

INTRUSION INC
Form 10-Q
August 13, 2008
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

x

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

For the quarterly period ended June 30, 2008

OR

o

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

For the transition period from to

Commission File Number 0-20191

INTRUSION INC.

(Exact name of small business issuer as specified in its charter)

Delaware

75-1911917

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(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

1101 East Arapaho Road, Suite 200, Richardson, Texas 75081

(Address of principal executive offices)

(Zip Code)

(972) 234-6400

(Issuer's telephone number, including area code)

Not Applicable

Former name, if changed since last report)

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

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

The number of shares outstanding of the Registrant's Common Stock, \$0.01 par value, on July 31, 2008 was 11,638,405.

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

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Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

| | June 30, 2008 | December 31, 2007 |
|--|------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 212 | \$ 362 |
| Accounts receivable, less allowance for doubtful accounts of \$40 in 2008 and 2007 | 554 | 110 |
| Inventories, net | 83 | 146 |
| Prepaid expenses | 64 | 75 |
| Total current assets | 913 | 693 |
| Property and equipment, net | 121 | 144 |
| Other assets | 39 | 39 |
| TOTAL ASSETS | \$ 1,073 | \$ 876 |
| LIABILITIES AND STOCKHOLDERS DEFICIT | | |
| Current Liabilities: | | |
| Accounts payable and accrued expenses | \$ 736 | \$ 688 |
| Line of credit | | 100 |
| Loans payable to officer | 1,180 | |
| Deferred revenue | 266 | 312 |
| Total current liabilities | 2,182 | 1,100 |
| Stockholders' Deficit: | | |
| Preferred stock, \$0.01 par value: Authorized shares 5,000 | | |
| Series 1 shares issued and outstanding 260 | | |
| Liquidation preference of \$1,347 as of June 30, 2008 | 918 | 918 |
| Series 2 shares issued and outstanding 460 | | |
| Liquidation preference of \$1,184 as of June 30, 2008 | 724 | 724 |
| Series 3 shares issued and outstanding 354 | | |
| Liquidation preference of \$795 as of June 30, 2008 | 504 | 504 |
| Common stock, \$0.01 par value: | | |
| Authorized shares 80,000 | | |
| Issued shares 11,648 | | |
| Outstanding shares 11,638 | 116 | 116 |
| Common stock held in treasury, at cost 10 shares | (362) | (362) |
| Additional paid-in capital | 55,475 | 55,527 |
| Accumulated deficit | (58,305) | (57,472) |
| Accumulated other comprehensive loss | (179) | (179) |

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| | | | | |
|--|-----------|--------------|-----------|------------|
| Total stockholders' deficit | | (1,109) | | (224) |
| TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT | \$ | 1,073 | \$ | 876 |

See accompanying notes.

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INTRUSION INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|---------------|------------------|---------------|
| | June 30, 2008 | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| Net product revenue | \$ 1,132 | \$ 829 | \$ 1,431 | \$ 1,727 |
| Net customer support and maintenance revenue | 151 | 174 | 315 | 368 |
| Total revenue | 1,283 | 1,003 | 1,746 | 2,095 |
| Cost of product revenue | 434 | 371 | 608 | 774 |
| Cost of customer support and maintenance revenue | 6 | 22 | 11 | 40 |
| Total cost of revenue | 440 | 393 | 620 | 814 |
| Gross profit | 843 | 610 | 1,126 | 1,281 |
| Operating expenses: | | | | |
| Sales and marketing | 361 | 504 | 732 | 1,019 |
| Research and development | 195 | 388 | 710 | 811 |
| General and administrative | 230 | 248 | 496 | 475 |
| Operating income (loss) | 57 | (530) | (812) | (1,024) |
| Other income (expense), net | | 1 | | 1 |
| Interest income (expense), net | (16) | (1) | (22) | 1 |
| Income (loss) before income tax provision | 41 | (530) | (834) | (1,022) |
| Income tax provision | | | | |
| Net income (loss) | \$ 41 | \$ (530) | \$ (834) | \$ (1,022) |
| Preferred stock dividends accrued | (40) | (43) | (105) | (86) |
| Net income (loss) attributable to common stockholders | \$ 1 | \$ (573) | \$ (939) | \$ (1,108) |
| Net loss per share attributable to common stockholders, basic and diluted | \$ 0.00 | \$ (0.06) | \$ (0.08) | \$ (0.12) |
| Weighted average common shares outstanding, basic and diluted | 11,638 | 9,271 | 11,638 | 8,873 |

See accompanying notes.

