connected to the network and monitor the traffic searching for matches to signatures or database information as evidence of an external or internal network attack or malicious use that could threaten information assets. Signatures are patterns, anomalies and traffic flows that match known attacks or indicate suspicious activities. When the Sensor matches traffic to a signature or customer defined database record it will detect, protect, block (if desired) and report to the Management System.

The Provider Management System controls the Sensors and displays events produced by the Sensors. The Intrusion Provider is a three-tier enterprise management and monitoring system. Provider is for enterprise deployments with no license limitations placed on architecture, freeing the enterprise to build the management system required. Provider follows the workflow of the security analyst with a highly productive environment for response, research, resolution and decision support. The Provider suite includes applications for event monitoring, policy creation and tuning and centralized software deployment making up the complete suite of tools required to manage and monitor a SecureNet, Compliance Commander or Spy Snare system from one sensor to more than 100 sensors.

We have simplified deployment, management and monitoring to reduce the total cost of ownership for an easy to set up and manage enterprise system. To reduce barriers and provide complete enterprise integration, the Intrusion systems provide more customization and event flow options for high-end deployments.

Our systems are plug-and-protect and can be connected to a network without interfering with the network operations by using the Intrusion Passive and Inline taps.

Intrusion Compliance Commander Products

Compliance Commander provides protection against the loss and misuse of regulated, classified and commercially sensitive data. Loss of information assets that contain customer data has spawned a multitude of federal and state legislation to set a standard of care, use and protection for customer information. Better known laws that regulate customer information include HIPAA, Gramm-Leach-Bliley Act (GLBA) and its UK equivalent Privacy Act of 1998, and California SB 1386. Penalties for non-compliance include fines, lawsuits, imposed processes and enforced business limitations. Any enterprise that falls within the scope of these laws is now working under a timeline to demonstrate compliance. In addition, both government and commercial institutions are becoming increasingly concerned about the misuse and loss of classified or commercially sensitive data, and are seeking proactive solutions to deal with these issues.

The Intrusion Compliance Commander products leverage the same Management systems as SecureNet NIP&DS products. Our Compliance Commander solutions are currently designed to address the security and confidentiality issues in the following industries and customers:

- Healthcare companies (including healthcare providers, insurance companies and medical equipment manufacturers) who are working to comply with HIPAA, and

- Financial institutions and e-commerce enterprises working to comply with the customer confidentiality provisions of GLBA and CA SB 1386.

The Compliance Commander solutions provide accuracy through our Dynamic Data Dictionary (D3) technology, which securely connects directly to the customer s database housing the confidential, classified, or regulated information. The Compliance Commander stays up to date with the database to match network traffic to the information that is resident in the database. This provides an automated accurate mechanism to identify leaks and misuse of information assets. By using the customer s own data, the Compliance Commander virtually eliminates any potential for false positives. Users not only benefit from the highly accurate data protection, but also quickly realize the low-cost of ownership by the fully automated updating feature.

Intrusion SpySnare Product

Spyware is software that gathers user information without their knowledge through their Internet connection. Most spyware programs are independent executable files that take on the authorization abilities of the victim. They include auto-install and auto-update capabilities and can report on any attempts to remove or modify them. Spyware can install Dynamic Link Library and other executable files. Spyware can also read, write and delete files and even reformat your hard drive and do this while sending a steady stream of information back to the advertising and marketing companies or hackers.

Usually bundled as a hidden component with software downloaded for free from or shared via the Internet, spyware monitors user activity on the Internet and transmits that information such as email addresses, Internet use, passwords and credit card numbers to someone else. Because spyware uses the host computer s memory and system resources while other computer programs are running, it can often lead to system crashes or instability.

Our SpySnare product utilizes our high-performance, low-latency network analysis engine to implement deep-packet inspections in order to determine if spyware signatures are attempting to get into the customer s network. In addition to spyware signatures, SpySnare also includes P2P file sharing signatures which may be an unwanted source for spyware insertions. Once the user connects to a P2P site, a spyware program can unknowingly get returned to the user s PC along with the intended file or application. By using specific signatures for known spyware, SpySnare provides real-time awareness of network traffic which removes much of the guesswork involved in establishing the necessary network defenses and preventing spyware infections. Once SpySnare detects a spyware signature match, it flags and drops the spyware traffic and alerts the administrator.

Another benefit of our SpySnare product is its ability to block outbound spyware notification attempts. For example, when a traveling laptop gets infected with spyware and returns to connect to the company network, the spyware program will notify the spyware host website of its presence. SpySnare will detect the outbound phone-home attempt and will likewise block the spyware traffic at the perimeter.

Intrusion SecureNet NIP&DS Products

We believe a primary advantage of the SecureNet NIP&DS is that with a single license purchase, the consumer may choose to deploy the system for intrusion prevention (IPS) or intrusion detection (IDS), providing a superior level of flexibility and simple migration from passive detection to active prevention without additional licensing cost.

Our Network Intrusion Detection System (NIDS) product provides detection of specific exploit and misuse patterns in the traffic that the firewall allows. NIDS detects known exploits and misuse patterns, suspicious activities and anomalous traffic or behavior within both inbound and outbound traffic. This added visibility provides a checking mechanism for the efficacy of the firewall s rule base.

Our Network Intrusion Prevention System (NIPS) product provides network monitoring and analysis functionality like NIDS, with the added ability to block malicious network traffic. NIPS actively regulates inbound and outbound traffic based on specific users access while controlling what they can do with that access on a granular, per-conversation basis.

Our SecureNet NIP&DS products provide user customizable, protocol decode detection technology for up to Gigabit networks. While Intrusion SecureNet Sensors are in the top-tier of the market for detection and throughput technology, we believe one of the primary benefits provided by our NIP&DS products is to reduce the total cost of ownership to our customers.

Our SecureNet Sensors have their own web browser interface for simplified configuration. SecureNet Sensors also deliver complete, stand-alone NIP&DS for the small and medium business with local management and monitoring. This allows customers to use their standard web browser to access a full power, full-featured NIP&DS, without additional hardware or software.

Our SecureNet NIP&DS Sensors are available as Software Sensors and Hardware Sensors with performance and pricing appropriate for networks ranging from 10Mb/s to Gigabit with a Common Criteria EAL2 certified Gigabit appliance.

Intrusion TraceCop Products

Our TraceCop product assists in identifying and locating network attackers who use, abuse and probe an enterprise network. TraceCop utilizes a database having worldwide IP addresses. The TraceCop database is regularly updated.

Third-Party Products

We believe that it is beneficial to work with third parties with complementary technologies to provide integrated solutions to our customers. As there is rapid technological advancement and significant consolidation in the network security industry, there can be no assurance that we will have access to all of the third-party products that may be desirable or for the term desirable to offer fully integrated solutions to our customers.

We currently have two third-party product relationships. We do not consider either of these third-party relationships to be material and we do not expect the sales from these relationships to be material, as the product offerings are only complementary to our existing product offerings.

Customer Services

In addition to offering our network security products, we also offer a wide range of services, including design and configuration, project planning, training, installation and maintenance.

Product Development

The network security industry is characterized by rapidly changing technology, standards, economy and customer demands. We believe that our future success depends in large part upon the timely enhancement of existing products as well as the development of technologically advanced new products that meet industry standards, perform successfully and simplify the users tasks so that they can do more with fewer resources. We are currently marketing SecureNet, Compliance Commander, SpySnare and TraceCop products to meet emerging market requirements and are continuously engaged in testing to ensure that our products interoperate with other manufacturers products, which comply with industry standards.

During 2006 and 2005, our research and development expenditures were $2.1 million and $2.6 million, respectively. All of our expenditures for research and development have been expensed as incurred. At December 31, 2006, we had 16 employees engaged in research and product development.

Manufacturing and Supplies

In the past, we relied on the outsourcing of manufacturing components, assembly and certain other operations to reduce fixed costs and to provide flexibility in meeting market demand of our hardware products. As we continue our transition from a hardware business to primarily a software business, we expect to reduce our reliance on third party manufacturers and suppliers.

Our internal manufacturing operations consist primarily of replication of software on CDs, packaging, testing and quality control of finished units.

The hardware we sell is standard off-the-shelf products, which we OEM or resell from our suppliers.

Intellectual Property and Licenses

Our success and our ability to compete are dependent, in part, upon our proprietary technology. While we have applied for certain patents, we currently rely on a combination of contractual rights, trade secrets and copyright laws to establish and protect our proprietary rights in our products. We have also entered into non-disclosure agreements with our suppliers, resellers and certain customers to limit access to and disclosure of proprietary information. There can be no assurance that the steps taken by us to protect our intellectual property will be adequate to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to our technology.

We have entered into software and product license agreements with various suppliers. These license agreements provide us with additional software and hardware components that add value to our security products. These license agreements do not provide proprietary rights that are unique or exclusive to us and are generally available to other parties on the same or similar terms and conditions, subject to payment of applicable license fees and royalties. We do not consider any of the product license, software or supplier agreements to be material to our business, but rather complementary to our business and product offerings.

Sales, Marketing and Customers

Field Sales Force. Our direct sales organization focuses on major account sales, channel partners including distributors, Value Added Resellers (VARs) and integrators; promotes our products to current and potential customers; and monitors evolving customer requirements. The field sales and technical support force provides training and technical support to our resellers and end users and assists our customers in designing secure data networking solutions.

We currently conduct sales and marketing efforts from our principal office in Richardson (Dallas), Texas. In addition, we have sales personnel, sales engineers or sales representatives located in California, Georgia, Europe and Asia.

Distributors. 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. 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.

Resellers. Resellers such as domestic and international system integrators and VARs sell our products as stand-alone solutions to end users and integrate our products with products sold by other vendors into network security systems that are sold to end users. Our field sales force and technical support organization provide support to these resellers. Our agreements with resellers are non-exclusive, and our resellers generally sell other products that may compete with our products. Resellers may place higher priority on products of other suppliers who are larger than and have more name recognition than us, and there can be no assurance that resellers will continue to sell and support our products.

Foreign Sales. We believe that rapidly evolving international markets are important sources of future net sales. Our export sales are currently being made through an indirect sales force comprised of international resellers in Europe, Asia and Canada. Export sales accounted for approximately 9.4% and 10.7% of total revenue in 2006 and 2005, respectively. See Management s Discussion and Analysis or Plan of Operations included in this report for a geographic breakdown of our revenue in 2006 and 2005. Sales to foreign customers and resellers generally have been made in United States dollars.

Marketing. We have implemented several methods to market our products, including public relations and placed articles, regular participation in and presenting during trade shows and seminars, advertisement in trade journals, telemarketing, distribution of sales literature and product specifications and ongoing communication with our resellers and installed base of end-user customers.

Customers. Our end-user customers include banks, credit unions, other financial institutions, U.S. federal government entities, foreign government entities and local government entities, high technology, e-commerce and telecommunication companies, hospital and other healthcare providers and academic institutions. Essentially, our customers include any entity requiring network security solutions for protecting their mission critical data. Sales to certain customers and groups of customers can be impacted by seasonal capital expenditure approval cycles, and sales to customers within certain geographic regions can be subject to seasonal fluctuations in demand.

Although we sell our products to many customers through various distribution channels, no one commercial customer or reseller accounted for 10% or more of our total revenue in any of the past three fiscal years. However, in 2006, 73.6% of our revenue was derived from a variety of U.S. government entities through direct sales and indirectly through system integrators and resellers. In 2006, 65.6% of our total revenues are attributable to three customers, one of which exceeds 10% of our total revenues individually. Comparatively, sales to the U.S. Government through direct and indirect channels totaled 70.7% of total revenues for 2005 and three of those entities represented more than 10% of our total revenues for the year. A reduction in our sales to U.S. government entities could have a material adverse effect on our business and operating results if not replaced.

Backlog. We believe that only a small portion of our order backlog is non-cancelable and that the dollar amount associated with the non-cancelable portion is immaterial. We purchase or contract inventory based upon our forecast of customer demand and maintain inventories in advance of receiving firm orders from customers. Orders are generally fulfilled within two days to two weeks following receipt of an order. Due to the generally short cycle between order and shipment, we do not believe that our backlog as of any particular date is indicative of future net sales.

Customer Support, Service and Warranty. We service, repair and provide technical support for our products. Our field sales and technical support force works closely with resellers and end-user customers on-site and by telephone to assist with pre- and post-sales support services such as network security design, system installation and technical consulting. By working closely with our customers, our employees increase their understanding of end-user requirements and provide input to the product development process.

We warrant all of our products against defects in materials and workmanship for periods ranging from 90 days to 12 months. Before and after expiration of the product warranty period, we offer both on-site and factory-based support, parts replacement and repair services. Extended warranty services are separately invoiced on a time and materials basis or under an annual maintenance contract.

Competition

The market for network and data protection security solutions is intensely competitive and subject to frequent product introductions with new technologies, improved price and performance characteristics. Industry suppliers compete 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. We believe that our approach focusing on network perimeters with market leading high-performance network technology that reduces the total cost of ownership as compared to our competition provides us with an advantage with large organizations with complex security requirements.

There are numerous companies competing in various segments of the data security markets. Our principal competitors in the network intrusion prevention and detection market include Internet Security Systems, Inc.(IBM), Cisco Systems, Inc., Symantec, Inc., Netscreen (Juniper Networks, Inc.) McAfee Inc., Tipping Point Technologies, a division of 3Com Corporation, and NFR Security (Checkpoint). Our competitors in the regulated information compliance market include Vontu, Port Authority (Websense), Vericept, Reconnex, Tablus and a small number of start-up companies that

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entered the space within the last two years. Regarding the spyware prevention market, we currently directly and indirectly compete with a number of host-based spyware detection systems, such as Ad-Aware, Spybot S&D and Spy Sweeper and some inline proxy solutions such as Blue Coat Systems, Inc.

