INTRUSION INC
Form 10-K
March 27, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2014

OR

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

For the transition period from to

COMMISSION FILE NUMBER 0-20191

Intrusion Inc.

(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	**75-1911917** (I.R.S. Employer Identification No.)
1101 EAST ARAPAHO ROAD, SUITE 200 **RICHARDSON, TEXAS** (Address of principal executive offices)	**75081** (Zip Code)

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

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

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.01 par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ý No o

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

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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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act:

Large Accelerated Filer o	Accelerated Filer o
Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller reporting company ý

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of June 30, 2014: $16,741,000.

As of March 27, 2015, 12,611,836 shares of the issuer s Common Stock were outstanding.

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement filed in connection with the Registrant s 2015 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

INTRUSION INC.

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PART I

Item 1. Description of Business.

In addition to the historical information contained herein, the discussion in this Annual Report on Form 10-K contains certain forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties, such as statements concerning:

- growth and anticipated operating results;
- developments in our markets and strategic focus;
- new products and product enhancements;
- potential acquisitions and the integration of acquired businesses, products and technologies;
- strategic relationships and future economic and business conditions.

The cautionary statements made in this Form 10-K should be read as being applicable to all related forward-looking statements whenever they appear in this Form 10-K. Our actual results could differ materially from the results discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the section captioned Risk Factors in Item 1A of this Form 10-K as well as those cautionary statements and other factors set forth elsewhere herein.

General

We develop, market and support a family of entity identification, high speed data mining, advanced persistent threat detection and regulated information compliance products. Our product families include:

- TraceCop for identity discovery and disclosure,
- Savant for network data mining and advanced persistent threat detection, and
- Compliance Commander for regulated information compliance.

We market and distribute our products through a direct sales force to:

- end-users,
- value-added resellers,
- system integrators,
- managed service providers, and
- distributors.

Our end-user customers include:

- U.S. federal government entities,
- local government entities,
- banks,
- credit unions,
- other financial institutions,
- hospitals and other healthcare providers, and
- other customers.

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. 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 the Company , we , us , our , Intrusion or Intrusion Inc. refer to Intrusion Inc. and its subsidiaries. Com Commander, TraceCop and Savant are trademarks of Intrusion Inc.

On March 29, 2006, we entered into a Loan and Security Agreement with Silicon Valley Bank (SVB) to establish a $1.0 million line of credit (the 2006 Credit Line). On June 30, 2008, we entered into an Amended and Restated Loan and Security

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Agreement with SVB to, among other things, replace the 2006 Credit Line with a $2.5 million line of credit (the 2008 Credit Line). On June 24, 2014, we entered into the Fifth Amendment to the Amended and Restated Loan and Security Agreement (as amended, the Loan Agreement) with SVB to replace our expiring line with a $0.625 million line of credit (the Current Line of Credit). Our obligations under the Loan Agreement are secured by substantially all of our assets, including all of our intellectual property. In addition, G. Ward Paxton, the Company s Chairman, President and Chief Executive Officer, has established a Guaranty Agreement with SVB securing all outstanding balances under the Current Line of Credit. Borrowings under the Current Line of Credit are based on advances (each an Advance) against certain of our accounts receivable that are approved by SVB (each an Eligible Account). 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 the greater of the prime rate plus 2.0% or 7.0%. 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 0.5% 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. We have certain non-financial and financial covenants, including a liquidity coverage ratio and a rolling EBITDA computation, as defined in the Loan Agreement. On June 23, 2015, the Loan Agreement terminates and all outstanding Advances, accrued but unpaid finance charges, outstanding collateral handing fees, and other amounts become due under the Loan Agreement and related documents. As of December 31, 2014, we had no borrowings outstanding under the Current Line of Credit.

On February 6, 2014, the Company entered into an unsecured revolving promissory note to borrow up to $2,200,000 from G. Ward Paxton, the Company s 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 balance due of $2,200,000 at any given time through March 2015.

On February 5, 2015, the Company renewed the CEO note described above on the same terms, with the Company being able to borrow, repay and reborrow on the note as needed up to an outstanding principal balance due of $2,200,000 at any given time through March 2016.

Amounts borrowed from this officer accrue interest at a floating rate per annum equal to SVB s prime rate plus 1% (5% at December 31, 2014). All outstanding borrowings and accrued but unpaid interest is due on March 31, 2016. As of December 31, 2014, the borrowings outstanding totaled $1,530,000 and accrued interest totaled $76,000.