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INTRUSION INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Six Months Ended | |
|---|------------------|------------------|
| | June 30, 2008 | June 30, 2007 |
| Operating Activities: | | |
| Net loss | \$ (834) | \$ (1,022) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 23 | 32 |
| Provision for doubtful accounts | | (14) |
| Stock-based compensation | 29 | 44 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (444) | 111 |
| Inventories | 64 | (15) |
| Prepaid expenses and other assets | 10 | 73 |
| Accounts payable and accrued expenses | (32) | (210) |
| Deferred revenue | (46) | (18) |
| Net cash used in operating activities | (1,230) | (1,019) |
| Investing Activities: | | |
| Purchases of property and equipment | | (37) |
| Financing Activities: | | |
| Net activity under line of credit | (100) | (75) |
| Borrowings from officer | 1,180 | |
| Dividends paid on preferred stock | | (87) |
| Proceeds from the issuance of common stock | | 1,000 |
| Net cash provided by financing activities | 1,080 | 838 |
| Net decrease in cash and cash equivalents | (150) | (218) |
| Cash and cash equivalents at beginning of period | 362 | 933 |
| Cash and cash equivalents at end of period | \$ 212 | \$ 715 |
| SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES: | | |
| Preferred stock dividends accrued | \$ 106 | \$ 86 |

See accompanying notes.

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INTRUSION INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

We develop, market and support a family of entity identification, regulated information compliance, data privacy protection and network intrusion prevention/detection products. Our product families include: TraceCop for identity discovery and disclosure, Compliance Commander for regulated information and data privacy protection, and Intrusion SecureNet for network intrusion prevention and detection. Our 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 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, hospitals and other healthcare providers and academic institutions. Essentially, our end-users can be defined as any end-users 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 and TraceCop are trademarks of Intrusion Inc.

As of June 30, 2008, we had cash, cash equivalents and investments of approximately \$0.2 million, down from approximately \$0.4 million as of December 31, 2007. Although we generated net income of \$41,000 in the second quarter of 2008, operating cash outflows may continue through the third quarter of 2008 and possibly later into the fiscal year 2008. 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. As of June 30, 2008, we had cash and cash equivalents of \$212,000, \$218,000 in funding available under our line of credit at Silicon Valley Bank and \$1.0 million funding available from a written commitment to invest up to \$1.5 million from G. Ward Paxton, the Company's Chairman, President and Chief Executive Officer. Based on projections for increased revenues in the remainder of 2008, a commitment from the Company's CEO to advance the Company up to \$1.0 million in additional funding should it be necessary, \$2.5 million line of credit with borrowings available of \$218,000 at June 30, 2008, and our Company's production of net income in the second quarter of 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.

We expect to fund our operations through Company profits, our line of credit, and possibly additional investments of private equity and debt, 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 upcoming quarters, 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.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Item 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The December 31, 2007 balance sheet was derived from audited financial statements, but does not include all the disclosures required by accounting principles generally accepted in the United States. However, we believe that the disclosures are adequate to make the information presented not misleading. In our opinion, all the adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. The results of operations for the three and six month periods ending June 30, 2008 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-KSB for the year ended December 31, 2007, filed with the commission on March 28, 2008.

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3. Inventories (In thousands)

| | June 30, 2008 | December 31, 2007 |
|-------------------------|------------------|----------------------|
| Inventories consist of: | | |
| Finished goods | \$ 72 | \$ 123 |
| Work in progress | 8 | 8 |
| Demonstration systems | 3 | 15 |
| Net inventory | \$ 83 | \$ 146 |

4. Loans Payable to Officer

On January 30, 2008, we entered into a revolving promissory note to borrow up to \$700,000 from G. Ward Paxton, the Company's Chairman, President and Chief Executive Officer. Under the terms of the note, the Company may borrow, repay and reborrow on the loan as needed up to an outstanding principal amount of \$700,000 at any date. All outstanding principal and accrued but unpaid interest are due on December 31, 2008. On March 20, 2008, we received a written commitment from our Chief Executive Officer to invest up to an additional \$1,500,000 in the Company until March 2009, should such funding be required by the Company. Amounts the Company borrows under the note and the commitment accrue interest at a floating rate per annum equal to the announced prime rate of Silicon Valley Bank (SVB) plus 1% and are unsecured. As of June 30, 2008 we had \$1.0 million available to borrow under the commitment.