Furthermore, some of our competitors have substantially greater financial, technical, sales and marketing resources, better name recognition and a larger customer base than we do. In addition, many of our competitors may provide a more comprehensive networking and security solution than we currently offer. Even if we do introduce advanced products that meet evolving customer requirements in a timely manner, there can be no assurance that our new products will gain market acceptance.

Certain companies in the network security industry have expanded their product lines or technologies in recent years as a result of acquisitions. Further, more companies have developed products which conform to existing and emerging industry standards and have sought to compete on the basis of price. We anticipate increased competition from large networking equipment vendors, which are expanding their capabilities in the network security market. In addition, we anticipate increased competition from private start-up companies that have developed or are developing advanced security products. Increased competition in the security industry could result in significant price competition, reduced profit margins or loss of market share, any of which could have a material adverse effect on our business, operating results and financial condition. There can be no assurance that we will be able to compete successfully in the future with current or new competitors.

Employees

As of December 31, 2006, we employed a total of 32 persons, including 11 in sales, marketing and technical support, 1 in manufacturing and operations, 16 in research and product development and 4 in administration and finance.

None of our employees are represented by a labor organization, and we are not a party to any collective bargaining agreement. We have not experienced any work stoppages and consider our relations with our employees to be good.

Competition in the recruiting of personnel in the networking and data security industry is intense. We believe that our future success will depend in part on our continued ability to hire, motivate and retain qualified management, sales and marketing, and technical personnel. To date, we have not experienced significant difficulties in attracting or retaining qualified employees.

Factors That May Affect Future Results of Operations

In addition to the other information in this Form 10-KSB, the following factors should be considered in evaluating Intrusion Inc. and our business.

Our cash, cash equivalents, and investments decreased from $3.3 million at December 31, 2005 to $0.9 million at December 31, 2006. As a result of our expected continuing net cash outflows, we may not have sufficient cash to operate our business and may not be able to maintain certain liquidity requirements.

As of December 31, 2006, we had cash, cash equivalents and investments of approximately $0.9 million, down from approximately $3.3 million as of December 31, 2005. We expect our net operating losses and operating cash outflows to continue through at least the first quarter of 2007 and possibly throughout the remainder of fiscal year 2007. In addition, we are obligated to make payments of accrued dividends on all our outstanding shares of preferred stock that will reduce our available cash resources. Of the $0.9 million in cash, cash equivalents and investments at December 31, 2006, $0.5 million was derived from a private investment by our Chief Executive and Chief Financial Officers which closed on December 28, 2006. As of February 28, 2007 we had cash and cash equivalents of $300,000 and less than $100,000 in available funding under our existing credit lines. We expect to fund our operations through additional investments of private equity, which, if we are able to obtain, will have the effect of diluting our existing common stockholders, perhaps significantly. Specifically, on March 15, 2007, we completed an additional private placement of 925,926 shares of our Common Stock for gross proceeds of $500,000 and we have a March 15, 2007 written commitment from our Chief Executive Officer to invest up to an additional $750,000 in the Company until March 2008, should such funding by required by the Company, on terms and conditions yet to be determined. 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. If our operations do not generate positive cash flow in the next few months, or if we are not able to obtain additional debt or equity financing on terms and conditions acceptable to us, if at all, we may be unable to implement our business plan, fund our liquidity needs or even continue our operations.

Our revenues declined from $6.0 million in 2005 to $5.2 million in 2006 in connection with a shift in focus from SecureNet products to Compliance Commander and TraceCop products. If our newer products do not achieve market acceptance, our revenues will continue to suffer.

We have transitioned our sales strategy focus from SecureNet to Compliance Commander and TraceCop. During this transition, sales of our newer products have not offset the losses in sales associated with our older products. As a result, our net revenues declined from $6.0 million in 2005 to $5.2 million in 2006. We can provide no assurances that sales of our newer products will ever offset the losses in sales of older products or generate sufficient revenues to sustain our business.

Our new network security products, regulated information compliance systems and entity identification products have only been in the market place for a limited period of time and may have longer sales cycles than our previous products. Accordingly, we may not achieve the meaningful revenue growth needed to sustain operations. If we are unable to recognize revenues due to longer sales cycles or other problems, our results of operations will be adversely affected, perhaps materially.

We have not yet received broad market acceptance for our newer products. 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 had a net loss of $3.0 million and an accumulated deficit of $55.1 million for the year ended December 31, 2006. As a result, we must generate substantially greater revenues from sales in order to achieve profitability.

We incurred significant operating losses for the fiscal year ended December 31, 2006 and have incurred operating losses in previous years. For the year ended December 31, 2006, we incurred a net loss of $3.0 million and had an accumulated deficit of approximately $55.1 million. 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 for the near term and possibly longer, and we may never achieve or sustain profitability or generate positive cash flow from operations.

A large percentage of our revenues are received from U.S. government entities, and the loss of one of these customers could reduce our revenues and materially harm our business and prospects.

A large percentage of our revenues result from sales to U.S. government entities. If we were to lose one or more of these key relationships, our revenues could decline and our business and prospects may be materially harmed. We expect that even if we are successful in developing relationships with non-governmental customers, our revenues will continue to be concentrated among government entities. For the years ended December 31, 2004, 2005 and 2006, sales to U.S. government entities collectively accounted for 53.6%, 70.7% and 73.6% of our total net revenues, respectively. The loss of any of these key relationships may send a negative message to other U.S. government entities or non-governmental customers concerning our product offering. We cannot assure you that U.S. government entities will be customers of ours in future periods or that we will be able to diversify our customer portfolio to adequately mitigate the risk of loss of any of these customers.

Government customers involve unique risks, which could adversely impact our revenues.

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, delays in approving a federal budget 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 are highly dependent on sales made through indirect channels, the loss of which would materially adversely affect our operations.

For the years ended December 31, 2004, 2005 and 2006, we derived 36.9%, 36.2% and 17.3% of our revenues from sales through indirect sales channels, such as distributors, value-added resellers, system integrators, original equipment manufacturers and managed service providers. We must expand our sales through these indirect channels in order to increase our revenues. 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. 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.

International sales comprise a material portion of our overall revenues. Our ability to sell our products internationally is subject to certain risks, which could harm our business.

Revenues from foreign customers for the fiscal years ended December 31, 2004, 2005 and 2006 accounted for approximately 19.2%, 10.7% and 9.4%, respectively, of our revenues. 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.

Any interruptions or declines in our international sales would result in a significant adverse impact on our results of operations and business.

The payment of accrued dividends on our preferred stock may strain our cash resources.

On March 25, 2004, we completed a $5,000,000 private placement pursuant to which we issued 1,000,000 shares of our 5% Convertible Preferred Stock (the Series 1 Preferred Stock) and warrants to acquire 556,619 shares of our common stock. The conversion price for the Series 1 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 February 28, 2007, there were 259,696 shares of the Series 1 Preferred Stock outstanding, representing approximately 413,003 shares of common stock upon conversion, and warrants to purchase 621,027 shares of common stock outstanding.

On March 28, 2005, we completed a $2,663,000 private placement pursuant to which we issued 1,065,200 shares of our Series 2 5% Convertible Preferred Stock (the Series 2 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 Series 2 Preferred Stock is $2.50 per share and the exercise price of the warrants is $2.77 per share. As of February 28, 2007, there were 460,000 shares of the Series 2 Preferred Stock outstanding, representing 460,000 shares of common stock upon conversion, and warrants to purchase 592,990 shares of common stock outstanding.

On December 2, 2005, we completed a $1,230,843 private placement pursuant to which we issued 564,607 shares of our Series 3 5% preferred stock (the Series 3 Preferred Stock) and warrants to acquire 282,306 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 27,531 shares of common stock. The conversion price of the Series 3 Preferred Stock is $2.18 per share and the exercise price of the warrants is $2.58 per share. As of February 28, 2007, there were 468,735 shares of Series 3 Preferred Stock outstanding, representing 468,735 shares of common stock upon conversion, and warrants to purchase 309,837 shares of common stock outstanding.

During the fiscal year ended December 31, 2006, we paid $66,000 in dividends to the holders of our 5% Preferred Stock, $74,000 in dividends to the holders of our Series 2 5% Preferred Stock and $53,000 in dividends to the holders of our Series 3 5% Preferred Stock. At December 31, 2006, we have dividends accrued of $16,364 related to our 5% Preferred Stock, $4,884 related to our Series 2 5% Preferred Stock and $4,339 related to our Series 3 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 as of December 31, 2006. 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. 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 all 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.

If we are unable to pay dividends on our preferred stock, we could be required to redeem the outstanding shares of Series 2 Preferred Stock and Series 3 Preferred Stock for shares of our common stock issued at a price equal to 75% of the average of the volume weighted average price of our common stock for the ten days ending on the day immediately preceding an election to redeem, subject, in the case of the Series 3 Preferred Stock, to a floor of $0.87. As a result, the issuance or potential issuance of these additional shares of common stock could cause our stock price to decline. Furthermore, our inability to pay dividends could adversely affect our ability to raise equity financing in the future if required.

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock and the exercise of warrants that we issued in our recent private placements or in the event we raise additional funds through the issuance of new shares of our common stock or securities convertible or exercisable into shares of common stock.

On March 16, 2007, we had 9,222,139 shares of common stock outstanding. Upon conversion of all outstanding shares of our preferred stock and exercise of the warrants, we will have 12,087,731 shares of common stock outstanding, approximately a 31.1% increase in the number of shares of our common stock outstanding.

Further, the occurrence of certain events entitles holders of our Series 2 Preferred Stock and Series 3 Preferred Stock to require us to redeem their shares for a certain number of shares of our common stock. Assuming (i) we have paid all liquidated damages and other amounts to the holders, (ii) incurred accrued but unpaid dividends on February 28, 2007 of $17,600, (iii) a volume weighted average price of $0.48, which was the ten-day volume weighted average closing price of our common stock on February 28, 2007, and (iv) our 8,296,213 shares of common stock outstanding on February 28, 2007, upon exercise of their redemption right by the holders of the Series 3 Preferred Stock and the Series 2 Preferred Stock, we would be obligated to issue approximately 13,107,243 shares of our common stock. This would represent an increase of approximately 158.0% in the number of shares of our common stock as of February 28, 2007.

In addition, management may issue additional shares of common stock or securities exercisable or convertible into shares of common stock in order to finance the Company s continuing operations. Any future issuances of such securities would have additional dilutive effects on the existing holders of our Common Stock.

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

The holders of the shares of our 5% Preferred Stock and warrants we issued in connection with the sale of our 5% Preferred Stock may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed with the Commission on August 6, 2004. As of February 28, 2007, 740,304 shares of our 5% Preferred Stock had converted into 1,177,327 shares of common stock.

The holders of the shares of Series 2 5% Preferred Stock and warrants we issued in connection with the sale of our Series 2 Preferred Stock may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed with the Commission on May 5, 2005. As of February 28, 2007, 605,200 shares of Series 2 Preferred Stock had converted into 605,200 shares of common stock.

The holders of the shares of Series 3 5% Preferred Stock and warrants we issued in connection with the sale of our Series 3 Preferred Stock, may freely convert their shares of Series 3 Preferred Stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed with the Commission on January 5, 2006. As of February 28, 2007, 95,872 shares of Series 3 Preferred Stock had converted into 95,872 shares of common stock.

For the four weeks ended on February 23, 2007, the average daily trading volume of our common stock on The OTCBB was 21,300shares. 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.

Certain rights of the holders of our preferred stock and the terms of our secured credit line may hinder our ability to raise additional financing.

Under the terms of our preferred stock instruments, we cannot issue shares of capital stock with rights senior to those of our existing 5% Preferred Stock, Series 2 5% Preferred Stock or Series 3 5% Preferred Stock without the approval of at least a majority of the holders of our 5% Preferred Stock, all of the holders of our Series 2 5% Preferred Stock, and holders of at least 75% of our Series 3 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 Preferred Stock. Furthermore, the terms of our secured credit line with Silicon Valley Bank include covenants which restrict our ability to incur additional debt and pay certain dividends. The combination of these provisions could hinder or delay our ability to raise additional debt or equity financing.

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

Since we began restructuring in 2002, we have incurred approximately $1.1 million in restructuring charges, severance, and related expenses. We have also implemented other strategic initiatives, 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.

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. We now depend exclusively on revenues generated from the sale of our network security products, which have received limited market acceptance. We have recently introduced our regulated information compliance systems, entity identification products and spyware products, and the market for these products has only begun to emerge. We can provide no assurances that our newly introduced products will ever achieve widespread market acceptance or that an adequate market for these products will ever emerge. 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, entity identification products and spyware 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, regulated information compliance systems, entity identification products and spyware products, our business, financial condition and operating results would be materially adversely affected.

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

As of March 16, 2007, our executive officers, directors and preferred stockholders beneficially own approximately 41.7% 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 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. Further, the Company contemplates the possible issuance of shares of our Common Stock or of securities exercisable or convertible into shares of our Common Stock in connection with a future investment by our Chief Executive Officer, pursuant to his written commitment to fund in an amount up to $750,000, should the Company require such funds. Any such issuance will increase the percentage of stock our Chief Executive Officer and our management group beneficially holds.