Government Sales

Sales to U.S. government customers accounted for 51.4% of our revenues for the year ended December 31, 2014, compared to 50.1% of our revenue in 2013. We expect to continue to derive a substantial portion of our revenues from sales to governmental entities in the future as we continue to market our entity identification products, our data mining products and our regulated compliance products to the government. Sales to the government present risks in addition to those involved in sales to commercial customers that could adversely affect our revenues, including potential disruption due to irregularities in or interruptions to appropriation and spending patterns, delays in approving a federal budget and the government s reservation of the right to cancel contracts and purchase orders for its convenience.

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

Industry Background

We develop, market and support a family of entity identification products, data mining, advanced persistent threat detection and regulated information compliance products. Our product families include:

- TraceCop for entity identification;
- Savant for data mining and advanced persistent threat detection; and
- Compliance Commander for regulated information compliance and data privacy protection.

Intrusion s products help protect critical information assets by quickly detecting, protecting, analyzing and reporting attacks or misuse of classified, private and regulated information for government and enterprise networks.

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Products

TraceCop

Our TraceCop product family includes a database of worldwide IP addresses which are regularly updated. In addition, other information and analysis results, such as geo-location data, may also be included. Customers use the TraceCop data to aid in the identification and location of individuals involved in cyber crime. In addition to the IP database, the TraceCop family includes analysis software and a GUI interface to assist analysts in locating the bad guys. We license TraceCop to our customers for a fee and offer continuing maintenance and upgrade services for the TraceCop database. We either install and service the database at the Intrusion facility or install the TraceCop database on a customer server onsite.

Savant

Savant, a product offering announced in the first quarter of 2010, is a high-speed network data mining product which organizes the data into networks of relationships. Savant operates on networks with data flows of up to 20 gigabits (10 gigabits at full duplex). Savant can read and record up to 20 gigabits without dropping packets. Some of the unique features include analysis which determines associations. Uses of the Savant product include data mining, data loss prevention, advanced persistent threat detection and Internet habits of the customer s network users. The Savant solution provides real-time access and insight into a company s own indisputable and quantifiable network data for more effective, unbiased decision making. We believe this new insight can provide the ability to address many of today s major challenges faced by corporations, such as company infrastructure issues, performance issues, and identifying the true Wizards or recognized experts within their organization. Savant provides deep inspection of network traffic recording interesting data and relationships. Savant is a software product which we license to our customers and for which we sell maintenance and upgrades. We also re-sell the server required to implement Savant into the customer s network.

Compliance Commander

Compliance Commander is our data leak prevention product family. Compliance Commander is a software product which operates on a standard computer or server and connects in-line to the customers network. We license the Compliance Commander software to our customers and sell software maintenance and upgrades. We also resell standard computers for implementation of the software.

Third-Party Products

We currently resell standard commercially available computers and servers from various vendors which we integrate with our different software products for implementation into our customer networks. We do not consider any of these third party relationships to be material to the Company s business or results of operations.

Customer Services

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

Product Development

The network security industry is characterized by rapidly changing technology, standards and customer demands all shaped by the current state of the economy. We believe that our future success depends in large part upon the timely enhancement of existing products as well as the development of new technologically advanced products that meet industry standards, perform successfully and efficiently. We are currently marketing TraceCop, Savant and Compliance Commander products to meet emerging market requirements and are continuously engaged in testing to ensure that our products interoperate with other manufacturers products, which comply with industry standards.

During 2014 and 2013, our research and development expenditures were approximately $1.9 and $1.6 million, respectively. All of our expenditures for research and development have been expensed as incurred. At December 31, 2014, we had 24 employees engaged in research, product development and engineering.

Manufacturing and Supplies

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

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The hardware we sell are standard off-the-shelf products, which we sell directly to OEM customers or resell from our suppliers.

Intellectual Property and Licenses

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

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

Sales, Marketing and Customers

Field Sales Force. Our direct sales organization focuses on major account sales, channel partners including distributors, value added resellers (VARs) and integrators; promotes our products to current and potential customers; and monitors evolving customer requirements. The field sales and technical support force provides training and technical support to our resellers and end users and assists our customers in designing secure data networking solutions. We currently conduct sales and marketing efforts from our principal office in Richardson (Dallas), Texas. In addition, we have sales personnel, sales engineers or sales representatives located in California, Europe and Asia.

Distributors. We have signed distribution agreements with distributors in the United States, Europe and Asia. In general, these relationships are non-exclusive.

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

Foreign Sales. We believe that rapidly evolving international markets are potential sources of future sales. Our export sales are currently planned to be made through an indirect sales force comprised of international resellers in Europe and Asia. Export sales did not account for any revenue in 2014 and 2013. See   Management   s Discussion and Analysis of Financial Condition and Results of Operations   included in this report for a geographic breakdown of our revenue in 2014 and 2013.