5. Line of Credit

On March 29, 2006, we entered into a Loan and Security Agreement (the Prior Agreement) with SVB to establish a \$1.0 million line of credit (the Prior Line of Credit) with SVB. On June 30, 2008, we entered into an Amended and Restated Loan and Security Agreement (the Loan Agreement) with SVB to, among other things, replace the Prior Line of Credit with a new \$2.5 million line of credit (the Line of Credit). Our obligations under the Loan Agreement are secured by substantially all of our assets, including all of our intellectual property. Borrowings under the Line of Credit are based on advances (each, an Advance) against certain of our accounts receivable that are approved by SVB (Eligible Accounts). SVB may make an Advance of up to eighty percent (80%) of each Eligible Account, or such other percentage SVB may determine in its sole discretion. Each Advance is subject to a finance charge calculated as a daily rate that is based on a 360-day annual rate of (a) the greater of the prime rate or 5.25%, plus (b) 1.5% or 2.0%, depending on certain qualifying financial factors specified in the Loan Agreement. Finance charges are payable at the same time its related Advance is due. Each Advance is also subject to a monthly collateral handling fee of 0.25% or 0.5% of all outstanding Advances, depending on certain qualifying financial factors specified in the Loan Agreement. The collateral handling fee is payable at the same time its related Advance is due. Each Advance must be repaid at the earliest of (a) the date that the Eligible Account related to the Advance is paid, (b) the date the Eligible Account is no longer eligible under the Loan Agreement, or (c) the date on which any Adjustment (as defined in the Loan Agreement) is asserted to the Eligible Account. The Loan Agreement terminates and all outstanding advances, accrued but unpaid finance charges, outstanding collateral handling fees, and other amounts due under the Loan Agreement and related documents. We have zero outstanding under this credit line as of June 30, 2008 and had borrowings available of \$218,000 based on our borrowing base calculation.

6. Accounting for Stock-Based Compensation

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The Company recognized \$24,000 and \$37,000, respectively, stock-based compensation expense for the three month periods ended June 30, 2008 and 2007.

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 Three Months Ended June 30, 2008 | For Three Months Ended June 30, 2007 | For Six Months Ended June 30, 2008 | For Six Months Ended June 30, 2007 |
|--|---|---|---|---|
| Weighted average grant date fair value | \$ 0.16 | \$ 0.31 | \$ 0.17 | \$ 0.32 |
| Weighted average assumptions used: | | | | |
| Expected dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Risk-free interest rate | 3.4% | 4.9% | 2.6% | 4.9% |
| Expected volatility | 111.0% | 105.0% | 107.1% | 105.1% |
| Expected life (in years) | 5.0 | 4.9 | 5.0 | 4.9 |

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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.

7. Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net loss attributable to common stockholders for the period by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing the net income (loss) attributable to common stockholders by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period. Our common stock equivalents include all common stock issuable upon conversion of preferred stock and the exercise of outstanding options and warrants. The aggregate number of common stock equivalents excluded from the diluted income (loss) per share calculation for the periods ended June 30, 2008 and 2007 are 4,227,826 and 4,226,998, respectively. Our common stock equivalents are not included in the diluted income (loss) per share for the three and six month periods ended June 30, 2008 and 2007, as they are antidilutive.

8. New Accounting Pronouncements

In February 2008, FASB Staff Position (FSP) FAS No. 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2), was issued. FSP 157-2 defers the effective date of SFAS 157-2 to fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Examples of items within the scope of FSP 157-2 are nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination (but not measured at fair value in subsequent periods), and long-lived assets, such as property, plant and equipment and intangible assets measured at fair value for an impairment assessment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

The partial adoption of SFAS 157-2 on January 1, 2008 with respect to financial assets and financial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis is not expected to have a material impact on our consolidated financial statements. We are in the process of analyzing the potential impact of SFAS 157-2 relating to our planned December 31, 2008 adoption of the remainder of the standard.

In December 2007, FASB issued SFAS No. 160, *Non-Controlling Interests in Consolidated Financial Statements an amendment of ARB No. 51* (SFAS 160). SFAS 160 establishes new standards for the accounting for and reporting of non-controlling interests (formerly minority interests) and for the loss of control of partially owned and consolidated subsidiaries. SFAS 160 does not change the criteria for consolidating a partially owned entity. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We do not expect the adoption of SFAS 160 will have a material impact on our consolidated financial statements.

Also in December 2007, FASB issued SFAS No. 141(revised 2007) (SFAS 141R), a revision of SFAS 141, *Business Combinations*. SFAS 141R establishes requirements for the recognition and measurement of acquired assets, liabilities, goodwill, and non-controlling interests. SFAS 141R also provides disclosure requirements related to business combinations. SFAS 141R is effective for fiscal years beginning after December 15, 2008. SFAS 141R will be applied prospectively to business combinations with an acquisition date on or after the effective date.