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 principal competitors in the network intrusion prevention and detection market include Internet Security Systems, Inc. (IBM), Cisco Systems, Inc., Symantec, Inc., Juniper Networks, Inc., McAfee Inc., Tipping Point Technologies, a division of 3Com Corporation, and NFR Security, Inc. Our competitors in the regulated information compliance market include Vontu, Port Authority (Websense), Vericept, Reconnex, Tablus and a small number of start-up companies that entered the space within the last two years. Regarding the spyware prevention market, we currently directly and indirectly compete with a number of host-based spyware detection systems, such as Ad-Aware, Spybot S&D and Spy Sweeper and some inline proxy solutions such as Blue Coat Systems, Inc. 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.

We cannot assure you that we will be able to compete successfully with our existing or new competitors. Some of our competitors may have, in relation to us, one or more of the following: longer operating histories, longer-standing relationships with OEM and end-user customers and greater customer service, public relations and other resources. As a result, these competitors may be able to more quickly develop or adapt to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, promotion and sale of their products. Additionally, it is likely that new competitors or alliances among existing competitors could emerge and rapidly acquire significant market share.

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 products are highly technical and if they contain undetected errors, our business could be adversely affected and we might have to defend lawsuits or pay damages in connection with any alleged or actual failure of our products and services.

Our products are highly technical and complex, are critical to the operation of many networks and, in the case of our security products, provide and monitor network security and may protect valuable information. Our products have contained and may contain one or more undetected errors, defects or security vulnerabilities. Some errors in our products may only be discovered after a product has been installed and used by end customers. Any errors or security vulnerabilities discovered in our products after commercial release could result in loss of revenues or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business and results of operations. In addition, we could face claims for product liability, tort or breach of warranty. Defending a lawsuit, regardless of its merit, is costly and may divert management s attention. In addition, if our business liability insurance coverage is inadequate or future coverage is unavailable on acceptable terms or at all, our financial condition could be harmed.

A breach of network security could harm public perception of our security products, which could cause us to lose revenues.

If an actual or perceived breach of network security occurs in the network of a customer of our security products, regardless of whether the breach is attributable to our products, the market perception of the effectiveness of our products could be harmed. This could cause us to lose current and potential end customers or cause us to lose current and potential value-added resellers and distributors. Because the techniques used by computer hackers to access or sabotage networks change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques

If our products do not interoperate with our customers networks, installations will be delayed or cancelled and could harm our business.

Our products are designed to interface with our customers existing networks, each of which have different specifications and utilize multiple protocol standards and products from other vendors. Many of our customers networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our products will be required to interoperate with many or all of the products within these networks as well as future products in order to meet our customers requirements. If we find errors in the existing software or defects in the hardware used in our customers networks, we may have to modify our software or hardware to fix or overcome these errors so that our products will interoperate and scale with the existing software and hardware, which could be costly and negatively impact our operating results. In addition, if our products do not interoperate with those of our customers networks, demand for our products could be adversely affected, orders for our products could be cancelled or our products could be returned. This could hurt our operating results, damage our reputation and seriously harm our business and prospects.

While we believe that we currently have adequate internal control over financial reporting, we are exposed to risks from recent legislation requiring companies to evaluate those internal controls.

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on the effectiveness of our internal control over financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. We have and will continue to incur significant expenses and devote management resources to Section 404 compliance on an ongoing basis. In the event that our chief executive officer, chief financial officer or independent registered public accounting firm determine in the future that our internal controls over financial reporting are not effective as defined under Section 404, investor perceptions may be adversely affected and could cause a decline in the market price of our stock.

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.

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. 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 shares, customer bases, sales forces, product offerings and technology and marketing expertise, which may make it more difficult for us to compete.

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. Third parties 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. Significant portions of our expenses are not variable in the short term and we cannot reduce them quickly to respond to unexpected 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, in fiscal year 2006, the market price of our common stock on The OTCBB and The Nasdaq Capital Market fluctuated between $0.22 and $2.87 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 past 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. We do not have employment agreements with 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. 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.

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.

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.

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, military 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.

Item 2. Description of Property.

Our headquarters are located in a two-story building in Richardson, Texas. We occupy approximately 30,000 square feet of floor space in this facility. This facility includes our corporate administration, operations, marketing, research and development, sales and technical support personnel. The lease for this facility extends through February 2010.

Approximately thirty percent of our security software research and development staff is located in a 6,464 square foot leased property in San Diego, California. This lease is currently on a month to month basis. Research and development personnel occupy this facility.

We believe that the existing facilities at December 31, 2006 will be adequate to meet our requirements through 2007. We believe that all facilities are adequately covered by appropriate property insurance. See Note 4 of Notes to Consolidated Financial Statements for additional information regarding our obligations under leases.

Item 3. Legal Proceedings.

We are subject to legal proceedings and claims that arise in the ordinary course of business. We do not believe that any claims exist where the outcome of such matters would 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 on future results.

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

There were no matters submitted to a vote of our security holders during the fourth quarter of 2006.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

Our common stock trades on The OTCBB, where it is currently listed under the symbol INTZ. As of February 28, 2007, there were approximately 119 registered holders of record of the common stock. The following table sets forth, for the periods indicated, the high and low per share intra-day sales prices for the common stock, as reported by The OTCBB.

	2006 High	Low	2005 High	Low
First Quarter	$ 2.87	$ 1.28	$ 6.20	$ 2.10
Second Quarter	1.52	.40	4.15	1.92
Third Quarter	.72	.28	3.59	2.61
Fourth Quarter	.53	.22	3.29	1.87

We have not declared or paid cash dividends on our common stock in our two most recent fiscal years. We intend to retain any earnings for use in our business and do not anticipate paying any cash dividends on our common stock in the foreseeable future. Future dividends on common stock, if any, will be determined by our Board of Directors. However, shares of our 5% convertible 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% and Series 3 5% convertible 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. We paid $192 thousand in dividends related to all of our 5% convertible preferred stock during 2006 and at December 31, 2006, we have dividends accrued related to all of our 5% convertible preferred stock of $26 thousand.

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 December 31, 2006. 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. 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. Furthermore, our inability to pay dividends could adversely affect our ability to raise equity financing in the future, if required.

All stock option plans under which our common stock is reserved for issuance have previously been approved by our shareholders. The following table provides summary information as of December 31, 2006 for all of our stock option plans (in thousands, except per share data). See Note 8 to our consolidated financial statements for additional discussion.

	Number of Shares of Common Stock to be Issued upon Exercise of Outstanding Options		Weighted Average Exercise Price of Outstanding Options, Excludes Warrants Rights	No. of Shares of Common Stock Remaining Available for Future Issuance	
Equity compensation plans approved by security holders	1,086	(1)	$ 3.23	96	(2)
Equity compensation plans not approved by security holders					
Total	1,086		$ 3.23	96	

(1) Included in the outstanding options are 654,500 from the 2005 Plan, 398,631 from the 1995 Plan and 32,500 from the 1995 Non-Employee Director Plan.

(2) Does not include Employee Stock Purchase Plan. At December 31, 2006, 79,298 shares were available for future issuance under this plan.

Item 6. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Safe Harbor Statement under the Private Litigation Reform Act of 1995

This Annual Report, including the sections entitled Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations, and Description of Business, contains forward-looking statements. These statements relate to future events or to our future financial performance, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements by the use of words such as may, could, expect, intend, plan, seek, anticipate, believe, estimate, predict, potential, continue, or the negative of these terms or terminology. You should not place undue reliance on forward-looking statements since they involve known and unknown risks, uncertainties and other factors which are, in some cases, beyond our control and which could materially affect actual results, levels of activity, performance or achievements. Factors that may cause actual results to differ materially from current expectations, which we describe in more detail elsewhere in this prospectus under the heading Risk Factors, include, but are not limited to:

- Failure to respond to rapid technological changes in the network security industry;
- Failure of our network intrusion detection, regulated information compliance, and entity identification products to achieve market acceptance;
- Our status as a developmental stage company;
- Our need to generate substantially greater revenues from sales in order to achieve profitability;
- intense competition from both start-up and established companies that may have significant advantages over us and our products;
- disruption to our business due to military actions;
- long sales and implementation cycles of our products;
- insufficient cash to operate our business;
- failure to realize the expected benefits of our recent restructuring efforts;
- the effect of consolidation in the network security industry;
- Risks involved with Government and international customers;
- Our inability to expand our sales;
- Failure to adequately protect our intellectual property; or
- The rights of the holders of our preferred stock and the terms of our secured credit line.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. Any forward-looking statement you read in this prospectus reflects our current views with respect to future events and is subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reason, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future. The Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act, each of which provide protection in connection with certain forward-looking statements, do not directly protect any statements we make in connection with this Annual Report.

Overview

We develop, market and support a family of network intrusion prevention, intrusion detection, regulated information compliance, data privacy protection and entity identification products. Our product families include the Compliance Commander for regulated information compliance and data privacy protection, Intrusion SpySnare for real-time inline blocking of spyware and unwanted peer-to-peer (P2P) applications, Intrusion SecureNet for network intrusion prevention and detection and TraceCop for identity identification. Intrusion s products help protect critical information assets by quickly detecting, protecting, analyzing and reporting attacks or misuse of classified, private and regulated information for government and enterprise networks.

We market and distribute our products through a direct sales force to end-users, distributors and numerous system integrators, managed service providers and value-added resellers. Our end-user customers include banks, credit unions, other financial institutions, U.S. federal government entities, foreign government entities and local government entities, high technology, e-commerce and telecommunication companies, hospital and other healthcare providers and academic institutions. Essentially, our end-user can be defined as any end-user requiring network security solutions for protecting their mission critical data .

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. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our ticker symbol from ODSI to INTZ to reflect our focus on intrusion prevention and detection solutions, along with information compliance and data privacy protection products. 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, Suite 200, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is www.intrusion.com. References to we , us , our or Intrusion Inc. refer to Intrusion Inc. and its subsidiaries Compliance Commander , SecureNet , TraceCop and SpySnare are registered trademarks of Intrusion Inc.

Our revenues have decreased over the past few years due primarily to the change in our product focus from networking hardware to network security software products with a corresponding decrease in our sales volume related to this change in our product mix. To date, we have not encountered significant competition in the market that has caused us to decrease our sales prices when compared to sales prices in previous years. To help counteract our declining revenues and bring our operations in line with our new strategic focus, we reduced our employee headcount in 2006. At December 31, 2005 we employed 43 employees and at December 31, 2006 we employed 32 employees. As a result of our migration to software-based solutions, our margins have increased over the past two years from 51.0% in 2004, to 58.0% in 2005 and 2006. We have also restructured our personnel and operations around the development and sale of our core software products. As a result of these efforts, we believe we have reduced operating expenses to a level that will remain consistent going forward.

In order for us to operate and grow our business, we must achieve and sustain operating profits and become cash flow positive. This will require us to counteract reduced sales of our SecureNet products by generating additional revenues from sales of our regulated information compliance and entity identification software products. In order to obtain these sales, our products must gain acceptance in intensely competitive and emerging markets. We believe our ability to introduce our Compliance Commander and TraceCop products into the marketplace in a timely manner and our efforts to maintain our reduced spending levels will help us achieve these results.

Critical Accounting Policies and Estimates

Management s discussion and analysis of financial condition and results of operations are based upon our 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, 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 consolidated financial statements.

Revenue Recognition

We generally recognize product revenue upon shipment of product. We accrue for estimated warranty costs and sales returns at the time of shipment based on our experience. Revenue from maintenance contracts is deferred and recognized over the contractual period the services are performed, generally one year. There is a risk that technical issues on new products could result in unexpected warranty costs and returns. However, as we migrate to more of a software-based business model, the warranty costs should continue to decline. To the extent that they do decline, our warranty reserve from current sales will decrease. To the extent that our warranty costs exceed our expectations, we will increase our warranty reserve to compensate for the additional expense expected to be incurred. We review these 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. Significant or subjective estimates associated with our revenue recognition policy include our estimate of warranty cost and sales returns.

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 criteria 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 estimated 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

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our receivables are uncollaterized and we expect to continue this policy in the future. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Historically, our estimates for sales returns and doubtful accounts have not differed materially 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 tables set forth, for the periods indicated, certain financial data as a percentage of net revenue.

	Year Ended December 31,			
	2006		2005	
Net product revenue	78.3	%	73.2	%
Net customer support and maintenance revenue	21.7		26.8	
Total revenue	100.0		100.0	
Cost of product revenue	38.2		39.4	
Cost of customer support and maintenance revenue	3.8		2.6	
Total cost of revenue	42.0		42.0	
Gross profit	58.0		58.0	
Operating expenses:				
Sales and marketing	51.8		52.5	
Research and development	39.4		42.7	
General and administrative	23.9		18.8	
Severance costs	0.2		1.0	
Operating loss	(57.3	)	(57.0	)
Interest income, net	0.8		1.4	
Other income, net	(1.2	)	0.0	
Loss from operations before income taxes	(57.7	)	(55.6	)
Income tax provision				
Net loss	(57.7	)	(55.6	)
Preferred stock dividends accrued	(3.3	)	(2.9	)
Beneficial conversion feature on preferred stock			(24.0	)
Net loss attributable to common stockholders	(61.0	)%	(82.5	)%

	2006		2005	
Domestic revenue	90.6	%	89.3	%
Export revenue to:				
Europe	7.1		7.8	
Canada	1.6		0.5	
Asia	0.6		2.3	
Latin America	0.1		0.1	
Net revenue	100.0	%	100.0	%

2006 compared with 2005

Net Revenue

Total revenue decreased to $5.2 million in 2006 from $6.0 million in 2005. The lack of revenue growth is related to shifting our focus from our SecureNet IPS product line to our Compliance Commander and TraceCop product lines. Our customer support and maintenance revenue decreased 29.1% from $1.6 million in 2005 to $1.1 million in 2006. This decline is mainly due to the expiration of maintenance contracts related to our SecureNet and zero maintenance related to TraceCop products. In 2006, total revenues related to our SecureNet product line decreased 56% or $2.2 million from $3.9 million in 2005 to $1.7 million in 2006, and our non-core product lines, including our PDS and SecureCom hardware products decreased 66.7% or $0.2 million from $0.3 million in 2005 to $0.1 million in 2006. Our product revenues remained constant at $4.1 million in 2006. We expect our product revenues to increase in the future as the market acceptance of our Compliance Commander and TraceCop product lines increase.

