INTRUSION INC
Form 10QSB
November 13, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

Commission File Number 0-20191

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

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

1101 East Arapaho Road, 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 issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes x No o

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

The number of shares outstanding of the Registrant s Common Stock, $0.01 par value, on November 3, 2006 was 7,046,213.

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

INTRUSION INC.

INDEX

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

	September 30, 2006	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 300	$ 2,844
Short-term investments		500
Accounts receivable, less allowance for doubtful accounts of $89 in 2006 and $102 in 2005	921	443
Inventories, net	239	373
Prepaid expenses	63	191
Total current assets	1,523	4,351
Property and equipment, net	179	256
Other assets	41	41
TOTAL ASSETS	$ 1,743	$ 4,648
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	$ 932	$ 1,142
Deferred revenue	361	527
Total current liabilities	1,293	1,669
Stockholders Equity:		
Preferred stock, $0.01 par value: Authorized Shares 5,000		
Series 1 shares issued and outstanding 260 in 2006 and 2005 Liquidation preference of $1,331 as of September 30, 2006	918	918
Series 2 shares issued and outstanding 460 in 2006 and 500 in 2005 Liquidation preference of $1,155 as of September 30, 2006	724	787
Series 3 shares issued and outstanding 469 in 2006 and 565 in 2005 Liquidation preference of $1,026 as of September 30, 2006	667	805
Common stock, $0.01 par value:		
Authorized shares 80,000		
Issued shares 7,056 in 2006 and 6,919 in 2005		
Outstanding shares 7,046 in 2006 and 6,909 in 2005	71	69
Common stock held in treasury, at cost 10 shares	(362)	(362)
Additional paid-in capital	53,464	52,994
Accumulated deficit	(54,853)	(52,053)
Accumulated other comprehensive loss	(179)	(179)
Total stockholders equity	450	2,979
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,743	$ 4,648

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	Three Months Ended September 30, 2006	September 30, 2005	Nine Months Ended September 30, 2006	September 30, 2005
Net product revenue	$ 1,465	$ 1,589	$ 2,840	$ 3,783
Net customer support and maintenance revenue	271	389	951	1,089
Total revenue	1,736	1,978	3,791	4,872
Cost of product revenue	755	789	1,441	2,010
Cost of customer support and maintenance revenue	23	8	183	54
Total cost of revenue	778	797	1,624	2,064
Gross profit	958	1,181	2,167	2,808
Operating expenses:				
Sales and marketing	562	797	2,227	2,429
Research and development	272	552	1,679	1,957
General and administrative	306	336	1,039	868
Severance and related costs				55
Operating loss	(182)	(504)	(2,778)	(2,501)
Other income (expense), net			(65)	2
Interest income, net	2	23	43	56
Loss before income tax provision	(180)	(481)	(2,800)	(2,443)
Income tax provision				
Net loss	$ (180)	$ (481)	$ (2,800)	$ (2,443)
Preferred stock dividends accrued	(44)	(44)	(132)	(129)
Beneficial conversion feature on preferred stock				(919)
Net loss attributable to common stockholders	$ (224)	$ (525)	$ (2,932)	$ (3,491)
Net loss per share attributable to common stockholders, basic and diluted	$ (0.03)	$ (0.08)	$ (0.42)	$ (0.56)
Weighted average common shares outstanding, basic and diluted	7,046	6,586	7,025	6,270

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30, 2006	September 30, 2005
Operating Activities:		
Net loss	$ (2,800)	$ (2,443)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	80	141
Provision for doubtful accounts	(13)	(285)
Stock based compensation	402	
Changes in operating assets and liabilities:		
Accounts receivable	(465)	603
Inventories	134	431
Prepaid expenses and other assets	128	227
Accounts payable and accrued expenses	(209)	(291)
Deferred revenue	(166)	(86)
Net cash used in operating activities	(2,909)	(1,703)
Investing Activities:		
Purchases of short-term investments		(2,350)
Maturities of short-term investments	500	1,925
Purchases of property and equipment	(3)	(136)
Net cash provided by (used in) investing activities	497	(561)
Financing Activities:		
Proceeds from the exercise of employee stock options	1	
Dividends paid on preferred stock	(133)	(137)
Proceeds from the issuance of preferred stock and warrants, net		2,490
Net cash provided by (used in) financing activities	(132)	2,353
Effect of foreign currency translation adjustment on cash and cash equivalents		(6)
Net decrease in cash and cash equivalents	(2,544)	83
Cash and cash equivalents at beginning of period	2,844	2,315
Cash and cash equivalents at end of period	$ 300	$ 2,398
SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES:		
Fair value of warrants issued in connection with sale of preferred stock	$	$ 815
Amortization of preferred stock beneficial conversion feature	$	$ 919