9. Commitments and Contingencies

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

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

Forward Looking Statements

This Quarterly Report on Form 10-Q, including, without limitation, the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 (The Exchange Act). Such forward-looking statements are generally accompanied by words such as estimate, expect, believe, should, would, could, anticipate, may or other words that convey uncertainty of future events or outcomes. 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. Factors that may cause actual results to differ materially from current expectations, which we describe in more detail elsewhere in this Quarterly Report on Form 10-Q under the heading Factors That May Affect Future Results of Operations, and in our 2007 Annual Report on Form 10-KSB in Item 1 Description of Business include, but are not limited to:

- insufficient cash to operate our business and inability to meet our liquidity requirements;
- loss of revenues due to the failure of our newer products to achieve market acceptance;
- our need to generate substantially greater revenues from sales in order to achieve profitability;
- concentration of our revenues from U.S. government entities and the possibility of loss of one of these customers and the unique risks associated with government customers;
- our dependence on sales made through indirect channels;
- the challenge of selling our products internationally;
- our dependence on equity or debt financing provided primarily by our Chief Executive Officer in order to meet our cash flow requirements;
- the effect that payment of accrued dividends on our preferred stock has on our cash resources and the substantial dilution upon the conversion or redemption of our preferred stock and exercise of outstanding warrants;
- the impact of conversion of preferred stock or exercise of warrants on the price of our common stock;
- the ability of our preferred stockholders and lenders to hinder additional financing; and
- the influence that our management and larger stockholders have over actions taken by the company.

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. These forward-looking statements and other statements made elsewhere in this report are made in reliance on the Private Securities Litigation Reform Act of 1995. Any forward-looking statement you read in this Quarterly Report on Form 10-Q or our Annual Report on Form 10-KSB 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

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forward-looking statements, even if new information becomes available in the future. The section below entitled "Factors That May Affect Future Results of Operations" sets forth and incorporates by reference certain factors that could cause actual future results of the Company to differ materially from these statements.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

We generally recognize product revenue upon shipment of product. We accrue for estimated warranty costs and sales returns at the time of shipment based on our experience. Revenue from maintenance contracts is deferred and recognized over the contractual period the services are performed, generally one year. There is a risk that technical issues on new products could result in unexpected warranty costs and returns. However, as we migrate to more of a software-based business model, 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) collectability 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.

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 uncollateralized 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.

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Results of Operations

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|---------------|------------------|---------------|
| | June 30, 2008 | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| Net product revenue | 88.2% | 82.7% | 82.0% | 82.4% |
| Net customer support and maintenance revenue | 11.8 | 17.3 | 18.0 | 17.6 |
| Total revenue | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of product revenue | 33.8 | 37.1 | 34.8 | 37.0 |
| Cost of customer support and maintenance revenue | 0.5 | 2.1 | 0.7 | 1.9 |
| Total cost of revenue | 34.3 | 39.2 | 35.5 | 38.9 |
| Gross profit | 65.7 | 60.8 | 64.5 | 61.1 |
| Operating expenses: | | | | |
| Sales and marketing | 28.2 | 50.2 | 41.9 | 48.7 |
| Research and development | 15.2 | 38.7 | 40.7 | 38.7 |
| General and administrative | 17.9 | 24.7 | 28.4 | 22.6 |
| Operating income (loss) | 4.4 | (52.8) | (46.5) | (48.9) |
| Other income (expense), net | | | | (0.1) |
| Interest expense | (1.2) | (0.1) | (1.3) | |
| Income (loss) before income tax provision | 3.2 | (52.9) | (47.8) | (48.8) |
| Income tax provision | | | | |
| Net income (loss) | 3.2% | (52.9)% | (47.8)% | (48.8)% |
| Preferred stock dividends accrued | (3.1) | (4.3) | (6.2) | (4.1) |
| Net income (loss) attributable to common stockholders | 0.1% | (57.2)% | (54.0)% | (52.9)% |
| | | | | |
| | Three Months Ended | | Six Months Ended | |
| | June 30, 2008 | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| Domestic revenues | 96.6% | 95.9% | 93.4% | 91.8% |
| Export revenues to: | | | | |
| Europe | 3.0 | 3.1 | 5.9 | 7.2 |
| Canada | 0.1 | 0.1 | 0.1 | 0.1 |
| Asia | 0.2 | 0.8 | 0.4 | 0.8 |
| Latin America | 0.1 | 0.1 | 0.2 | 0.1 |
| Net revenues | 100.0% | 100.0% | 100.0% | 100.0% |

Net Revenues. Net revenues for the quarter and six months ended June 30, 2008 were \$1.3 million and \$1.7 million, respectively, compared to \$1.0 million and \$2.1 million for the same periods in 2007. Product revenues increased \$0.3 million for the quarter ended June 30, 2008, and decreased \$0.3 million for the six months ended June 30, 2008

compared to the same periods in 2007. Customer support and maintenance revenue decreased \$22 thousand and \$53 thousand for the quarter and six months ended June 30, 2008 compared to the same periods in 2007. This decrease was due to the current sales mix with a high concentration of government sales not requiring a maintenance contract.