Export sales in 2006 decreased to $0.5 million, or 9.4% of net revenue, compared to $0.6 million, or 10.7% of net revenue in 2005 primarily due our focus on domestic revenue sales. As part of our headcount reductions, we have focused most of our sales personnel on the domestic market. Sales of our products internationally may be subject to exchange risk, which may cause our products to effectively increase in price, if the exchange rate moves significantly and the dollar gains value over the foreign currency.

Historically, due to the timing of our sales cycle, a significant portion of our monthly sales occurs in the second half of the month. Accordingly, our receivables increase at the end of each month, which causes a higher accounts receivable balance at month end. This monthly trend also causes an inflated comparative relationship between revenue and accounts receivable. We believe that this monthly trend will continue because monthly sales forecast and planning meetings are held in the first week of every month, the middle of the month is focused on sales calls to customers and the later half of the month on closing sales.

Gross Profit

Gross profit decreased 12.8% to $3.0 million in 2006 from $3.5 million in 2005. As a percentage of net revenue, gross profit remained constant at 58.0% for 2006 and 2005. Gross profit on products increased from 46.0% in 2005 to 51.3% in 2006 due to the shift in a more profitable product mix, namely our software-based products. Gross profit on customer support and maintenance decreased from 90.2% in 2005 to 82.2% in 2006. The decrease in gross profit on customer support and maintenance was relatively small and our gross profit in this area should remain strong as our hardware-related repair costs in conjunction with our strategic decision to move towards software-based solutions should remain low. As we continue to migrate from our older hardware-based products to our newer software-based products, we expect our product margins to continue to increase.

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

Sales and Marketing

Sales and marketing expenses decreased 12.9% to $2.7 million in 2006 from $3.1 million in 2005, as we reduced expenses to respond to the decline in sales. As a percentage of net revenue, sales and marketing expenses decreased to 51.8% in 2006 from 52.5% in 2005. We expect sales and marketing expenses to decrease in 2007 compared to 2006 as we hold the expense levels near fourth quarter 2006 levels, which decreased as a result of a decrease in employee headcount. We also expect sales and marketing expenses, as a percentage of net revenue, to decrease in 2007 compared to 2006 as we expect an increase in revenue in 2007.

Research and Development

Research and development expenses decreased to $2.1 million, or 39.4% of net revenue, in 2006 compared to $2.6 million, or 42.7% of net revenue, in 2005. Our research and development costs are expensed in the period in which they are incurred. We expect research and development expenses to remain relatively constant in 2007 compared to 2006. We expect research and development, as a percentage of net revenue, also to decrease in 2007 compared to 2006 as our revenue increases.

General and Administrative

General and administrative expenses increased slightly to $1.3 million, or 23.9% of net revenue in 2006 compared to $1.1 million or 18.8 % of net revenue in 2005. We expect general and administration expenses to remain relatively constant in 2007 compared to 2006.

Severance Costs

In connection with our strategic alignment of our sales force domestically and our continued shift to our new security product lines during 2004, we streamlined operations and activities that are not aligned with these core markets and strategies. During 2006 we recorded severance charges of $10 thousand, compared to $55 thousand in 2005. All severance obligations related to the 2006 expense were paid prior to December 31, 2006. All severance obligations related to the 2005 expense were paid prior to December 31, 2005. We were not receiving any benefits from those severed individuals subsequent to the year of the applicable expense.

Interest Income, Net

Net interest income decreased 46.4% to $45 thousand in 2006 from $84 thousand in 2005 primarily due to a decrease in average cash and interest-bearing investment balances. We expect net interest income to remain consistent in 2007 compared to 2006. Net interest income will vary in the future based on our cash flow and rate of return on investments.

Income Taxes

Our effective income tax rate was 0% in 2006 and 2005 as valuation allowances have been recorded for the entire amount of the net deferred tax assets due to uncertainty of realization. We have fully utilized our net operating loss carryback.

Liquidity and Capital Resources

Our principal sources of liquidity at December 31, 2006 were $0.9 million of cash and cash equivalents. As of December 31, 2006, we do not hold investments with a stated maturity beyond one year. Working capital at December 31, 2006 was $0.5 million compared to $2.7 million as of December 31, 2005.

Net cash used in operations in 2006 was $2.9 million, primarily due to an operating loss of $3.0 million for the year, a decrease in deferred revenue of $0.2 million, a decrease in inventories of $0.2 million, offset by depreciation and amortization of $0.1 million and an increase in accounts receivable of $0.4 million. Future fluctuations in accounts receivable, inventory balances and accounts payable will be dependent upon several factors, including quarterly sales, timely collection of accounts receivable, and the accuracy of our forecasts of product demand and component requirements.

Net cash provided by investing activities in 2006 was $0.5 million, which consisted of maturities of short term investments of $0.5 million of available for sale securities.

Net cash provided by financing activities in 2006 was $0.5 million, consisting of net financing proceeds from private placements of $0.5 million, net proceeds from line of credit of $.2 million and dividends paid on preferred stock of $0.2 million.

At December 31, 2006, we did not have any material commitments for capital expenditures. Operating lease commitments of $1.2 million are detailed below. During 2006, we funded our operations through the use of available cash, cash equivalents and investments, which was raised primarily through financing generated through the sale of our Series 3 5% convertible preferred stock.

As of December 31, 2006, we had cash, cash equivalents and investments in the amount of approximately $0.9 million, down from approximately $3.3 million as of December 31, 2005. However, throughout 2006, we continued to reduce expenses and realize the benefit of cost-cutting actions taken in previous years. Our net loss during the third and fourth quarter 2006 was approximately $200 thousand per quarter.

On December 28, 2006, we completed a private placement of 1,250,000 shares of our Common Stock for gross proceeds of $500,000.

On March 15, 2007, we completed an additional private placement of 925,926 shares of our Common Stock for gross proceeds of $500,000.

On March 29, 2006, we established a $1,000,000 line of credit with Silicon Valley Bank. Under the terms of this agreement, we may borrow an amount equal up to 80% of eligible accounts receivable balances. In addition, we may obtain inventory advances equal to 35% of finished good inventory, capped at the lesser of the inventory availability, $300,000 or 35% of our total borrowing base. If our credit line increases to $2,000,000, inventory advances will be capped at the lesser of the inventory availability, $600,000 or 35% of our borrowing base. Amounts we borrow under the credit line accrue interest at an annual rate of prime plus 1% and are secured by a lien on all of our assets. Accrued interest on all outstanding amounts is payable monthly in arrears and all outstanding principal and accrued but unpaid interest on the amounts we borrow are due on March 28, 2008. Our ability to receive advances under this credit line will increase if we generate additional receivables and inventory from the sale of our products. We have current balance due under this credit line of $200,000 at December 31, 2006. Also, assuming eligible receivables and inventory equal to the $844,000 of net accounts receivable and the $180,000 of finished goods inventory we had at December 31, 2006, we could borrow up to an additional $139,000 under our credit line at December 31, 2006. The line of credit was renewed on March 29, 2007, accrued interest on all outstanding amounts is payable monthly in arrears and all outstanding principal and accrued but unpaid interest on the amounts we borrow are due on March 28, 2008.

We expect our net operating losses and operating cash outflows to continue through at least the first quarter of 2007 and possibly throughout the remainder of fiscal year 2007. The sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. In addition, we are obligated to make payments of accrued dividends on all our outstanding shares of preferred stock that will reduce our available cash resources. Of the $0.9 million in cash, cash equivalents and investments at December 31, 2006, $0.5 million was derived from a private investment by our Chief Executive and Chief Financial Officers which closed on December 28, 2006. As of February 28, 2007 we had cash and cash equivalents of $300,000 and less than $100,000 in available funding under our existing credit line. Based on projections for increased revenues in 2007, the closing of the $0.5 million private placement on March 15, 2007 and a commitment from the Company s CEO to advance the Company up to $0.75 million in funding should it be necessary, we believe that our available credit line and available cash resources will provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. It is possible that we may need to fund our operations through additional investments of private equity, which, if we are able to obtain, will have the effect of diluting our existing common stockholders, perhaps significantly. 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. If our operations do not generate positive cash flow in the next few months, or if we are not able to obtain additional debt or equity financing on terms and conditions acceptable to us, if at all, we may be unable to implement our business plan, fund our liquidity needs or even continue our operations.

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, 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.

Contractual Obligations

The following table sets forth certain information concerning the future contractual obligations under our operating leases at December 31, 2006. We have no other significant contractual obligations at December 31, 2006.

Future minimum lease payments consisted of the following on December 31, 2006 (in thousands):

2007	$ 378
2008	393
2009	409
2010	68
	$ 1,248

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Off-Balance Sheet Arrangements

As of December 31, 2006, we did not have any significant off-balance sheet arrangements, as defined in Item 303(c)(2) of Regulation S-B.

Quantitative and Qualitative Disclosures About Market Risk.

Foreign Exchange. Our revenue originating outside the U.S. in 2006 and 2005 was 9.4% and 10.7% of total revenues, respectively. Revenues generated from the European region in 2006 and 2005 were 7.1% and 7.8% of total revenues, respectively. Revenues generated from the Asia region in 2006 and 2005 were 0.6% and 2.3% of total revenues, respectively. International sales are generated primarily from our foreign sales subsidiaries in the local countries and are typically denominated in U.S. dollars. These subsidiaries incur substantially all of their expenses in the local currency.

Our international business is subject to risks typical of an international business, including differing economic conditions, changes in political climate, differing tax structures, import and export regulations, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, our results could be materially adversely impacted by changes in these or other factors. The effect of foreign exchange rate fluctuations on our business in 2005 and 2004 was not material.

Interest Rates. We invest our cash in a variety of investment grade 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 Statement of Financial Accounting Standards 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 values 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 interest rate on investment securities for the year ended December 31, 2006 was 5.1%. We held no short-term investments at December 31, 2006.

Item 7. Financial Statements.

The information required by this item is included in Part III Item 13.

Item 8. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 8A. Controls and Procedures

We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable assurance of achieving the desired control objectives, and we necessarily are required to apply our judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures.

Our management, including our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2006 and concluded that the disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2006 that have materially affected, or are reasonable likely to materially affect, our internal control over financial reporting.

At the end of 2007, Section 404 of the Sarbanes-Oxley Act will require our management to provide an assessment of the effectiveness of our internal control over financial reporting, and at the end of 2008, our independent registered public accountants will be required to audit management s assessment. We are in the process of performing the system and process documentation, evaluation and testing required for management to make this assessment and for its independent registered public accountants to provide their attestation report. We have not completed this process or its assessment, and this process will require significant amounts of management time and resources. In the course of evaluation and testing, management may identify deficiencies that will need to be addressed and remediated.

Item 8B. Other Information

Not applicable.

PART III

Certain information required by Part III is omitted from this Form 10-KSB because we will file a definitive Proxy Statement for our 2006 annual meeting of stockholders pursuant to Regulation 14A (the Proxy Statement) no later than 120 days after the end of the fiscal year covered by this Form 10-KSB, and certain information to be included therein is incorporated herein by reference.

Item 9. Directors and Executive Officers of Intrusion Inc.

The information required regarding Directors and Executive Officers of Intrusion Inc. appearing under the captions Election of Directors , Compliance with Section 16 Reporting Requirements and Executive Officers contained in the Proxy Statement is incorporated herein by reference.

Item 10. Executive Compensation.

The information set forth under the caption Executive Compensation contained in the Proxy Statement is incorporated herein by reference.

Compensation Committee Interlocks and Insider Participation

The members of the Compensation Committee of our Board of Directors for the entire 2006 fiscal year were J. Fred Bucy, Jr. (Chairman), Donald M. Johnston, and James F. Gero, each of whom is an independent director.

No member of our Board of Directors or any committees of the Board, including the Compensation Committee, has an interlocking relationship with the board (or member of such board) or any committee (or member of such committee) of a board of any other company.

March 25, 2004 Private Placement

On March 25, 2004, we completed a $5,000,000 private placement of 1,000,000 shares of our 5% convertible preferred stock and warrants to purchase 556,619 shares of our common stock at an initial exercise price of $3.144 per share to various purchasers. Mr. Gero, a director and one of the members of the Compensation Committee, invested $300,000 in the private placement in consideration for 60,000 shares of preferred stock and warrants to purchase 33,397 shares of common stock. Mr. Gero participated in the private placement on the same terms and conditions as other investors, except that he is not entitled to a preemptive right to purchase a pro rata portion of certain future sales of securities by us. In addition, as a director, Mr. Gero agreed not to sell any shares of common stock owned by him until the registration statement described below is declared effective by the SEC.

