

INTRUSION INC  
Form 10-K/A  
August 06, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-K/A**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 [FEE REQUIRED]**

**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

For the transition period \_\_\_\_\_ to \_\_\_\_\_  
COMMISSION FILE NUMBER 0-20191

**Intrusion Inc.**

(Exact name of registrant as specified in its charter)

**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

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

**1101 EAST ARAPAHO ROAD  
RICHARDSON, TEXAS**  
(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)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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Indicate by check mark if disclosure of delinquent filers pursuant 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. o

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Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12-b2): Yes  No

State the aggregate market value of the voting and non-voting 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 the last business day of the Registrants' most recently completed second fiscal quarter: \$10,381,910. As of February 27, 2004, 20,652,425 shares of the Registrant's Common Stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement filed in connection with the Registrant's 2003 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

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**INTRUSION INC.  
INDEX**

		<b>Page</b>
<b>PART I</b>		
Item 1.	Business	3
Item 2.	Properties	21
Item 3.	Legal Proceedings	22
Item 4.	Submission of Matters to a Vote of Security Holders	22
<b>PART II</b>		
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	23
Item 6.	Selected Financial Data	24
Item 7.	Management's Discussion and Analysis of Financial Condition And Results of Operations	25
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	39
Item 8.	Financial Statements and Supplementary Data	39
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	40
Item 9A.	Controls and Procedures	40
<b>PART III</b>		
Item 10.	Directors and Executive Officers of Intrusion Inc.	41
Item 11.	Executive Compensation	41
Item 12.	Security Ownership of Certain Beneficial Owners and Management	42
Item 13.	Certain Relationships and Related Transactions	42
Item 14.	Principal Accountant Fees and Services	42
<b>PART IV</b>		
Item 15.	Exhibits, Financial Statement Schedules, and Reports on Form 8-K	43
	Signatures	46

**PART I**

**Item 1. Business.**

In addition to the historical information contained herein, the discussion in this Form 10-K contains certain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties, such as statements concerning: growth and anticipated operating results, developments in our markets and strategic focus; new products and product enhancements; potential acquisitions and the integration of acquired businesses, products and technologies; strategic relationships and future economic and business conditions. The cautionary statements made in this Form 10-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 "Factors That May Affect Future Results of Operations" in Item 1 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 network intrusion prevention and detection systems and regulated information compliance systems that address vital security issues facing organizations with mission critical business applications or housing classified, confidential, or customer information assets. We currently provide network security and regulated information compliance solutions under our SecureNet family of hardware and software solutions.

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

We were organized in Texas in September 1983 and reincorporated in Delaware in October 1995. For more than 15 years, we provided local area networking equipment and were known as Optical Data Systems or ODS Networks. On April 17, 2000, we announced plans to sell, or otherwise dispose of, our networking divisions, which included our Essential Communications division ("Essential") and our local area networking assets. In accordance with these plans, we have accounted for these businesses as discontinued operations. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our NASDAQ ticker symbol from ODSI to INTZ to reflect our focus on intrusion detection solutions. On November 1, 2001, we changed our name from Intrusion.com, Inc. to Intrusion Inc.

Our principal executive offices are located at 1101 East Arapaho Road, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is [www.intrusion.com](http://www.intrusion.com). References to "we", "us", "our" or "Intrusion Inc." refer to Intrusion Inc. and its subsidiaries.

**Product Transition**

Over the last three years, we have transitioned our business from sales of our hardware-based PDS and SecureCom network security products to our higher margin software-based SecureNet products. Our SecureNet products include intrusion detection, intrusion prevention and regulated information compliance products.

During this transition, our sales have declined from \$16.7 million in 2001 to \$7.8 million in 2002 and \$6.5 million in 2003 as sales of our new software products have not been sufficient to offset reduced sales of our hardware products. Accordingly, we restructured our business to reflect our focus on our sales and to reduce our expenses. These efforts resulted in a reduction in our operating loss from (\$43.3) million in 2001 to (\$22.8) million in 2002 and (\$9.8) million in 2003.

We plan to continue to focus our business strategy on sales of our higher margin software products, and we believe that our revenues and operating margins will increase as these products gain market acceptance.