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

Customers. Our end-user customers include U.S. federal government entities, banks, credit unions, other financial institutions, hospitals and healthcare providers. Sales to certain customers and groups of customers can be impacted by seasonal capital expenditure approval cycles, and sales to customers within certain geographic regions can be subject to seasonal fluctuations in demand.

In 2014, 51.4% of our revenue was derived from a variety of U.S. government entities through direct sales and indirectly through system integrators and resellers. These sales are attributable to four U.S. Government customers through direct and indirect channels, all exceeded 10% of total revenue individually in 2014. Comparatively, sales to the U.S. Government through direct and indirect channels totaled 50.1% of total revenues for 2013 and 46.0% of our total revenues in 2013 were attributable to four customers, three of which exceeded 10% of our total revenues individually. A reduction in our sales to U.S. government entities could have a material adverse effect on our business and operating results if not replaced.

Backlog. We believe that only a small portion of our order backlog is non-cancelable and that the dollar amount associated with the non-cancelable portion is immaterial. We purchase, or contract for the purchase of, our inventory based upon our forecast of customer demand and we maintain inventories in advance of receiving firm orders from customers. Commercial orders are generally

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fulfilled within two days to two weeks following receipt of an order. Certain orders may be scheduled over several months, generally not exceeding one year.

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

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

Competition

The market for network and data protection security solutions is intensely competitive and subject to frequent product introductions with new technologies, improved price and performance characteristics. Industry suppliers compete in areas such as conformity to existing and emerging industry standards, interoperability with networking and other security products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support. The market for identity identification and data mining is more fragmented and thus allows more opportunities for small companies to compete in.

There are numerous companies competing in various segments of the data security markets. At this time, we have limited competitors for TraceCop; however, we expect competitors to emerge in the future. These competitors perform only a portion of the functions that we currently perform with TraceCop. Also, we have been collecting the TraceCop data continuously for more than six years. We believe that none of our current or future competitors have the ability to provide this historical data. In our newest market segment, data mining and advanced persistent threat detection, we compete with several companies including Niksun, NetScout, Fireeye (Mandiant) and Palo Alto Networks. Our competitors in the regulated information compliance market include Vontu (Symantec), Port Authority (Websense), Vericept, Reconnex (McAfee Inc.), Tablus (RSA Security) and a small number of start-up companies that entered the space within the last two years.

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

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

Employees

As of December 31, 2014, we employed a total of 36 full time persons, including 8 in sales, marketing and technical support, 24 in research, product development and engineering, and 4 in administration and finance.

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

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

Item 1A. Risk Factors

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

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We may not have sufficient cash to operate our business and may not be able to maintain certain liquidity requirements under our existing debt instruments. 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 December 31, 2014, we had cash and cash equivalents of approximately $1,006,000, down from approximately $1,139,000 as of December 31, 2013. We generated a net loss of $274,000 for the year ended December 31, 2014 compared to net income of $623,000 for the year ended December 31, 2013. As of December 31, 2014, in addition to cash and cash equivalents of $1,006,000, we had $475,000 in funding available under our $0.625 million line of credit at Silicon Valley Bank (SVB) and $670,000 funding available from a promissory note to borrow up to $2.2 million from G. Ward Paxton, the Company s Chief Executive Officer. We are obligated to make payments of accrued dividends on all our outstanding shares of preferred stock that will reduce our available cash resources. Based on projections of growth in revenue and net income in the coming quarters, and the borrowings available previously mentioned, we believe that we will have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. We expect to fund our operations through anticipated Company profits, our line of credit, borrowings from the Company s CEO, 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 year, 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 had a net loss of $0.3 million for the year ended December 31, 2014 and have an accumulated deficit of $59.0 million as of December 31, 2014. To achieve sustainable profitability, we must continue to generate increased revenue.

For the year ended December 31, 2014, we had a net loss of $0.3 million and had an accumulated deficit of approximately $59.0 million as of December 31, 2014, compared to a net income of $0.6 million and an accumulated deficit of approximately $58.0 million as of December 31, 2013. We need to generate greater revenue from the sales of our products if we are to sustain profitability. If we are unable to generate greater revenue, net losses may return and we may never be able to sustain profitability or generate positive cash flow from operations in the future.

If our newer products do not achieve market acceptance, our revenue growth may suffer.

Our new network security products, advanced persistent threat and entity identification products have 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. We can provide no assurances that sales of our newer products will continue to grow or generate sufficient revenues to sustain our business. If we are unable to recognize revenues due to longer sales cycles or other problems, our results of operations will be adversely affected, perhaps materially.

We have not yet received broad market acceptance for our newer products. We cannot assure you that our present or future products will achieve market acceptance on a sustained basis. In order to achieve market acceptance and achieve future revenue growth, we must introduce complementary security products, incorporate new technologies into our existing product lines and design, develop and successfully commercialize higher performance products in a timely manner. We cannot assure you that we will be able to offer new or complementary products that gain market acceptance quickly enough to avoid decreased revenues during current or future product introductions or transitions.