As part of this private placement, we entered into a Registration Rights Agreement, pursuant to which we are required to file a registration statement to register the shares of common stock issuable upon the conversion of the preferred stock and upon the exercise of the warrants issued to the investors in the private placement. We failed to file the registration statement by April 24, 2004 and did not have the registration statement declared effective by July 24, 2004. As a result, we paid liquidated damages equal to 2% of the aggregate purchase price paid to us in the private placement for each thirty-day period, pro rated for any shorter period, that the filing or effectiveness of the registration statement is delayed. Mr. Gero

waived his right for any liquidated damages related to our late filing of the registration statement. In accordance with this obligation, we filed a registration statement on Form S-3 including these shares of common stock on April 20, 2004. The registration statement includes the 128,817 shares of common stock underlying the preferred stock and warrants purchased by Mr. Gero in the private placement as well as 125,000 shares previously acquired by Mr. Gero in a private transaction with a third party.

March 28, 2005 Private Placement

On March 28, 2005, we completed a $2,663,000 private placement of 1,065,200 shares of our Series 2 5% convertible preferred stock and warrants to purchase 532,600 shares of our common stock at an initial exercise price of $2.77 per share to various purchasers. Mr. Gero invested $150,000 in this private placement in consideration for 60,000 shares of preferred stock and warrants to purchase 30,000 shares of common stock. Mr. Gero participated in the private placement on the same terms and conditions as other investors except that he is not entitled to a preemptive right to purchase a pro rata portion of certain future sales of securities by us or to receive liquidated damages under the provisions of the Registrations Rights Agreement we executed in connection with this private placement.

December 2, 2005 Private Placement

On December 2, 2005, we completed a $1,230,843 private placement of 564,607 shares of our Series 3 5% convertible preferred stock and warrants to purchase 282,306 shares of our common stock at an initial exercise price of $2.58 per share to various purchasers. Mr. Gero invested $60,000 in this private placement in consideration for 27,523 shares of preferred stock and warrants to purchase 13,762 shares of common stock. Mr. Gero participated in the private placement on the same terms and conditions as other investors except that he is not entitled to a preemptive right to purchase a pro rata portion of certain future sales of securities by us or to receive liquidated damages under the provisions of the Registrations Rights Agreement we executed in connection with this private placement. In addition, Mr. Gero will not be able to convert his shares of preferred stock into, or exercise his warrants for, shares of common stock unless and until approved by our stockholders to the extent required by Nasdaq.

Item 11. Security Ownership of Certain Beneficial Owners and Management.

The information set forth under the caption Security Ownership of Certain Beneficial Owners and Management contained in the Proxy Statement is incorporated herein by reference.

Item 12. Certain Relationships and Related Transactions.

The information set forth under Certain Transactions with Management contained in the Proxy Statement is incorporated herein by reference.

Item 13. Exhibits.

(a) 1. **Consolidated Financial Statements.**

The following consolidated financial statements of Intrusion Inc. and subsidiaries, are submitted as a separate section of this report (See F-pages), and are incorporated by reference in Item 7:

(b) **Exhibits**

The following Exhibits are filed herewith pursuant to Item 601 of Regulation S-B or incorporated herein by reference to previous filings as noted:

Exhibit Number	Description of Exhibit
2.1(3)	Certificate of Ownership and Merger Merging Intrusion.com, Inc. into Intrusion Inc.
3.1(5)	Amended and Restated Certificate of Incorporation of the Registrant
3.2(7)	Certificate of Amendment to Certificate of Incorporation of Registrant
3.3(8)	Certificate of Designation for the Registrant s 5% Convertible Preferred Stock
3.4(10)	Certificate of Designations of the Registrant s Series 2 5% Convertible Preferred Stock
3.5(11)	Certificate of Designation for the Registrant s Series 3 5% Convertible Preferred Stock
3.6(4)	Bylaws of the Registrant
4.1(9)	Specimen Common Stock Certificate
4.2(8)	Specimen 5% Convertible Preferred Stock Certificate
4.3(10)	Specimen Series 2 5% Convertible Preferred Stock Certificate
4.4(11)	Specimen Series 3 5% Convertible Preferred Stock Certificate
4.5(8)	Form of Warrant to Purchase Shares of Common Stock issued to the investors in the Registrant s March 25, 2004 private placement
4.6(8)	Warrant to Purchase Common Stock dated March 25, 2004, issued by the Registrant to Black Point Partners
4.7(8)	Registration Rights Agreement dated as of March 25, 2004, by and among the Registrant and the entities listed on Schedule A thereto
4.8(8)	Form of Lock-Up Agreement executed by the Registrant s officers and directors in connection with the Registrant s March 25, 2004 private placement
4.9(10)	Form of Common Stock Purchaser Warrant issued to the investors in the Registrant s March 28, 2005 private placement
4.10(10)	Form of Representative s Warrant for the Purchase of Shares of Common Stock issued to certain affiliates of Stonegate Securities, Inc. on March 28, 2005
4.11(10)	Registration Rights Agreement dated as of March 28, 2005, by and among the Registrant and each of the purchasers listed on the signature pages thereto
4.12(10)	Form of Voting Agreement executed by each of the officers and directors of Registrant in connection with the March 28, 2005 private placement
4.13(10)	Securities Purchase Agreement dated as of March 28, 2005, by and among the Registrant and the investors listed on Exhibit A thereto
4.14(10)	Placement Agency Agreement dated February 7, 2005, by and between the Registrant and Stonegate Securities, Inc.
4.15(11)	Form of Common Stock Purchaser Warrant issued to the investors in the Registrant s December 2, 2005 private placement
4.16(11)	Form of Representative s Warrant for the Purchase of Shares of Common Stock issued to certain affiliates of Stonegate Securities, Inc. on December 2, 2005
4.17(11)	Registration Rights Agreement dated as of December 2, by and among the Registrant and each of the purchasers listed on the signature pages thereto
4.18(11)	Form of Voting Agreement executed by each of the officers and directors of Registrant in connection with the December 2, 2005 private placement
4.19(11)	Securities Purchase Agreement dated as of December 2, 2005, by and among the Registrant and the investors listed on Exhibit A thereto
4.20(11)	Placement Agency Agreement dated December 2, 2005, by and between the Registrant and Stonegate Securities, Inc.
10.1(1)	1987 Incentive Stock Option Plan of the Registrant, as amended
10.2(1)	1995 Stock Option Plan of the Registrant, as amended
10.3(1)	Form of Indemnification Agreement
10.4(2)	1995 Non-Employee Directors Stock Option Plan of the Registrant (amended and restated as of January 10, 2002)
10.5(9)	Lease Agreement between CalWest Industrial Holdings Texas, L.P. and Intrusion Inc.
10.6(8)	Securities Purchase Agreement dated as of March 25, 2004, by and among the Registrant and the purchasers listed on Exhibit A thereto

10.7(4)	Amended and Restated 401(k) Savings Plan of the Registrant
10.8(4)	1997 Employee Stock Purchase Plan of the Registrant, as amended January 17, 2001
10.9(6)	Intrusion Inc. 401(k) Savings Plan Summary of Material Modifications
10.10(12)	2005 Stock Incentive Plan of the Registrant
10.11(12)	Form of Notice of Grant of Stock Option
10.12(12)	Form of Stock Option Agreement
10.13(12)	Form of Stock Issuance Agreement
10.14(12)	Form of Notice of Grant of Non-Employee Director Automatic Stock Option (Initial Grant)
10.15(12)	Form of Notice of Grant of Non-Employee Director Automatic Stock Option (Annual Grant)
10.16(12)	Form of Automatic Stock Option Agreement
10.17(13)	Waiver of Liquidated Damages dated as of July 23, 2004, by and among the Registrant, G. Ward Paxton and James F. Gero
10.18(14)	Loan and Security Agreement dated as of March 29, 2006, by and between the Registrant and Silicon Valley Bank
10.19(14)	Intellectual Property Security Agreement dated as of March 29, 2006, by and between the Registrant and Silicon Valley Bank
10.20(15)	Subscription and Investment Representation Agreement by and between Intrusion Inc. and G. Ward Paxton, dated December 28, 2006.
10.20(15)	Subscription and Investment Representation Agreement by and between Intrusion Inc. and Michael L. Paxton, dated December 28, 2006.
10.20(16)	Subscription and Investment Representation Agreement by and between Intrusion Inc. and G. Ward Paxton, dated March 15, 2007.
10.20(16)	Subscription and Investment Representation Agreement by and between Intrusion Inc. and Michael L. Paxton, dated March 15, 2007.
21(5)	List of Subsidiaries of Registrant
23.1(17)	Consent of KBA Group LLP, Independent Registered Public Accounting Firm
31.1(17)	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act
31.2(17)	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act
32.1(17)	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(17)	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

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(1) Filed as an Exhibit in the Registrant s Registration Statement on Form S-1, as amended (File No. 33-6899), which was declared effective on May 21, 1992, by the Securities and Exchange Commission, which Exhibit is incorporated herein by reference.

(2) Filed as an Exhibit to the Registrant s Definitive Proxy Statement on Schedule 14A in connection with the solicitation of proxies for its 2002 Annual Meeting of Stockholders, which Exhibit is incorporated herein by reference.

(3) Filed as an Exhibit to the Registrant s Definitive Proxy Statement on Schedule 14A in connection with the solicitation of proxies for its 2002 Annual Meeting of Stockholders, which Exhibit is incorporated herein by reference.

(4) Filed as an Exhibit to the Registrants Annual Report on Form 10-K, for the fiscal year ended December 31, 2000.

(5) Filed as an Exhibit to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2001, which Exhibit is incorporated herein by reference.

(6) Filed as an Exhibit to the Registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, which Exhibit is incorporated herein by reference.

(7) Filed as an Exhibit to the Registrant s Definitive Proxy Statement on Schedule 14A in connection with the solicitation of proxies for its Special Meeting of Stockholders held March 18, 2004, which Exhibit is incorporated

herein by reference.

(8) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated March 26, 2004 (as amended), which Exhibit is incorporated by reference.

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(9) Filed as an Exhibit to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003 (as amended), which Exhibit is incorporated herein by reference.

(10) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated March 29, 2005, which Exhibit is incorporated herein by reference

(11) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated December 6, 2005, which Exhibit is incorporated herein by reference.

(12) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated June 15, 2005, which Exhibit is incorporated herein by reference.

(13) Filed as an Exhibit to the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, which Exhibit is incorporated herein by reference.

(14) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated March 29, 2006, which Exhibit is incorporated herein by reference.

(15) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated January 4, 2007, which Exhibit is incorporated herein by reference.

(16) Filed as an Exhibit to the Registrant s Current Report on Form 8-K dated March 16, 2007, which Exhibit is incorporated herein by reference.

(17) Filed herewith.

Item 14. Principal Accountant Fees and Services

The information set forth under Fees Paid to Independent Public Accountants contained in the Proxy Statement is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: March 29, 2007

INTRUSION INC.
(Registrant)

By: /s/ G. WARD PAXTON
G. Ward Paxton
Chairman, President, and Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ G. WARD PAXTON G. Ward Paxton	Chairman, President, Chief Executive Officer, and Director	March 29, 2007
/s/ T. JOE HEAD T. Joe Head	Vice Chairman, Vice President and Director	March 29, 2007
/s/ MICHAEL L. PAXTON Michael L. Paxton	Vice President, Chief Financial Officer, Treasurer and Secretary (Principal Financial and Accounting Officer)	March 29, 2007
/s/ JAMES F. GERO James F. Gero	Director	March 29, 2007
/s/ J. FRED BUCY, JR. J. Fred Bucy, Jr.	Director	March 29, 2007
/s/ DONALD M. JOHNSTON Donald M. Johnston	Director	March 29, 2007

ANNUAL REPORT ON FORM 10-KSB

ITEM 7

FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 and 2005

INTRUSION INC.

RICHARDSON, TEXAS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Intrusion Inc.

We have audited the accompanying consolidated balance sheets of Intrusion Inc. and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have nor were we engaged to perform audits of their internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Intrusion Inc. and subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2006, the Company adopted Statement of Accounting Standards No. 123(R), Share-Based Payment.

/s/ KBA Group LLP
Dallas, Texas
March 29, 2007

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INTRUSION INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

	December 31, 2006	2005
Assets		
Current Assets:		
Cash and cash equivalents	$ 933	$ 2,844
Short-term investments		500
Accounts receivable, net of allowance for doubtful accounts and returns of $90 in 2006 and $102 in 2005	844	443
Inventories, net	209	373
Prepaid expenses	198	191
Total current assets	2,184	4,351
Property and Equipment:		
Equipment	409	650
Furniture and fixtures	20	48
Leasehold improvements	101	101
	530	799
Accumulated depreciation and amortization	(368)	(543)
	162	256
Other assets	41	41
TOTAL ASSETS	$ 2,387	$ 4,648
Liabilities and Stockholders Equity		
Current Liabilities:		
Line of credit	$ 200	$
Accounts payable, trade	555	415
Accrued vacation expense	212	263
Accrued warranty expense	49	49
Other accrued expenses	283	415
Deferred revenue	367	527
Total current liabilities	1,666	1,669
TOTAL LIABILITIES	1,666	1,669
Commitments and Contingencies		
Stockholders Equity:		
Preferred stock, $0.01 par value:		
Authorized shares 5,000		
Series 1 shares issued and outstanding 260 in 2006 and 260 in 2005 Liquidation preference of $1,331 in 2006	918	918
Series 2 shares issued and outstanding 460 in 2006 and 500 in 2005 Liquidation preference of $1,155 in 2006	724	787
Series 3 shares issued and outstanding 469 in 2006 and 565 in 2005 Liquidation preference of $1,026 in 2006	667	805
Common stock, $0.01 par value:		
Authorized shares 80,000		
Issued shares 8,306 in 2006 and 6,919 in 2005		
Outstanding shares 8,296 in 2006 and 6,909 in 2005	83	69
Common stock held in treasury, at cost 10 shares	(362)	(362)
Additional paid-in-capital	53,947	52,994
Accumulated deficit	(55,077)	(52,053)
Accumulated other comprehensive loss	(179)	(179)
Total stockholders equity	721	2,979
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 2,387	$ 4,648

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	Year Ended December 31, 2006	2005
Net product revenue	$ 4,106	$ 4,375
Net customer support and maintenance revenue	1,136	1,603
Total revenue	5,242	5,978
Cost of product revenue	2,002	2,357
Cost of customer support and maintenance revenue	202	157
Total cost of revenue	2,204	2,514
Gross profit	3,038	3,464
Operating expenses:		
Sales and marketing	2,714	3,137
Research and development	2,067	2,553
General and administrative	1,251	1,126
Severance costs	10	55
Operating loss	(3,004)	(3,407)
Interest income, net	45	84
Other income (expense), net	(65)	2
Loss from operations before income taxes	(3,024)	(3,321)
Income tax provision		
Net loss	(3,024)	(3,321)
Preferred stock dividends accrued	(175)	(168)
Beneficial conversion feature on preferred stock		(1,434)
Net loss attributable to common stockholders	$ (3,199)	$ (4,923)
Net loss per share attributable to common stockholders (basic and diluted)	$ (0.45)	$ (0.77)
Weighted average common shares outstanding (basic and diluted)	7,043	6,424

See accompanying notes.