#### **Government Sales**

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

Sales to U.S. government customers accounted for 17.0% of our revenues for the year ended December 31, 2003, compared to 19.9% of our revenue in 2002. 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 Common Criteria Certified network security products as well as government use of our regulated information compliance system products. Sales to the government present risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including potential disruption due to appropriation and spending patterns 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 rather than long-term contracts. Our customers, including government customers may cancel their orders with little or no prior notice without penalty. Although we transact business with various government entities, we do not believe that the cancellation of any particular order would have a material effect on our financial results. In addition, we do not believe that any of our revenues with government customers are subject to renegotiation of profits. However, because we derive and expect to continue to derive a substantial portion of our revenue from sales to government entities, a large number of cancelled or renegotiated government orders could possibly 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.

## Recent Developments

On March 25, 2004, we completed a \$5.0 million private placement of 5% Convertible Preferred Stock and warrants. In the private placement, the company sold 1,000,000 shares of preferred stock at a price of \$5.00 per share, which convert into 6,361,323 shares of common stock at an initial conversion price of \$0.786 per share, and warrants to purchase 2,226,459 shares of common stock at an exercise price of \$0.786 per share. In connection with the closing of this private placement, we issued warrants to purchase 257,633 shares of our common stock at an exercise price of \$0.786 per share to our financial advisor for the private placement.

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

## Industry Background

In the last decade, network security has changed from being a technology deployed only by the government and the most sophisticated or most paranoid of companies, to technology employed by all sizes of business and a mandatory component of all mission critical systems. This change has come about with the permeation of the Internet as a business enabler. Today, email, instant messengers, World Wide Web access, web sites, web-based applications and e-commerce are integral components of communications and operations for business and government.

Although the Internet has many business advantages, its openness and accessibility makes it a potential threat to the networks and systems that are attached to it. Computer hackers, curious or disgruntled employees, competitors and innocent mistakes may compromise or destroy information assets or disrupt the normal operations and brand equity of the enterprise.

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

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

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

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

*Network Intrusion Prevention and Detection Systems*

Network Intrusion Prevention & Detection Systems (NIP&DS) analyze network traffic for attacks and can block threats from entering the network. They examine individual packets within the data stream to identify threats from authorized users, back-door attacks and hackers who have thwarted the firewall to exploit network connections, cause system outages and access information assets. NIP&DS provide insight into the nature and character of the network that can be used to:

Identify threats in real time and block or terminate offending communications or simply alert administrators so that human intervention can protect the network;

Increase the value and efficacy of the control systems like firewalls and routers with evidence of the efficacy of those systems; and

Provide decision support for the altering of the enterprise security policy and network management.

*Regulated Information Compliance Systems*

Regulated Information Compliance Systems (RICS) build upon NIP&DS with the added capability to more deeply analyze traffic searching for classified, confidential or customer information assets. Working under the same management and monitoring umbrella of NIP&DS, RICS address data confidentiality, security and integrity issues facing industries subject to the Health Portability and Accountability Act of 1996 (HIPAA), Gramm, Leach, Bliley Act (GLBA), Sarbanes-Oxley, California Senate Bill 1386 (CA SB 1386) and others. These laws affect a broad range of both private and public entities, including those that maintain information that can personally identify a customer or patient and those that house both classified and unclassified information. Penalties for non-compliance include fines, lawsuits, and business process reviews.

**Our Solution and Products**

Intrusion Inc. addresses the challenges of ensuring the confidentiality, security and integrity of electronic information assets by developing, marketing and supporting a family of NIP&DS and RICS for deployment by public and private enterprises, to include remote and branch offices, and for managed security service providers. We believe implementing adequate perimeter defenses and monitoring network traffic to "trust-but-verify" are critical elements for the protection of information assets and integrity.

**Our SecureNet Network Systems**

The Intrusion SecureNet System has two primary components, Sensors and the Management System.

Sensors are devices or software components that are connected to the network and monitor the traffic searching for matches to signatures as evidence of an external network attack or malicious use that could threaten information assets. Signatures are patterns, anomalies and traffic flows that match known attacks or indicate suspicious activities. When the Sensor matches traffic to a signature it will send an event to the Management System.