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

A large percentage of our revenues result from sales to U.S. government entities. If we were to lose one or more of these key relationships, our revenues could decline and our business and prospects may be materially harmed. We expect that even if we are successful in developing relationships with non-governmental customers, our revenues will continue to be concentrated among government entities. For the years ended December 31, 2012, 2013 and 2014, sales to U.S. government entities collectively accounted for 40.5%, 50.1% and 51.4% of our total net revenues, respectively. The loss of any of these key relationships may send a negative message to other U.S. government entities or non-governmental customers concerning our product offering. We cannot assure you that U.S. government entities will be customers of ours in future periods or that we will be able to diversify our customer portfolio to adequately mitigate the risk of loss of any of these customers.

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

We expect to continue to derive a substantial portion of our revenues from U.S. government customers in the future. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruption due to

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appropriation and spending patterns, delays in approving a federal budget and the government s right to cancel contracts and purchase orders for its convenience. General political and economic conditions, which we cannot accurately predict, directly and indirectly may affect the quantity and allocation of expenditures by federal departments. In addition, obtaining government contracts may involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, budgetary constraints, political agendas, extensive specification development and price negotiations and milestone requirements. Each government entity also maintains its own rules and regulations with which we must comply and which can vary significantly among departments. As a result, cutbacks or re-allocations in the federal budget or losses of government sales due to other factors could have a material adverse effect on our revenues and operating results.

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

For the years ended December 31, 2012, 2013 and 2014, we derived 33.1%, 32.4% and 55.7% 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.

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

On March 25, 2004, we completed a $5,000,000 private placement pursuant to which we issued 1,000,000 shares of our 5% Convertible Preferred Stock (the Series 1 Preferred Stock) and warrants to acquire 556,619 shares of our common stock. The conversion price for the Series 1 Preferred Stock is $3.144 per share. As of February 28, 2015, there were 200,000 shares of the Series 1 Preferred Stock outstanding, representing approximately 318,065 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. As of February 28, 2015, 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 conversion price for the Series 3 Preferred Stock is $2.18 per share. As of February 28, 2015, there were 289,377 shares of Series 3 Preferred Stock outstanding, representing 289,377 shares of common stock upon conversion.

If we are unable to pay scheduled dividends on shares of our preferred stock it could potentially result in additional consequences, some of them material.

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 cannot assure you that our net assets will exceed our stated capital or that we will have sufficient net profits in order to pay these dividends in the future.

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock 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 February 28, 2015, we had 12,611,836 shares of common stock outstanding. Upon conversion of all outstanding shares of preferred stock, we will have 13,679,279 shares of common stock outstanding, approximately an 8.5% increase in the number of shares of our common stock outstanding.

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.

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) paid all outstanding dividends, (iii) a volume weighted average price of $2.29, which was the ten-day volume weighted average closing price of our common stock on February 28, 2015, and (iv) our 12,611,836 shares of common stock outstanding on February 28, 2015, upon exercise of their redemption right by the holders of the Series 3 Preferred

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Stock and the Series 2 Preferred Stock, we would be obligated to issue approximately 1,361,000 shares of our common stock. This would represent an increase of approximately 10.8% in the number of shares of our common stock as of February 28, 2015.

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

The holders of the shares of our 5% Preferred Stock may freely convert their shares of preferred stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of February 28, 2015, 800,000 shares of our 5% Preferred Stock had converted into 1,272,263 shares of common stock.

The holders of the shares of Series 2 5% Preferred Stock may freely convert their shares of preferred stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of February 28, 2015, 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 may freely convert their shares of Series 3 Preferred Stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of February 28, 2015, 275,230 shares of Series 3 Preferred Stock had converted into 275,230 shares of common stock.

For the four weeks ended on February 28, 2015, the average daily trading volume of our common stock on the OTCQB was 12,400 shares. Consequently, if holders of preferred stock elect to convert their remaining shares 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 SVB 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.

You will experience substantial dilution upon the exercise of certain stock options currently outstanding.

On February 28, 2015, we had 12,611,836 shares of common stock outstanding. Upon the exercising of current options issued at or below the exercise price of $1.10, we will have approximately 14,905,000 shares of common stock outstanding, a 19.6% increase in the number of shares of our common stock outstanding.

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 entity identification and data mining 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 entity identification and data mining products to achieve market acceptance and produce a sustainable revenue stream;
- our ability to manage costs and expenses;
- our dependence on key personnel;
- our ability to obtain financing on acceptable terms; and
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