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INTRUSION INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Year Ended December 31, 2006	2005
NUMBER OF PREFERRED SHARES ISSUED AND OUTSTANDING		
Balance, beginning of year	1,325	840
Issuance of preferred shares pursuant to private placement		1,630
Conversion of preferred shares to common shares	(137)	(1,145)
Balance, end of year	1,188	1,325
PREFERRED STOCK		
Balance, beginning of year	$ 2,510	$ 2,968
Issuance of preferred shares pursuant to private placement, net of warrants and transaction costs		2,480
Conversion of preferred shares to common shares	(201)	(2,938)
Balance, end of year	$ 2,309	$ 2,510
NUMBER OF COMMON SHARES ISSUED		
Balance, beginning of year	6,919	5,431
Issuance of common shares under private placement	1,250	
Conversion of preferred shares to common shares	137	1,488
Balance, end of year	8,306	6,919
COMMON STOCK		
Balance, beginning of year	$ 69	$ 54
Issuance of common shares under private placement	13	
Conversion of preferred shares to common shares	1	15
Balance, end of year	$ 83	$ 69
TREASURY SHARES		
Balance, beginning of year	$ (362)	$ (362)
Purchase of treasury shares		
Balance, end of year	$ (362)	$ (362)
ADDITIONAL PAID-IN-CAPITAL		
Balance, beginning of year	$ 52,994	$ 49,095
Stock based compensation	441	
Issuance of warrants with preferred stock private placement		1,141
Conversion of preferred shares to common shares	200	2,926
Issuance of common shares under private placement	488	
Preferred stock dividends accrued	(176)	(168)
Balance, end of year	$ 53,947	$ 52,994
ACCUMULATED DEFICIT		
Balance, beginning of year	$ (52,053)	$ (48,732)
Net loss	(3,024)	(3,321)
Balance, end of year	$ (55,077)	$ (52,053)
ACCUMULATED OTHER COMPREHENSIVE LOSS		
Balance, beginning of year	$ (179)	$ (173)
Foreign currency translation adjustment		(6)
Balance, end of year	$ (179)	$ (179)
TOTAL STOCKHOLDERS EQUITY	$ 721	$ 2,979
TOTAL COMPREHENSIVE LOSS	$ (3,024)	$ (3,327)

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31, 2006	2005
Operating Activities:		
Net loss	$ (3,024)	$ (3,321)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	97	185
Provision for doubtful accounts	(12)	(405)
Stock based compensation	441	
Changes in operating assets and liabilities:		
Accounts receivable	(389)	1,182
Inventories	164	577
Other assets	(7)	225
Accounts payable and accrued expenses	(27)	(503)
Deferred revenue	(160)	(272)
Net cash used in operating activities	(2,917)	(2,332)
Investing Activities:		
Purchases of short-term investments		(2,850)
Maturities of short-term investments	500	2,425
Proceeds from sale of property and equipment		2
Purchases of property and equipment	(3)	(144)
Net cash provided by (used in) investing activities	497	(567)
Financing Activities:		
Proceeds from line of credit	200	
Proceeds from exercise of employee stock options	1	
Proceeds from the issuance of common stock, net	500	3,620
Dividends paid on preferred stock	(192)	(186)
Net cash provided by financing activities	509	3,434
Effect of foreign currency translation adjustment on cash and cash equivalents		(6)
Net increase (decrease) in cash and cash equivalents	(1,911)	529
Cash and cash equivalents at beginning of year	2,844	2,315
Cash and cash equivalents at end of year	$ 933	$ 2,844
SUPPLEMENTAL CASHFLOW INFORMATION:		
Interest paid	$ 1	$
Income taxes paid	$	$
SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES:		
Fair value of warrants issued in connection with sale of preferred stock	$	$ 1,141
Amortization of preferred stock beneficial conversion feature	$	$ 1,434
Preferred stock dividends accrued	$ 176	$ 168

See accompanying notes.

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INTRUSION INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

We develop, market and support a family of network intrusion prevention, intrusion detection, regulated information compliance, data privacy protection and entity identification products. Our product families include the Compliance Commander for regulated information and data privacy protection, Intrusion SpySnare for real-time inline blocking of spyware and unwanted peer-to-peer (P2P) applications, Intrusion SecureNet for network intrusion prevention and detection and TraceCop for identity identification. Intrusion s products help protect critical information assets by quickly detecting, protecting, analyzing and reporting attacks or misuse of classified, private and regulated information for government and enterprise networks.

We market and distribute our products through a direct sales force to end-users, distributors and numerous system integrators, managed service providers and value-added resellers. Our end-user customers include banks, credit unions, other financial institutions, U.S. federal government entities, foreign government entities and local government entities, high technology, e-commerce and telecommunication companies, hospital and other healthcare providers and academic institutions. Essentially, our end-user can be defined as any end-user requiring network security solutions for protecting their mission critical data .

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 sold, or otherwise disposed of, our networking divisions, which included our Essential Communications division and our local area networking assets. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our ticker symbol from ODSI to INTZ to reflect our focus on intrusion prevention and detection solutions, along with information compliance and data privacy protection products. 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.

References to we , us , our or Intrusion Inc. refer to Intrusion Inc. and its subsidiaries. Compliance Commander , SecureNet , TraceCop and SpySnare are registered trademarks of Intrusion Inc.

As of December 31, 2006, we had cash, cash equivalents and investments of approximately $0.9 million, down from approximately $3.3 million as of December 31, 2005. On March 28, 2005, we closed a $2.66 million private placement of Convertible Preferred Stock and warrants. On December 2, 2005, we closed a $1.23 million private placement of Convertible Preferred Stock and warrants. On March 29, 2006, we established a $1.0 million line of credit with Silicon Valley Bank, which was renewed on March 29, 2007. On December 28, 2006, we closed a $0.5 million private placement of common stock. Based on projections for increased revenues in 2007,the closing of another $0.5 million private placement on March 15, 2007 and a commitment from the Company s CEO to advance the Company up to $0.75 million in funding should it be necessary through March 2008, we believe that our available credit line and available cash resources will provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. The sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. In addition, the payment of dividends on our outstanding preferred stock may reduce our available cash resources. Moreover, despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue through at least the first quarter of 2007 and possibly throughout the remainder of fiscal year 2007. We do not currently have any arrangements for additional 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 such funding. Additionally, we may not have sufficient availability under our credit line when we need additional funds. Under the terms of our credit line, we may borrow an amount equal up to 80% of eligible accounts receivable balances. In addition, we may obtain inventory advances equal to 35% of finished good inventory, capped at the lesser of the inventory availability, $300,000 or 35% of our total borrowing base. If our business does not generate sufficient cash flows from operations and sufficient 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. Summary of Significant Accounting Policies

Principles of Consolidation

Our consolidated financial statements include our accounts and those of our wholly owned subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and all highly liquid investments purchased with an original maturity of less than three months are considered to be cash and cash equivalents.

Short-term Investments

Short-term investments consist of U.S. government obligations and corporate securities with maturities between 90 days and one year as of the balance sheet date. Short-term investments are classified as available for sale. These investments are valued at market value, which approximates amortized cost. The difference between fair market value and amortized cost is not significant. Realized gains and losses from the sale of short-term investments are included in other income, net and are derived using the specific identification method for determining the cost of securities.

Risk Concentration

Financial instruments, which potentially subject us to concentrations of credit risk, are primarily cash and cash equivalents, investments and accounts receivable. Cash and cash equivalent deposits are at risk to the extent that they exceed Federal Deposit Insurance Corporation insured amounts. To minimize risk, we place our investments in U.S. government obligations, corporate securities and money market funds. Substantially all of our cash, cash equivalents and investments are maintained with two major U.S. financial institutions.

We sell our products to customers in diversified industries worldwide, primarily in North America, Europe and Asia. Fluctuations in currency exchange rates and adverse economic developments in foreign countries could adversely affect the Company s operating results. We perform ongoing credit evaluations of our customers financial condition and generally require no collateral. We maintain reserves for potential credit losses, and such losses, in the aggregate, have not exceeded management expectations.

While we believe that many of the materials used in the production of our products are generally readily available from a variety of sources, certain components are available from one or a limited number of suppliers. The inability of any supplier or manufacturer to fulfill supply requirements of the Company could impact future results.

Accounts Receivable and Allowance for Doubtful Accounts

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.

Inventories and Change in Method for Valuing Inventory

Inventories are stated at the lower of cost or market. We value our inventories using average cost, which approximates actual cost on a first-in, first-out basis. Our management estimates the allowance required to state inventory at the lower of cost or market. There is a risk that we will forecast demand for our products and market conditions incorrectly and maintain excess inventories. Therefore, there can be no assurance that we will not maintain excess inventory and incur inventory lower of cost or market charges in the future.

Property and Equipment

Equipment is stated at cost less accumulated depreciation and is depreciated on a straight-line basis over the estimated useful lives of the assets. Such lives vary from 1 to 3 years. Furniture and fixtures are stated at cost less accumulated depreciation and is depreciated on a straight-line basis over the estimated useful lives of the assets. Such lives vary from 1 to 5 years. Leasehold improvements are stated at cost less accumulated amortization and are amortized on a straight-line basis over the shorter of estimated useful lives of the assets or the remaining terms of the leases. Such lives vary from 2 to 5 years. Expenditures for major renewals and betterments that extend the useful lives of property and equipment are capitalized. Repair and maintenance costs are expensed as incurred. Depreciation and amortization expense totaled approximately $97,000 and $185,000 for the years ended December 31, 2006 and 2005, respectively.

Long-Lived Assets

We follow the guidance in SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets and review long-lived assets, including property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows to be generated by the asset. If the carrying value exceeds the future undiscounted cash flows, the assets are written down to fair value using discounted cash flows. As of December 31, 2006 and 2005, there was no impairment of long-lived assets.

Foreign Currency Translation

Our international subsidiaries use the United States dollar as their functional currency. Although, our international offices pay operating expenses in their local currency, they are fully funded by us in United States dollars, and we exchange the United States dollars locally to settle operating expenses incurred. As outlined in SFAS 52, assets and liabilities are translated at the exchange rate in effect at the balance sheet date, and income and expense accounts at average exchange rates during the year. We recorded approximately $1,000 and $6,000 in operating expenses in 2006 and 2005, respectively, which represents the total accumulated foreign currency translation adjustments related to foreign offices. These amounts also represent the annual change in the accumulated other comprehensive loss during 2006 and 2005.

Accounting for Stock Options

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which replaces SFAS 123 and supersedes APB Opinion No. 25. SFAS 123(R) 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.

Prior to January 1, 2006, we accounted for employee stock-based compensation in accordance with APB 25 and followed the disclosure requirements in accordance with SFAS 148. No compensation cost was recorded for stock options, as historically all options granted under our stock option plans have an exercise price equal (at minimum) to the market value of the underlying common stock on the date of grant.

We adopted SFAS 123(R) on January 1, 2006 using the modified prospective application method described in the statement. Results for prior periods have not been restated. Stock-based compensation expense recognized during each period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the consolidated statement of operations during 2006 included compensation expense for stock-based payment awards granted prior to, but not yet vested, as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 148 and compensation expense for the stock-based payment awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with SFAS 123(R). As stock-based compensation expense recognized in the statement of operations after December 31, 2005 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under SFAS 148 for the periods prior to 2006, we accounted for forfeitures as they occurred.

By adopting SFAS 123(R) we anticipate recording substantial non-cash stock compensation expenses. The adoption of SFAS 123(R) 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.

Effect of Adopting SFAS No. 123(R)

The effect of adopting SFAS No. 123(R) as of January 1, 2006 for the year ended December 31, 2006 (in thousands, except per share data) is as follows:

	For Year Ended December 31, 2006
Stock-option compensation expense recognized (for stock options only):	
Cost of revenue	$ 26
Research and development	109
Sales and marketing	178
General and administrative	128
Effect on net loss	$ 441
Effect on basic and diluted earnings per common share	$ (0.06)

Pro Forma Presentation for Periods Prior to the Adoption of SFAS 123(R)

Under the modified prospective application method, results for prior periods have not been restated to reflect the effects of implementing SFAS No. 123(R). The following pro forma information was reported, as required by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure for the year ended December 31, 2005.