The Management System controls the Sensors and displays events produced by the Sensors. Management is used for both configuration of the system and providing highly productive monitoring of the events produced by the system. Management is typically three-tier, where Sensors report to a centralized management system that has multiple analysts viewing the data. Management can also be a standalone system for small- and medium-businesses where configuration and monitoring are all done directly from the Sensor.



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

Our SecureNet system is "plug-and-protect" and can be connected to any network without interfering with the network operations by using the Intrusion SecureNet passive and inline taps.

*Intrusion SecureNet NIP&DS Products*

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

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

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

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

The SecureNet NIP&DS product family provides intuitive and powerful data mining and configuration. Intrusion SecureNet Provider is the three-tier enterprise management and monitoring system. SecureNet Provider is for enterprise deployments with no license limitations placed on architecture, freeing the enterprise to build the management system required. SecureNet Provider follows the workflow of the security analyst with a highly productive environment for response, research, resolution and decision support. The SecureNet Provider suite includes applications for event monitoring, policy creation and tuning and centralized software deployment making up the complete suite of tools required to manage and monitor a SecureNet System from five sensors to more than 100.

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

Our SecureNet NIP&DS Sensors are available as Software-Appliances and Hardware-Appliances with performance and pricing appropriate for networks ranging from 10Mb/s to Gigabit with a Common Criteria EAL2 certified Gigabit appliance. The following is a list of our IPS and IDS products

Intrusion SecureNet 7000 Software-Appliance products for networks up to 1000Mb/s. Seamlessly turns leading servers and workstations into SecureNet Sensors.

Intrusion SecureNet CC 7345 rack mount Hardware-Appliance, highly redundant, gigabit Sensor with Common Criteria EAL2 certification specifically for government deployments.

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Intrusion SecureNet 7145 rack mount, gigabit Hardware-Appliance available with either a copper- or a fiber-monitoring interface.

Intrusion SecureNet 5500 Software-Appliance for networks up to 250Mb/s. Seamlessly turns leading servers and workstations into SecureNet Sensors.

Intrusion SecureNet 5545 rack mount 250Mb/s Hardware-Appliance for server rooms and datacenters.

Intrusion SecureNet 5000 Software-Appliance for networks up to 100Mb/s. Seamlessly turns leading servers and workstations into SecureNet Sensors.

Intrusion SecureNet 5445 rack mount and 2445 desktop 100Mb/s Hardware-Appliances for network deployments and remote and branch offices.

Intrusion SecureNet 2000 Software-Appliance for networks up to 10Mb/s. Seamlessly turns leading servers and workstations into SecureNet Sensors.

Intrusion SecureNet 2245 Hardware-Appliance for remote and branch offices with throughput up to 10Mb/s at about the price of a laptop.

### *Intrusion SecureNet RICS Products*

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

The Intrusion SecureNet RICS products leverage the same Management and Sensor components of the SecureNet NIP&DS products. Our SecureNet RICS solutions are currently designed to address the security and confidentiality issues in the following industries and customers:

Department of defense to help prevent the leakage of classified information,

Health care companies (including health care providers, insurance companies and medical equipment manufacturers) who are working to comply with HIPAA, and

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

The Intrusion SecureNet RICS products leverage the same Management and Sensor components of the SecureNet IDS AND IPS products. The SecureNet RICS is designed to address the [privacy, confidentiality and information security] concerns of the department of defense, health care vertical (including health care providers, insurance companies and medical equipment manufacturers), financial institutions and e-commerce.

SecureNet RICS solutions provide accuracy through our Dynamic Data Dictionary (D3) technology, which securely connects directly to a database housing the confidential, classified, or regulated information. The RICS stays up to date with the database to match network traffic to the information that is resident in the database. This provides an automated accurate mechanism to identify leaks and misuse of information assets.



The Intrusion SecureNet LPS, leak prevention system targets public and private enterprises with confidential and classified information. The first release specifically targets the U.S. department of defense and protecting against "spillage", when classified information leaks to unclassified networks.