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

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

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

We were organized in Texas in September 1983 and reincorporated in Delaware in October 1995. For more than 15 years, we provided local area networking equipment and were known as Optical Data Systems or ODS Networks. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our Nasdaq ticker symbol from ODSI to INTZ to reflect our focus on intrusion detection solutions. On November 1, 2001, we changed our name from Intrusion.com, Inc. to Intrusion Inc.

Our principal executive offices are located at 1101 East Arapaho Road, Suite 200, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is www.intrusion.com. Information contained in or linked to our website are not a part of this report. References to we, us and our in this report refer to Intrusion Inc. and its subsidiaries.

As of September 30, 2006, we had cash, cash equivalents and short-term investments in the amount of approximately $0.3 million, down from approximately $3.3 million as of December 31, 2005. The decrease in cash and short-term investments funded our operations for the first nine months of 2006. On March 29, 2006, we established a $1.0 million line of credit with Silicon Valley Bank. Our existing cash resources, line of credit and revenues for the remainder of 2006 and 2007, may not provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. Therefore, it is possible that we will need to seek additional debt or equity financing to fund our operations for the next year. Despite actions to reduce our costs and improve our profitability, our operating losses and net operating cash outflows may continue through the fourth quarter of 2006 and into 2007. We may not be able to achieve the revenue and gross margin objectives necessary without obtaining additional equity financing. We do not currently have any arrangements for additional financing and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. Additionally, we may not have sufficient availability under our credit line when additional funds are needed. We had approximately $487,000 available to borrow on our credit line as of September 30, 2006.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-QSB and Item 310 of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The December 31, 2005 balance sheet was derived from audited financial statements, but does not include all the disclosures required by accounting principles generally accepted in the United States. However, we believe that the disclosures are adequate to make the information presented not misleading. In our opinion, all the adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. The results of operations for the three and nine month period ending September 30, 2006 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s annual report on Form 10-KSB for the year ended December 31, 2005.

3. Inventories (In thousands)

	September 30, 2006	December 31, 2005
Inventories consist of:		
Finished goods	$ 192	$ 290
Work in progress	8	8
Demonstration systems	39	75
Net inventory	$ 239	$ 373

4. Accounting for Stock-Based Compensation

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

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

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

By adopting SFAS 123(R) we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123(R) is not expected to have a significant effect on our financial condition or cash flows but is expected to have a significant, adverse effect on our results of operations.

At September 30, 2006, we had three stock-based compensation plans, which are described below. These plans were developed to retain and attract key employees and directors.

In 1995, we adopted our 1995 Stock Option Plan (the 1995 Plan), which provides for the issuance of up to 400,000 shares of common stock upon exercise of options granted pursuant to the 1995 Plan. On April 26, 2001, our stockholders increased the overall number of shares available for issuance pursuant to the plan to 825,000 shares of common stock. The 1995 Plan provides for the issuance of both non-qualified and incentive stock options to our employees, officers, and employee-directors. The 1995 Plan expired by its terms on March 21, 2005 and no options were available for future issuance after the expiration. At September 30, 2006, 67,365 employee options have been exercised and employee options to purchase a total of 497,677 shares of common stock are outstanding. A total of 2,290,295 options have been granted pursuant to the 1995 Plan, of which, 1,725,253 have been cancelled.