	For Year Ended December 31, 2005
Net loss attributable to common stockholders	$ (4,923)
Deduct: Total stock-based compensation determined under fair value-based method for all awards	(831)
Pro forma net loss attributable to common stockholders	$ (5,754)
Net loss per share attributable to common stockholders:	
as reported (basic and diluted)	$ (0.77)
pro forma (basic and diluted)	$ (0.90)
Weighted-average shares used in computation:	
Basic and diluted	6,424

Valuation Assumptions

The fair values of option awards were estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions for fiscal years ending December 31, 2006 and 2005, respectively:

	2006	2005
Weighted average grant date fair value	$ 0.32	$ 2.34
Weighted average assumptions used:		
Expected dividend yield	0.0 %	0.0 %
Risk-free interest rate	4.4 %	3.9 %
Expected volatility	106.0 %	112.4 %
Expected life (in years)	5	4.4

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially

affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Expected volatility is based on historical volatility and in part on implied volatility. The expected term considers the contractual term of the option as well as historical exercise and forfeiture behavior. The risk-free interest rate is based on the rates in effect on the grant date for U.S. Treasury instruments with maturities matching the relevant expected term of the award.

Net Loss Per Share

We report two separate earnings per share (EPS) numbers, basic EPS and diluted EPS. Basic net loss attributable to common stockholders per share is computed by dividing net loss attributable to common stockholders for the year by the weighted average number of common shares outstanding for the year. Diluted net loss attributable to common stockholders per share is computed by dividing the net loss attributable to common stockholders for the year by the weighted average number of common shares and common stock equivalents outstanding for the year. 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 at December 31, 2006 and 2005 totaled 3,951,223 and 3,892,157, respectively. Common stock equivalents are not included in the diluted loss per share for the years ended December 31, 2006 and 2005, as they are anti-dilutive as a result of incurring net losses during these years.

Revenue Recognition

We generally recognize product revenue upon shipment. These products include both hardware and perpetual software licenses, as we do not currently offer software on a subscription basis. We accrue for estimated warranty costs and sales returns at the time of shipment based on our experience. There is a risk that technical issues on new products could result in unexpected warranty costs and returns. However, as we migrate to more of a software-based business model, the warranty costs should continue to decline. To the extent that they do decline, our warranty reserve will decrease. To the extent that our warranty costs exceed our expectations, we will increase our warranty reserve to compensate for the additional expense expected to be incurred. We review these estimates periodically and determine the appropriate reserve percentage. However, to date, warranty costs and sales returns have not been material. The customer may return a product only under very limited circumstances during the first thirty days from delivery for a replacement if the product is damaged or for a full refund if the product does not perform as intended. Historically, most or our sales returns were related to hardware-based products. As we continue to migrate away from the hardware-based products, these returns have declined. In addition, the cost related to returns for repair and refurbishment have also declined, as our hardware costs and assembly costs have declined. Most of our returns have been related to inventory held at distributors, as they have stock rotation privileges. Since these returns are not related to sales, as they are maintained in deferred revenue until the distributors sell the product, these returns have not impacted our sales return allowance methodology.

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 software product revenue is recognized at time of delivery, as our licenses are not sold on a subscription basis. In the case of product sales, which include maintenance and customer support, a Vendor Specific Objective Evidence analysis would be performed to appropriately determine the amount of revenue derived from each deliverable. All of our product offering and service offering market values are readily determined based on current and prior stand-alone sales. We defer and recognize maintenance and support revenue over the term of the contract period, which is generally one year.

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. These revenues are included in net customer support and maintenance revenues in the statement of operations.

Our normal payment terms offered to customers, distributors and resellers are net 30 days domestically and net 45 days internationally. We do not offer payment terms that extend beyond one year and rarely do we extend payment terms beyond our normal terms. If certain customers do not meet our credit standards, we do require payment in advance to limit our credit exposure.

Shipping and handling costs are billed to the customer and included in product revenue. Our costs of shipping and handling are included in product cost of revenue.

Research and Development Costs

We incur research and development costs that relate primarily to the development of new security software, appliances and integrated solutions, and major enhancements to existing services and products. Research development costs are comprised primarily of salaries and related benefits expenses, contract labor and prototype and other related expenses.

Software development costs are included in research and development and are expensed as incurred. SFAS 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, requires that software development costs incurred subsequent to reaching technological feasibility be capitalized, if material. If the process of developing a new product or major enhancement does not include a detailed program design, technological feasibility is determined only after completion of a working model. To date, the period between achieving technological feasibility and the general availability of such software has been short, and the software development costs qualifying for capitalization have been insignificant.

Severance Charges

In connection with our continued shift to our new intrusion detection and security appliance product lines, we streamlined operations and activities that are not aligned with these core markets and strategies. During 2006, we recorded $10 thousand for severance as a result of reductions in force. During 2005, we recorded $0.1 million for severance as a result of reductions in force. Severance obligations were paid prior to December 31, 2006 and 2005 for the respective reporting periods, and we were not receiving further benefit from the severed individuals after December 31, 2006 and 2005, respectively.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates are used for, but not limited to, the accounting for doubtful accounts, sales discounts, sales returns, revenue recognition, warranty costs, inventory obsolescence, depreciation and taxes. Actual results could differ from these estimates.

Income Taxes

We account for income taxes pursuant to SFAS No. 109, Accounting for Income Taxes, which uses the liability method to calculate deferred income taxes. Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts. The realization of deferred tax assets is based on historical tax positions and expectations about future taxable income. The liability method also requires the recognition of future tax benefits such as net operating loss carryforwards, to the extent that realization of such benefits is more likely than not. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Recent Accounting Pronouncements

FASB Interpretation No. 48 - Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the recognition threshold and measurement of a tax position taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006 (January 1, 2007 for us). FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes. We are currently evaluating the impact, if any, the adoption of FIN 48 will have on our financial statements.

SFAS No. 157 - Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires (or permits) assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This standard also will require additional disclosures in both annual and quarterly reports. SFAS 157 will be effective for fiscal years beginning after November 15, 2007 (January 1, 2008 for us). We are currently evaluating the impact, if any, the adoption of FIN 157 will have on our financial statements.

3. Balance Sheet Detail (in thousands)

Inventories

	December 31, 2006	2005
Finished products	$ 180	$ 290
Work in process	8	8
Demonstration systems	21	75
	$ 209	$ 373

Other Accrued Expenses

	December 31, 2006	2005
Accrued sales commissions	$ 10	$ 26
Accrued payroll	115	141
Accrued property taxes	26	63
Accrued sales taxes	34	139
Other	98	46
	$ 283	$ 415

4. Commitments and Contingencies

Leases

We lease office space for our corporate headquarters in Richardson, Texas under an operating lease, the base term of which expires in February 2010. We lease office space in San Diego, California for a portion of our security software research and development staff under an operating lease that expired in August 2006 and has continued on a month to month basis.

The Company s lease for the headquarters facility contains escalation provisions. In accordance with SFAS 13 Accounting for Leases, FASB Technical Bulletin 88-1 Issues Relating to Accounting for Leases, and FASB Technical Bulletin 85-3 Accounting for Operational Leases with Scheduled Rent Increases, the Company records rent expense on facility leases on a straight-line basis. Real estate taxes, insurance and maintenance expenses are the obligations of the Company. Rent expense totaled approximately $486,000 and $600,000 for the years ended December 31, 2006 and 2005, respectively.

Future minimum lease payments consisted of the following on December 31, 2006 (in thousands):

2007	$ 378
2008	393
2009	409
2010	68
	$ 1,248

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.

We are not aware of any material claims outstanding or pending against Intrusion Inc. at December 31, 2006.

5. Employee Benefit Plans

Employee Stock Purchase Plan

On April 24, 1997, we adopted an Employee Stock Purchase Plan (the Purchase Plan) under which 125,000 shares of common stock have been reserved for issuance. Eligible employees may designate not more than 10% of their compensation to be deducted each pay period for the purchase of common stock under the Purchase Plan. The Purchase Plan was amended January 17, 2001 to increase the maximum number of shares that can be purchased per participant from 500 shares to 1,000 shares per offering. Each participant may purchase up to 2,000 shares in any one calendar year. On January 31 and July 31 of each calendar year, shares of common stock are purchased with the employees payroll deductions over the immediately preceding six months at a price per share of 85% of the lesser of the market price of the common stock on the purchase date or the market price on the first day of the six-month period. The Purchase Plan will terminate no later than April 24, 2007. No shares were purchased under the Purchase Plan in the years ended December 31, 2006 and December 31, 2005. A total of 45,702 shares have been issued under the Purchase Plan and 79,298 shares are available for purchase as of December 31, 2006.

Employee 401(k) Plan

We adopted a plan known as the Intrusion Inc. 401(k) Savings Plan (the Plan) to provide retirement and incidental benefits for our employees. The Plan covers substantially all employees who meet minimum age and service requirements. As allowed under Section 401(k) of the Internal Revenue Code, the Plan provides tax deferred salary deductions for eligible employees.

Employees may contribute from 1% to 25% of their annual compensation to the Plan, limited to a maximum amount as set by the Internal Revenue Service. Participants who are over the age of 50 may contribute an additional amount of their salary per year, as defined annually by the Internal Revenue Service. We match employee contributions at the rate of $0.25 per each $1.00 of contribution on the first 4% of compensation. Matching contributions to the Plan were approximately $23,000 and $24,000 for the years ended December 31, 2006 and 2005, respectively.

6. Line of Credit

On March 29, 2006, we established a $1,000,000 line of credit with Silicon Valley Bank which may increase to $2,000,000 if we have EBITDA of at least $200,000 for two consecutive quarters. Under the terms of this agreement, we may borrow an amount equal up to 80% of eligible accounts receivable balances. In addition, we may obtain inventory advances equal to 35% of finished goods inventory, capped at the lesser of the inventory availability, $300,000 or 35% of our total borrowing base. The financial covenant is a ratio of unrestricted cash on deposit with Silicon Valley Bank plus the amount equal to 80% of our eligible accounts receivable to the amount of the obligations of not less than 1.25:1.00. Beginning on the date the revolving line increases to $2,000,000 and measured thereafter on a rolling three (3) month basis as of the end of each month, EBITDA, less the aggregate amount of Permitted Dividends, must be at least $0.00. If our credit line increases to $2,000,000, inventory advances will be capped at the lesser of the inventory availability, $600,000 or 35% of our borrowing base. We have current balance due under this credit line of $200,000 at December 31, 2006. Also, assuming eligible receivables and inventory equal to the $844,000 of net accounts receivable and the $180,000 of finished goods inventory we had at December 31, 2006, we could borrow up to an additional $139,000 under our credit line at December 31, 2006. Amounts we borrow under the credit line accrue interest at an annual rate of prime plus 1% and are secured by a lien on all of our assets. As described in Note 12, the line of credit was renewed on March 29, 2007, accrued interest on all outstanding amounts is payable monthly in arrears and all outstanding principal and accrued but unpaid interest on the amounts we borrow are due on March 28, 2008.

7. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. There are no deferred tax liabilities as of December 31, 2006 and 2005. Significant components of our deferred tax assets as of December 31, 2006 and 2005 are as follows (in thousands):

	December 31 2006	2005
Net operating loss carryforwards	$ 30,462	$ 29,355
Net operating loss carryforwards of foreign subsidiaries	374	374
Book over tax depreciation	94	87
Intangibles	939	1,118
FAS 123 options expense	162	
Vacation accrual	78	97
Allowance for doubtful accounts and returns	24	26
Warranty accrual	18	18
Inventory allowance	69	51
Other	1,553	1,587
Deferred tax assets	33,773	32,713
Valuation allowance for deferred tax assets	(33,773)	(32,713)
Deferred tax assets, net of allowance	$	$

Deferred tax assets are required to be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of the future benefits related to the deferred tax assets is dependent on many factors, including the Company s ability to generate taxable income within the near to medium term. Management has considered these factors in determining the valuation allowance for 2006 and 2005.

The differences between the provision for income taxes and income taxes computed using the federal statutory rate for the years ended December 31, 2006 and 2005 are as follows (in thousands):

	2006	2005
Reconciliation of income tax benefit to statutory rate:		
Income tax benefit at statutory rate	$ (1,028)	$ (1,129)
State income taxes, net of federal income tax benefit	(80)	(87)
Change in valuation allowance	1,060	1,205
Other	48	11
	$	$

At December 31, 2006, we had federal net operating loss carryforwards of $83.1 million for income tax purposes that begin to expire in 2008 and are subject to the ownership change limitations under Internal Revenue Code Section 382. We also had $96.5 million of state net operating loss carryforwards. Net operating loss carryforwards of the foreign subsidiaries of $0.4 million at December 31, 2006 are available indefinitely for offset only against taxable income generated by the foreign subsidiaries.

We made no federal tax payments during 2006 and 2005, and did not receive any federal income tax refunds in 2006 or 2005 for income taxes paid in previous years.

8. Stock Options

At December 31, 2006, we had three stock-based compensation plans, which are described below. These plans were developed to retain and attract key employees and directors.