### **Third-Party Products**

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

We currently have two third-party product relationships. Our primary third-party relationship with Check Point Technologies has been significant in previous years due to sales of our PDS appliances, which are integrated with Check Point software. In connection with our strategy to focus our sales efforts on our higher-margin SecureNet software products, the sales of our PDS products have decreased from 29.1% of our revenue in 2002 to 16.7% of our revenue in 2003. As we continue to migrate our business away from our PDS and other hardware products, we expect our reliance on CheckPoint to continue to decline; however, sales of our new software products may not replace the anticipated decline in sales of our PDS products, and our revenues may decline as a result. Our other third-party relationship is not material and is not expected to be material as the product offering is only a complimentary item to our existing product offering.

### **Customer Services**

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

### **Product Development**

The network security industry is characterized by rapidly changing technology, standards, economy and customer demands. We believe that our future success depends in large part upon the timely enhancement of existing products as well as the development of technologically advanced new products that meet industry standards, perform successfully and simplify the user's tasks so that they can do more with less resources, all to achieve market acceptance. We are currently marketing next-generation network NIP&DS products and RICS products and are developing 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 2003, 2002 and 2001, our research and development expenditures were \$3.5 million \$6.1 million, and \$12.5 million, respectively. All of our expenditures for hardware and software research and development costs have been expensed as incurred. At December 31, 2003, we had 15 employees engaged in research and product development.

### **Manufacturing and Supplies**

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

Our internal manufacturing operations consist primarily of replication of software on CDs, packaging, testing and quality control of finished units. Materials used in our manufacturing processes include semiconductors such as microprocessors, memory chips and application specific integrated circuits ("ASICs"), printed circuit boards, power supplies and enclosures. Our need for these components is decreasing as we focus on sales of our software products.

Our external manufacturing operations consists of U.S. based hardware assembly and configuration and the loading of the appropriate software. We have relationships with various interchangeable outsourced assembly operations and do not rely on any one operation as the work performed is not specific to the assembler we use. We do not anticipate any problems with our current outsourcing operations nor do we believe there will be any problems with changing or adding to existing operations.

### **Intellectual Property and Licenses**

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

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

We currently conduct sales and marketing efforts from our principal office in Richardson (Dallas), Texas and through foreign sales offices located in the following countries: England, France and Malaysia. In addition, we have sales personnel, sales engineers or sales representatives located in Los Angeles, Eastern Europe and Spain.

**Distributors.** We have signed distribution agreements with distributors in the United States, Europe and Asia. In general, these relationships are non-exclusive. Distributors typically maintain an inventory of our products. Under these agreements, we provide certain protection to the distributors for their inventory of our products for price reductions as well as products that are slow moving or have been discontinued. Recognition of sales to distributors and related gross profits are deferred until the distributors resell the merchandise. However, since we have legally sold the inventory to the distributor and we no longer have care, custody or control over the inventory, we recognize the trade accounts receivable and reduce inventory related to the sale at the time of shipment to the distributor.

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

**Foreign Sales.** We believe that rapidly evolving international markets are important sources of future net sales. Our export sales are currently being made through a direct sales force supplemented by international resellers in Europe, Asia and Canada. Export sales accounted for approximately 31.4%, 33.4% and 36.4% of net sales in 2003, 2002 and 2001, respectively. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this report for a geographic breakdown of our product revenue in 2003, 2002 and 2001. Sales to foreign customers and resellers generally have been made in United States dollars.

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

**Customers.** Our end-user customers include manufacturing, high technology, telecommunications, retail, transportation, health care, insurance, entertainment, utilities and energy companies, government agencies, financial institutions and academic institutions. Sales to certain customers and groups of customers can be impacted by seasonal capital expenditure approval cycles, and sales to customers within certain geographic regions can be subject to seasonal fluctuations in demand.

Although we sell our products to many customers, through various distribution channels, no one customer or reseller accounted for 10% or more of our net sales in any of the past three fiscal years.

However, in 2003, 17.0% of our revenue was derived from the sales to a variety of U.S. government entities through system integrators and resellers. The loss of sales to the various U.S. government agencies could have a material adverse effect on our business and operating results if not replaced. No other customer accounted for 10% or more of our net sales in 2003, 2002 or 2001, respectively.