Concentration of Revenues. Revenues from sales to various U.S. government entities totaled \$1.1 million, or 86.5% of revenues, for the quarter ended June 30, 2008 compared to \$0.8 million, or 80.3% of revenues, for the same period in 2007. Revenues from sales to various U.S. government entities totaled \$1.4 million, or 79.6% of revenues, for the six months ended June 30, 2008 compared to \$1.6 million, or 75.2% of revenues, for the same period in 2007. Although we expect our concentration of revenues to vary among customers in future periods depending upon the timing of certain sales, we anticipate that sales to government customers will continue to account for a significant portion of our revenues in future periods. Sales to the government present risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including, without limitation, potential disruption to appropriation and spending patterns and the government's reservation of the right to cancel contracts and purchase orders

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for its convenience. Although we do not believe that any of our revenues with government customers are subject to renegotiation, a large number of cancelled or renegotiated government orders could have a material adverse effect on our financial results. Currently, we are not aware of any proposed cancellation or renegotiation of any of our existing arrangements with government entities and, historically, government entities have not cancelled or renegotiated orders which had a material adverse effect on our business.

Gross Profit. Gross profit was \$0.8 million or 65.7% of net revenues for the quarter ended June 30, 2008, compared to \$0.6 million or 60.8% of net revenues for the quarter ended June 30, 2007. Gross profit was \$1.1 million or 64.5% of net revenues for the six months ended June 30, 2008 compared to \$1.3 million or 61.1% of net revenues for the six months ended June 30, 2007. Gross profit on product revenues for the quarter and six months ended June 30, trended from 55.2% and 55.2%, respectively, in 2007 to 61.6% and 57.5%, respectively, in 2008 mainly due to an increase in net revenues and/or decreases in fixed costs. Gross profit on customer support and maintenance revenues for the quarter and six months ended June 30, trended from 87.6% and 89.1%, respectively, in 2007 to 96.1% and 96.4%, respectively, in 2008. Gross profit as a percentage of net revenues is impacted by several factors, including shifts in product mix, changes in channels of distribution, revenue volume, pricing strategies, and fluctuations in revenues of integrated third-party products.

Sales and Marketing. Sales and marketing expenses decreased to \$0.4 million for the quarter ended June 30, 2008, compared to \$0.5 million for the quarter ended June 30, 2007. Sales and marketing expenses decreased to \$0.7 million for the six months ended June 30, 2008, compared to \$1.0 million for the six months ended June 30, 2007 primarily due to a planned reduction in sales and marketing related expenses. Sales and marketing expenses may vary in the future. However, we believe that these costs will remain relatively constant through the end of 2008, although expenses may be increased relative to increases in revenue.

Research and Development. Research and development expenses decreased to \$0.2 million for the quarter ended June 30, 2008 compared to \$0.4 million for the quarter ended June 30, 2007. Research and development expenses decreased to \$0.7 million for the six months ended June 30, 2008, compared to \$0.8 million for the six months ended June 30, 2007. Research and development costs are expensed in the period incurred. Research and development expenses decreased in the three and six months ended June 30, 2008, compared to the same periods in 2007 primarily due to shifts from research and development expenses to cost of sales in relation to engineering contract jobs. Research and development expenses may vary in the future; however, we believe that these costs will remain relatively constant through the end of 2008, although expenses may be increased relative to increases in revenue.

General and Administrative. General and administrative expenses remained at \$0.2 million for the quarter ended June 30, 2008 compared to \$0.2 million for the quarter ended June 30, 2007. General and administrative expenses remained at \$0.5 million for the six months ended June 30, 2008, compared to \$0.5 million for the six months ended June 30, 2007. It is expected that general and administrative expenses will remain relatively constant throughout the remainder of 2008, although expenses may be increased relative to increases in revenue.

Interest. Net interest expense increased to \$16 thousand interest expense for the quarter ended June 30, 2008 compared to \$0.6 thousand interest expense for the same period in 2007. Net interest expense increased to \$22 thousand for the six months ended June 30, 2008 compared to \$0.4 thousand of interest income for the same period in 2007. The decrease in interest income was primarily due to a decrease of cash and short-term investment balances when compared to the prior year and an increase in interest expense related to the line of credit. Net interest income may vary in the future based on our cash flow and rate of return on investments.

Liquidity and Capital Resources

Our principal source of liquidity at June 30, 2008 is approximately \$0.2 million of cash and cash equivalents. At June 30, 2008 there was a working capital deficiency of \$1.3 million compared to a surplus of \$0.5 million at June 30, 2007.