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

7

On March 17, 2005, the Board approved the 2005 Stock Incentive Plan (the 2005 Plan), which was approved by the stockholders on June 14, 2005. The 2005 Plan serves as a replacement for the 1995 Non-Employee Director Plan and the 1995 Option Plan which expired by their terms on March 21, 2005. The approval of the 2005 Plan had no effect on the 1995 Plans or any options granted pursuant to either plan. All options will continue with their existing terms and will be subject to the 1995 Non-Employee Director Plan or the 1995 Plan, as applicable. Further, the Company will not be able to re-issue any option which is cancelled or terminated under the 1995 Non-Employee Director Plan or the 1995 Option Plan. The 2005 Plan provides for the issuance of up to 750,000 shares of common stock upon exercise of options granted pursuant to the 2005 Plan. The 2005 Plan consists of three (3) separate equity incentive programs: the Discretionary Option Grant Program; the Stock Issuance Program; and the Automatic Option Grant Program for non-employee Board members. Officers and employees, non-employee Board members and independent contractors are eligible to participate in the Discretionary Option Grant and Stock Issuance Programs. Participation in the Automatic Option Grant Program is limited to non-employee members of the Board. Each non-employee Board member will receive an option grant for 10,000 shares of Common Stock upon initial election or appointment to the Board, provided that individual has not previously been employed by the Company in the preceding six (6) months. In addition, on the date of each annual stockholders meeting, each Board member will automatically be granted an option to purchase 5,000 shares of Common Stock, provided he or she has served as a non-employee Board member for at least six (6) months. At September 30, 2006, no 2005 plan options have been exercised and employee and non-employee Board member options to purchase a total of 326,000 shares of common stock are outstanding. A total of 348,000 options have been granted under the 2005 Plan, of which 22,000 have been cancelled and options for 424,000 shares remain available for future grant. No shares have been issued pursuant to the Stock Issuance Program.

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

Effect of Adopting SFAS No. 123(R)

The following is the effect of adopting SFAS No. 123(R) as of January 1, 2006 for the three and nine months ended September 30, 2006 (in thousands, except per share data).

	For Three Months Ended September 30, 2006	**For Nine Months Ended September 30, 2006**
Stock-option compensation expense recognized (for stock options only):		
Cost of revenue	$ 1	$ 24
Research and development	15	94
Sales and marketing	16	164
General and administrative	7	120
Effect on net loss	$ 39	$ 402
Effect on basic and diluted earnings per common share	$ (0.01)	$ (0.06)

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 (no options were granted during the three months ended September 30, 2006):

	For Three Months Ended September 30, 2006	**For Three Months Ended September 30, 2005**	**For Nine Months Ended September 30, 2006**	**For Nine Months September 30, 2005**
Weighted average grant date fair value	n/a	$ 2.29	$ 1.03	$ 2.35
Weighted average assumptions used:				
Expected dividend yield	n/a	0.0 %	0.0 %	0.0 %

Risk-free interest rate	n/a	4.2	%	4.6	%	3.9	%
Expected volatility	n/a	104.0	%	98.6	%	113.1	%
Expected life (in years)	n/a	5.0		5.0		4.4	

8

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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

Stock Incentive Plan Activity

Stock option activity under the Company s various long-term incentive and director compensation plans during the nine months ended September 30, 2006, were as follows:

	Number of Options (in thousands)	**Weighted Average Exercise Price**
Outstanding at December 31, 2005	891	$ 5.48
Granted	48.0	1.37
Exercised	(1)	0.76
Forfeited	(54)	2.72
Expired	(28)	8.24
Outstanding at September 30, 2006	856	$ 5.34

Stock Options Outstanding and Exercisable

Summarized information about outstanding stock options as of September 30, 2006, that are fully vested and those that are expected to vest in the future as well as stock options that are fully vested and currently exercisable, are as follows:

	Outstanding Stock Options (Fully Vested and Expected to Vest)*	**Options that are Exercisable**
As of September 30, 2006		
Number of outstanding options	856	683
Weighted average remaining contractual life	7.47	7.16
Weighted average exercise price per share	$ 5.34	$ 6.08
Intrinsic value	$ 0	$ 0

* Includes effects of expected forfeitures

The options detailed in the table above have a $0 intrinsic value as the fair market value on September 30, 2006 is less than the exercise prices of all of the options vested and expected to vest. As of September 30, 2006, the total unrecognized compensation cost related to non-vested options not yet recognized in the statement of operations totaled approximately $118 thousand and the weighted period over which these awards are expected to be recognized was 1.02 years.

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

Under the modified prospective application method, results for prior periods have not been restated to reflect the effects of implementing SFAS No. 123(R). The following pro forma information was reported, as required by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure for the quarter and nine months ended September 30, 2005.

	Quarter Ended September 30, 2005		Nine Months September 30, 2005	
Net loss attributable to common stockholders	$	(525)	$	(3,491)
Deduct: Total stock-based compensation determined under fair value-based method for all awards	(283)		(589)	
Pro forma net loss attributable to common stockholders	$	(808)	$	(4,080)
Net loss per share attributable to common stockholders:				
as reported (basic and diluted)	$	(0.08)	$	(0.56)
pro forma (basic and diluted)	$	(0.12)	$	(0.65)
Weighted-average shares used in computation:				
Basic and diluted				