In 1995, we adopted our 1995 Stock Option Plan (the 1995 Plan), which provides for the issuance of up to 400,000 shares of common stock upon exercise of options granted pursuant to the 1995 Plan. On April 26, 2001, our stockholders increased the overall number of shares available for issuance pursuant to the plan to 825,000 shares of common stock. The 1995 Plan provides for the issuance of both non-qualified and incentive stock options to our employees, officers, and employee-directors. The 1995 Plan expired by its terms on March 21, 2005 and no options were available for future issuance after the expiration. At December 31, 2006, 67,365 employee options have been exercised and employee options to purchase a total of 398,631 shares of common stock are outstanding. A total of 2,290,295 options have been granted pursuant to the 1995 Plan, of which, 1,824,299 have been cancelled.

In 1995, we adopted the 1995 Non-Employee Director Stock Option Plan (the 1995 Non-Employee Director Plan). The 1995 Non-Employee Director Plan provided for the issuance of non-qualified stock options to non-employee directors. The 1995 Non-Employee Director Plan was amended in April 2002 to increase the number of shares available for issuance to 65,000 from 40,000 shares. The 1995 Non-Employee Director Plan expired by its terms on March 21, 2005 and no options were available for future issuance after the expiration. No options have been exercised under the 1995 Non-Employee Director Plan. Non-employee options to purchase a total of 32,500 shares of common stock are outstanding at December 31, 2006. A total of 62,500 options have been granted to directors pursuant to the 1995 Non-Employee Director Plan, of which, 30,000 have been cancelled.

On March 17, 2005, the Board approved the 2005 Stock Incentive Plan (the 2005 Plan), which was approved by the stockholders on June 14, 2005. The 2005 Plan serves as a replacement for the 1995 Non-Employee Director Plan and the 1995 Option Plan which expired by their terms on March 21, 2005. The approval of the 2005 Plan had no effect on the 1995 Plans or any options granted pursuant to either plan. All options will continue with their existing terms and will be subject to the 1995 Non-Employee Director Plan or the 1995 Plan, as applicable. Further, the Company will not be able to re-issue any option which is cancelled or terminated under the 1995 Non-Employee Director Plan or the 1995 Option Plan. The 2005 Plan provides for the issuance of up to 750,000 shares of common stock upon exercise of options granted pursuant to the 2005 Plan. The 2005 Plan consists of three (3) separate equity incentive programs: the Discretionary Option Grant Program; the Stock Issuance Program; and the Automatic Option Grant Program for non-employee Board members. Officers and employees, non-employee Board members and independent contractors are eligible to participate in the Discretionary Option Grant and Stock Issuance Programs. Participation in the Automatic Option Grant Program is limited to non-employee members of the Board. Each non-employee Board member will receive an option grant for 10,000 shares of Common Stock upon initial election or appointment to the Board, provided that individual has not previously been employed by the Company in the preceding six (6) months. In addition, on the date of each annual stockholders meeting, each Board member will automatically be granted an option to purchase 5,000 shares of Common Stock, provided he or she has served as a non-employee Board member for at least six (6) months. At December 31, 2006, no 2005 plan options have been exercised and employee and non-employee Board member options to purchase a total of 654,500 shares of common stock are outstanding. A total of 726,500 options have been granted under the 2005 Plan, of which 72,000 have been cancelled and options for 95,500 shares remain available for future grant. No shares have been issued pursuant to the Stock Issuance Program.

Common shares reserved for future issuance, including conversions of preferred stock, warrants, outstanding options and options available for future grant under all of the stock option plans and employee stock purchase plans total approximately 4,126,021 million shares at December 31, 2006 as follows:

(In thousands)	**Outstanding**	**Available for Future Grant**
Preferred Stock	1,342	
Warrants	1,524	
1995 Plan	399	
1995 Non-Employee Director Plan	32	
2005 Plan	655	96
Employee Stock Purchase Plan		79
Total	3,952	175

The Compensation Committee of our Board of Directors determines for all employee options, the term of each option, option exercise price within limits set forth in the plans, number of shares for which each option is granted and the rate at which each option is exercisable (generally ratably over one, three or five years from grant date). However, the exercise price of any incentive stock option may not be less than the fair market value of the shares on the date granted (or less than 110% of the fair market value in the case of optionees holding more than 10% of our voting stock of the Company), and the term cannot exceed ten years (five years for incentive stock options granted to holders of more than 10% of our voting stock).

Stock Incentive Plan Summary

A summary of our stock option activity and related information for the years ended December 31, 2006 and 2005 is as follows:

	2006		2005	
	Number of Options (in thousands)	Weighted Average Exercise Price	Number of Options (in thousands)	Weighted Average Exercise Price
Outstanding at beginning of year	891	$ 5.48	404	$ 11.08
Granted at price = market value	367	.44	579	3.01
Granted at price > market value	60	.33		
Exercised	(1)	.76	(1)	2.02
Forfeited	(69)	2.75	(63)	2.45
Expired	(162)	8.42	(28)	41.73
Outstanding at end of year	1,086	$ 3.23	891	$ 5.48
Options exercisable at end of year	554	$ 5.47	307	$ 10.29

Stock Options Outstanding and Exercisable

Information related to stock options outstanding at December 31, 2006, is summarized below:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding at 12/31/06 (in thousands)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable at 12/31/06 (in thousands)	Weighted Average Exercise Price
$0.30-$2.00	526	8.51 years	$ 0.62	97	$ 1.46
$2.01-$5.00	484	7.90 years	$ 3.02	382	$ 3.06
$5.01-$10.00	39	4.81 years	$ 5.97	38	$ 5.97
$10.01-$20.00	17	4.02 years	$ 19.21	17	$ 19.21
$20.01-$63.00	20	3.32 years	$ 57.78	20	$ 57.78
	1,086	7.94 years	$ 3.23	554	$ 5.47

Summarized information about outstanding stock options as of December 31, 2006, that are fully vested and those that are expected to vest in the future as well as stock options that are fully vested and currently exercisable, are as follows:

	Outstanding Stock Options (Fully Vested and Expected to Vest)*	Options that are Exercisable
As of December 31, 2006		
Number of outstanding options	1,084	554
Weighted average remaining contractual life	.76	7.04
Weighted average exercise price per share	$ 3.24	$ 5.47
Intrinsic value	$ 58.6	$ 0

* Includes effects of expected forfeitures

The exercisable options detailed in the table above have a $0 intrinsic value as the fair market value on December 31, 2006 is less than the exercise prices of all of the exercisable options. As of December 31, 2006, the total unrecognized compensation cost related to non-vested options not yet recognized in the statement of operations totaled approximately $139 thousand (including expected forfeitures) and the weighted period over which these awards are expected to vest was 1.56 years.

9. Preferred Stock

5% Preferred Stock

On March 25, 2004, we completed a $5.0 million private placement of our 5% convertible preferred stock and warrants. In the private placement, we sold 1,000,000 shares of our 5% preferred stock at a price of $5.00 per share for gross proceeds of $5.0 million, less $275,000 of issuance costs. The 5% preferred shares were initially convertible into 1,590,331 shares of common stock at a conversion price of $3.144 per share. Holders of the 5% convertible preferred stock include 140,000 shares purchased by our CEO and 60,000 shares purchased by a director of the Company.

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

Included in this transaction were warrants to purchase 556,619 shares of common stock at an exercise price of $3.144 per share. Warrant holders include 80,000 held by our CEO and 30,000 held by a director of the Company. In connection with the closing of this private placement, we issued warrants to purchase 64,408 shares of our common stock at an exercise price of $3.144 per share to our financial advisor for assistance with the private placement. All of the warrants were immediately exercisable and expire on March 25, 2009. These 621,027 warrants were valued at $1.2 million using the Black-Scholes model and have been treated as a discount to the 5% Preferred Stock and recorded as an increase in additional paid in capital. The issuance of the warrants resulted in a beneficial conversion feature to the 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 2004, 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.

The 5% preferred stock was recorded as the financing proceeds of $5.0 million less $275,000 issuance costs and the fair value of the warrants issued in conjunction with the 5% preferred stock of $1.2 million.

We have the right to redeem any or all of the outstanding 5% preferred stock at a price of $5.00 per share plus accrued dividends at any time after September 25, 2004 if certain conditions are met.

During 2005, 580,304 shares of our 5% preferred stock were converted into 922,875 shares of our common stock. There were no conversions of our 5% preferred stock during 2006. At December 31, 2006 there are 259,696 shares of our 5% preferred stock outstanding.

Series 2 5% Preferred Stock

On March 28, 2005, we completed a $2.7 million private placement of Series 2 5% convertible 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 stockholders. 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

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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 reduction 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.

During 2005, 565,200 shares of Series 2 5% preferred stock were converted into 565,200 shares of our common stock. During 2006, 40,000 shares of Series 2 5% preferred stock were converted into 40,000 shares of our common stock. At December 31, 2006 there are 460,000 shares of Series 2 5% preferred stock outstanding.

Series 3 5% Preferred Stock

On December 2, 2005, we completed a $1.2 million private placement of Series 3 5% convertible preferred stock and warrants. In the private placement, we sold 564,607 shares of preferred stock at a price of $2.18 per share for gross proceeds of $1.2 million, less $100,000 of issuance costs. The shares of Series 3 5% preferred stock are convertible into 564,607 shares of common stock at an initial conversion price of $2.18 per share. Holders of the Series 3 5% preferred stock include 55,046 shares purchased by our CEO and 27,523 shares purchased by a director of the Company.

The 5% dividends accruing on the Series 3 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 March 1, 2006. The liquidation preference for the preferred stock is an amount equal to $2.18 per share plus any accrued and unpaid dividends. Holders of our Series 3 5% preferred stock have liquidation preference rights over holders of our 5% preferred, Series 2 5% preferred stock and common stock. The holders of the Series 3 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 3 5% preferred stock.

Included in this transaction were warrants to purchase 282,306 shares of common stock at an exercise price of $2.58 per share. Warrant holders include 27,523 held by our CEO and 13,762 held by a director of the Company. The relative fair value of these warrants was valued at $0.3 million using the Black-Scholes model and has been recorded as a discount to the Series 3 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 3 5% preferred stock valued at $0.5 million. In accordance with EITF 98-5, the beneficial conversion feature was fully amortized on the grant date, 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 27,531 shares of our common stock at an exercise price of $2.58 per share to an affiliate of our financial advisor for assistance with the private placement. These warrants were valued at $37,000 using the Black-Scholes model and have been recorded as a reduction to the Series 3 5% preferred stock and an increase to additional paid-in capital.

The Series 3 5% preferred stock was recorded as the net of the proceeds of $1.2 million less $100,000 issuance costs and the fair value of the warrants issued in conjunction with the Series 3 5% preferred stock totaling $0.3 million.

Holders of Series 3 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 $2.834 and the product of the volume weighted average price of our common stock on the trading day immediately preceding the event multiplied by $2.18 divided by the conversion price then in effect plus (2) any accrued

but unpaid dividends on the Series 3 5% preferred stock plus (3) all liquidated damages or other amounts payable to the holders of Series 3 5% preferred stock.

During 2006, 95,872 shares of Series 3 5% preferred stock were converted into 95,872 shares of our common stock. At December 31, 2006 there are 468,735 shares of Series 3 5% preferred stock outstanding.

10. Common Stock Private Placement

On December 28, 2006, we completed a private placement of 1,250,000 shares of our Common Stock for gross proceeds of $500,000. G.Ward Paxton, our Chairman, President and Chief Executive Officer purchased 1,000,000 shares for a total of $400,000. Michael L.Paxton, our Vice President and Chief Financial Officer purchased 250,000 shares for a total of $100,000.

As described in Note 12, on March 15, 2007, we completed an additional private placement of 925,926 shares of our Common Stock for gross proceeds of $500,000. G. Ward Paxton, our Chairman, President and Chief Executive Officer purchased 833,333 shares for a total of $450,000. Michael L. Paxton, our Vice President and Chief Financial Officer purchased 92,593 shares for a total of $50,000.

11. Segments, Major Customers and Geographic Information

Our operations are concentrated in one area security software and appliances. Sales to the U.S. Government through direct and indirect channels totaled 73.6% of total revenues for 2006 and 70.7% of total revenues for 2005. During 2006 approximately 65.6% of total revenues are attributable to three government customers. During 2005 approximately 59.7% of total revenues are attributable to three government customers. There were no individual commercial customers in 2006 or 2005 that exceeded 10% of total revenues for that year. Our similar product and service offerings are not viewed as individual segments, as our management analyzes the business as a whole and expenses are not allocated to each product offering.

Export sales (based on our customers location), primarily to Europe, Asia and Canada, were $0.5 million in 2006 and $0.6 million in 2005. No significant long-lived assets are deployed outside of the United States. Our foreign operations act only as sales support offices in those regions.

12. Subsequent Events

On March 29, 2007, we renewed our existing $1,000,000 line of credit with Silicon Valley Bank. Under the terms of this agreement, we may borrow an amount equal up to 80% of eligible accounts receivable balances. In addition, we may obtain inventory advances equal to 35% of finished goods inventory, capped at the lesser of the inventory availability, $300,000 or 35% of our total borrowing base. The line of credit will increase to $2,000,000 upon achieving two consecutive quarters of $200,000 in positive EBITDA. If the credit line increases to $2,000,000, inventory advances will be capped at the lesser of the inventory availability, $600,000 or 35% of our borrowing base. Amounts we borrow under the credit line accrue interest at an annual rate of prime plus 1% and are secured by a lien on all of our assets. Accrued interest on all outstanding amounts is payable monthly in arrears and all outstanding principal and accrued but unpaid interest on the amounts we borrow are due on March 28, 2008.

On March 15, 2007, we completed an additional private placement of 925,926 shares of our Common Stock for gross proceeds of $500,000.