Cash used in operations for the six months ended June 30, 2008 was \$1.2 million, primarily due to a net loss of \$0.8 million, an increase in accounts receivable of \$444 thousand and decreases in deferred revenue of \$46 thousand and accounts payable and accrued expense of \$32 thousand. This cash decrease was partially offset by depreciation expense of \$23 thousand, stock-based compensation expense of \$29 thousand, a decrease in inventories of \$64 thousand, and a decrease in prepaid expenses and other assets of \$10 thousand. Cash used in operations for the six months ended June 30, 2007 was \$1.0 million, primarily due to a net loss of \$1.0 million, a decrease in accounts payable and accrued expenses of \$210 thousand, a reduction in deferred revenue of \$18 thousand, an increase in inventories of \$15 thousand, and a reduction in the provision for doubtful accounts of \$14 thousand. This cash decrease was partially offset by depreciation expense of \$32 thousand, stock-based compensation expense of \$44 thousand, a decrease in accounts receivable of \$111 thousand, and a decrease in prepaid expenses and other assets of \$73 thousand. Future fluctuations in inventory balances, accounts receivable and accounts payable will be dependent upon several factors, including, but not limited to, quarterly sales, our strategy in building inventory in advance of receiving orders from customers, and the accuracy of our forecasts of product demand and component requirements.

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There was no cash used in investing activities in the six months ended June 30, 2008 compared to \$37 thousand of cash used in investing activities in the six months ended June 30, 2007 for net purchases of property and equipment.

Cash provided by financing activities in the six months ended June 30, 2008 was \$1.1 million, primarily consisting of the proceeds from a promissory note and commitment by our Chief Executive Officer, G. Ward Paxton, for \$1.2 million which was offset by repayments to the line of credit of \$100 thousand compared to cash provided by financing activities in the six months ended June 30, 2007 of \$0.8 million, primarily consisting of proceeds from the issuance of common stock of \$1.0 million which was offset by payment of dividends on preferred stock of \$87 thousand and a net reduction in the line of credit of \$75 thousand.

At June 30, 2008, the Company did not have any material commitments for capital expenditures.

During the six months ended June 30, 2008, the Company funded its operations through the use of cash and cash equivalents and borrowings of \$1.2 million from our CEO, G. Ward Paxton.

On March 29, 2006, we entered into a Loan and Security Agreement (the "Prior Agreement") with SVB to establish a \$1.0 million line of credit (the "Prior Line of Credit") with SVB. On June 30, 2008, we entered into an Amended and Restated Loan and Security Agreement (the "Loan Agreement") with SVB to, among other things, replace the Prior Line of Credit with a new \$2.5 million line of credit (the "Line of Credit"). Our obligations under the Loan Agreement are secured by substantially all of our assets, including all of our intellectual property. Borrowings under the Line of Credit are based on advances (each, an "Advance") against certain of our accounts receivable that are approved by SVB ("Eligible Accounts"). SVB may make an Advance of up to eighty percent (80%) of each Eligible Account, or such other percentage SVB may determine in its sole discretion. Each Advance is subject to a finance charge calculated as a daily rate that is based on a 360-day annual rate of (a) the greater of the prime rate or 5.25%, plus (b) 1.5% or 2.0%, depending on certain qualifying financial factors specified in the Loan Agreement. Finance charges are payable at the same time its related Advance is due. Each Advance is also subject to a monthly collateral handling fee of 0.25% or 0.5% of all outstanding Advances, depending on certain qualifying financial factors specified in the Loan Agreement. The collateral handling fee is payable at the same time its related Advance is due. Each Advance must be repaid at the earliest of (a) the date that the Eligible Account related to the Advance is paid, (b) the date the Eligible Account is no longer eligible under the Loan Agreement, or (c) the date on which any Adjustment (as defined in the Loan Agreement) is asserted to the Eligible Account. The Loan Agreement terminates and all outstanding advances, accrued but unpaid finance charges, outstanding collateral handling fees, and other amounts due under the Loan Agreement and related documents. We have zero outstanding under this credit line as of June 30, 2008 and had borrowings available of \$218,000 based on our borrowing base calculation.

Although we generated net income of \$41,000 in the second quarter of 2008, operating cash outflows may continue through the third quarter of 2008 and possibly later into the fiscal year 2008. 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. As of June 30, 2008 we had cash and cash equivalents of \$212,000, \$218,000 funding available under our line of credit at Silicon Valley Bank and \$1.0 million funding available from a written commitment to invest up to \$1.5 million from G. Ward Paxton, the Company's Chairman, President and Chief Executive Officer. Based on projections for increased revenues in the remainder of 2008, a commitment from the Company's CEO to advance the Company up to \$1.0 million in additional funding should it be necessary, \$2.5 million line of credit with borrowings available of \$218,000 at June 30, 2008, and our Company's production of net income in the second quarter of 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. We expect to fund our operations through Company profits, our line of credit, and possibly additional investments of private equity and debt, 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 upcoming quarters, 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 may explore the possible acquisitions of businesses, products and technologies that are complementary to our existing business. We are continuing to identify and prioritize additional security technologies, which we may wish to develop, either internally or through the licensing, or acquisition of products from third parties. While we may engage from time to time in discussions with respect to potential acquisitions, there can be no assurances that any such acquisitions will be made or that we will be able to successfully integrate any acquired business. In order to finance such acquisitions and working capital it may be necessary for us to raise additional funds through public or private financings. Any equity or debt financings, if available at all, may be on terms, which are not favorable to us and, in the case of equity financings, may result in dilution to our stockholders.

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Item 4T. **CONTROLS AND PROCEDURES**

We maintain disclosure controls and procedures, as defined in Rule 13a-15(e) and 15d-15(e) under 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 June 30, 2008 and concluded that the disclosure controls and procedures were effective.

There have not been any changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. **LEGAL PROCEEDINGS**

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

Item 1A. **RISK FACTORS**

Factors That May Affect Future Results of Operations

We are providing the following information regarding changes that have occurred to previously disclosed risk factors from our Annual Report on Form 10-KSB for the year ended December 31, 2007. In addition to the other information set forth below and elsewhere in this report, you should consider the factors discussed under the heading "Factors That May Affect Future Results of Operations" in our Form 10-KSB for the year ended December 31, 2007. The risks described in our Quarterly Reports on Form 10-Q are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business,

financial condition and/or operating results.

Our cash, cash equivalents, and investments decreased from \$0.4 million at December 31, 2007 to \$0.2 million at June 30, 2008. If net cash outflows continue, we may not have sufficient cash to operate our business and may not be able to maintain certain liquidity requirements. Additional debt and equity offerings to fund future operations may not be available and, if available, may significantly dilute the value of our currently outstanding common stock.

As of June 30, 2008, we had cash, cash equivalents and investments of approximately \$0.2 million, down from approximately \$0.4 million as of December 31, 2007. Although we generated net income of \$41,000 in the second quarter of 2008, operating cash outflows may continue through the third quarter of 2008 and possibly later into the fiscal year 2008. 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. As of June 30, 2008 we had cash and cash equivalents of \$212,000, \$218,000 funding available under our line of credit at Silicon Valley Bank and \$1.0 million funding available from a written commitment to invest up to \$1.5 million from G. Ward Paxton, the Company's Chairman, President and Chief Executive Officer. Based on projections for increased revenues in the remainder of 2008, a commitment from the Company's CEO to advance the Company up to \$1.0 million in additional funding should it be necessary, \$2.5 million line of credit with borrowings available of \$218,000 at June 30, 2008, and our Company's production of net income in the second quarter of 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. We expect to fund our operations through Company profits, our line of credit, and possibly additional investments of private equity and debt, 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 upcoming quarters, 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.

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Our revenues increased from \$1.0 million in the second quarter 2007 to \$1.3 million in the second quarter 2008 as a continuing effect from an increase in TraceCop product sales. If our newer products do not achieve market acceptance, our revenues may decline.

We have transitioned our sales strategy focus from SecureNet to TraceCop and Compliance Commander. During this transition, sales of our newer products have only recently offset the losses in sales associated with our older products. As a result, our net revenue increased from \$1.0 million in the second quarter 2007 to \$1.3 million in the second quarter 2008. We can provide no assurances that sales of our newer products will continue to 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 increase sales of our newer products, 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.

Although we had a net profit of \$41 thousand for the quarter ended June 30, 2008, we have historically incurred losses and have an accumulated deficit of \$58.3 million as of June 30, 2008. To achieve continued profitability, we must generate substantially greater revenues.

We incurred modest operating income for the quarter ended June 30, 2008, but have incurred operating losses in previous years. For the year ended December 31, 2007, we incurred a net loss of \$2.4 million and had an accumulated deficit of approximately \$57.5 million as of December 31, 2007. We need to generate and sustain substantially greater revenues from the sales of our products if we are to achieve continued profitability. If we are unable to achieve these greater revenues, losses may continue for the near term and possibly longer. To the extent that revenues decline or do not grow at anticipated rates, increases in operating expenses precede or are not subsequently followed by commensurate increases in revenues or we are unable to adjust operating expense levels accordingly, your investment could be jeopardized.

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 quarter ended June 30, 2008, sales to U.S. government entities collectively accounted for 86.5% of our revenues. For the years ended December 31, 2005, 2006 and 2007, sales to U.S. government entities collectively accounted for 70.7%, 73.6% and 73.2% 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

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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.

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We are highly dependent on sales made through indirect channels, the loss of which would materially adversely affect our operations.

We derived 36.3% of revenue in the second quarter of 2008 through indirect channels of mainly government resellers. For the years ended December 31, 2005, 2006 and 2007, we derived 36.2%, 17.3% and 19.2% 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 portion of our overall revenues. Our ability to sell our products internationally is subject to certain risks, which could harm our business.

Foreign sales in the second quarter of 2008 were 3.4% of revenue. Revenues from foreign customers for the fiscal years ended December 31, 2005, 2006 and 2007 accounted for approximately 10.7%, 9.4% and 9.2%, respectively, of our revenue. 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.

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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. As of July 31, 2008, there were 259,696 shares of the Series 1 Preferred Stock outstanding, representing approximately 413,003 shares of common stock upon conversion.

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. 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 July 31, 2008, there were 460,000 shares of the Series 2 Preferred Stock outstanding, representing 460,000 shares of common stock upon conversion.

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. 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. As of July 31, 2008, there were 354,056 shares of Series 3 Preferred Stock outstanding, representing 354,056 shares of common stock upon conversion.

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During the quarter ended June 30, 2008, we accrued \$16,000 in dividends to the holders of our 5% Preferred Stock, \$14,000 in dividends to the holders of our Series 2 5% Preferred Stock and \$10,000 in dividends to the holders of 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 and as of the six months ended June 30, 2008, did not 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 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 will accrue an additional late fee penalty of 18% per annum on the unpaid dividends for the Series 2 Preferred Stock and Series 3 Preferred Stock, and 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 July 31, 2008, we had 11,638,405 shares of common stock outstanding. Upon conversion of all outstanding shares of preferred stock and exercise of the outstanding warrants, we will have 14,389,318 shares of common stock outstanding, approximately a 25.0% increase in the number of shares of our common stock outstanding.

Further, the occurrence of certain events could entitle 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 July 31, 2008 of \$119,000, (iii) a volume weighted average price of \$0.20, which was the ten-day volume weighted average closing price of our common stock on July 31, 2008, and (iv) our 11,638,405 shares of common stock outstanding on July 31, 2008, 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 17,449,298 shares of our common stock. This would represent an increase of approximately 149.9% in the number of shares of our common stock as of July 31, 2008.

In addition, management may issue additional shares of common stock or securities exercisable or convertible into shares of common stock in order to finance our 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.

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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 Rule 144 of the Securities and Exchange Commission. As of July 31, 2008, 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 Rule 144 of the Securities and Exchange Commission. As of July 31, 2008, 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 Rule 144 of the Securities and Exchange Commission. As of July 31, 2008, 210,551 shares of Series 3 Preferred Stock had converted into 210,551 shares of common stock.

For the four weeks ended on August 1, 2008, the average daily trading volume of our common stock on The OTCBB was 1,678 shares. Consequently, if holders of preferred stock or warrants elect to convert their remaining shares or exercise their warrants

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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 each class 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 and entity identification 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 and entity identification products to achieve market acceptance and produce a sustainable revenue stream;
- our ability to manage costs and expenses;

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- 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 and entity identification 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 to approve or take actions that may be adverse to your interests.

As of July 31, 2008, our executive officers, directors and preferred stockholders beneficially own approximately 38.7% 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, we contemplate the possible issuance of shares of our Common Stock or of securities exercisable or convertible into shares of our Common Stock in the future by our Chief Executive Officer. Any such issuance will increase the percentage of stock our Chief Executive Officer and our management group beneficially holds.

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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 (Symantec), Port Authority (Websense), Vericept, Reconnex, Tablus and a small number of start-up companies that entered the space within the last two years. 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.

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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 primarily on a combination of 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

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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 2007, the market price of our common stock on The OTCBB Market fluctuated between \$0.17 and \$0.75 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;

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- 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.

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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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders was held on May 30, 2008, at the Radisson Hotel, Dallas North in Richardson, Texas. The following is a brief description of each matter voted upon by stockholders, including a number of votes cast for, against, or withheld with regard to each matter of nominee.

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

| | FOR | WITHHELD |
|--------------------|------------|-----------------|
| G. Ward Paxton | 11,230,118 | 308,207 |
| T. Joe Head | 11,228,448 | 309,877 |
| James F. Gero | 11,231,247 | 307,078 |
| J. Fred Bucy, Jr. | 11,232,722 | 305,603 |
| Donald M. Johnston | 11,232,897 | 305,428 |

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- (2) Ratification and approval for the amendment of the 2005 Stock Incentive Plan.

| FOR | AGAINST | ABSTAIN |
|------------|----------------|----------------|
| 8,218,813 | 248,425 | 7,997 |

- (3) Ratification and approval of selection by the Board of Directors of KBA Group LLP as independent auditors of the Registrant for the fiscal year ending December 31, 2008.

| FOR | AGAINST | ABSTAIN |
|------------|----------------|----------------|
| 11,488,013 | 21,954 | 28,359 |

Item 6. EXHIBITS

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

- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
32.1 Certification 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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SIGNATURES

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

INTRUSION INC.

Date: August 13, 2008

/s/ G. Ward Paxton
G. Ward Paxton
Chairman, President & Chief Executive Officer
(Principal Executive Officer)

Date: August 13, 2008

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