**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 inventory based upon our forecast of customer demand and maintain inventories of sub-assemblies and finished products in advance of receiving firm orders from customers. Orders are generally fulfilled within two days to two weeks following receipt of an order. Due to the generally short cycle between order and shipment and occasional customer-initiated changes in delivery schedules or cancellation of orders that are made without significant penalty, we do not believe that our backlog as of any particular date is indicative of future net sales.

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

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

### **Competition**

The market for network security solutions is intensely competitive and subject to frequent product introductions with new technologies, improved price and performance characteristics. Industry suppliers compete in areas such as conformity to existing and emerging industry standards, interoperability with networking and other security products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support. We believe that our approach focusing on the network perimeters with market leading network intrusion detection technology that reduces the total cost of ownership compared to the competition provides us with an advantage with large organizations with complex security requirements.

There are numerous companies competing in various segments of the data security markets. Our principle competitors in the network intrusion prevention and detection market include Internet Security Systems, Inc., Cisco Systems, Inc., Symantec, Inc., Netscreen Technologies, Inc., Network Associates, Inc., Tipping Point Technologies Inc., and NFR Security, Inc. Our competitors in the regulated information compliance market include a small number of start up companies that entered the space within the last two-years. Several of our competitors have substantially greater financial, technical, sales and marketing resources, better name recognition and a larger customer base than we do. In addition, many of our competitors may provide a more comprehensive networking and security solution than we currently offer. Even if we do introduce advanced products, which 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, 2003, we employed a total of 44 persons, including 17 in sales, marketing and technical support, 3 in manufacturing and operations, 15 in research and product development and 9 in administration and finance.

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

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

### **Factors That May Affect Future Results of Operations**

In addition to the other information in this Form 10-K, the following factors should be considered in evaluating Intrusion Inc. and our business. This report may include various non-GAAP financial measures (as defined by SEC Regulation G), including our cash used in operations excluding costs associated with a litigation settlement and severance charges. Our management believes these measures provide useful information to investors about our financial condition and results of operations for the period presented by eliminating the affects of one-time and other transactions that can distort underlying operational results in order to provide greater comparability of our financial performance on a year-to-year basis. The most directly comparable GAAP financial measures and reconciliation of the difference between GAAP and non-GAAP financial measures can be found in the test of this report and our consolidated financial statements included in this report.

*If we fail to respond to rapid technological changes in the network security industry, we may lose customers or our products may become obsolete.*

The network security industry is characterized by frequent product introductions, rapidly changing technology and continued evolution of new industry standards. We must also introduce upgrades to our products rapidly in response to customer needs such as new computer viruses or other novel external attacks on computer networks. In addition, the nature of the network security industry requires our products to be compatible and interoperable with numerous security products, networking products, workstation and personal computer architectures and computer and network operating systems offered by various vendors, including our competitors. As a result, our success depends upon our ability to develop and introduce in a timely manner new products and enhancements to our existing products that meet changing customer requirements and evolving industry standards. The development of technologically advanced network security products is a complex and uncertain process requiring high levels of innovation, rapid response and accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully in a timely manner. Further, we or our competitors may introduce new products or product enhancements that shorten the life cycle of our existing products or cause our existing products to become obsolete.

*Our revenues have declined from \$16.7 million in 2001 to \$6.5 million in 2003 in connection with a shift to sales of our newer product lines. If our network intrusion detection and regulated information compliance system products do not achieve market acceptance, our revenues will suffer.*

Over the past three years, we have transitioned our sales strategy from our lower margin SecureCom and PDS security appliance products to the development and sales of our higher margin SecureNet network intrusion detection products. During this transition, sales of our new products were not enough to counteract the loss in sales associated with our older products. As a result, our net revenues have declined from approximately \$16.7 million in 2001, to approximately \$7.8 million in 2002 and approximately \$6.5 million in 2003

Our new network security products and regulated information compliance systems have only been in the market place for a limited period of time and may have longer sales cycles than our previous products. Although response to our products has been positive, we have not yet received broad market acceptance. We cannot assure you that our present or future products will achieve market acceptance on a sustained basis.



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

***We resemble a developmental stage company and our business strategy may not be successful.***

From our founding in 1983 until 2000, we derived substantially all of our revenue from the design, manufacture and sale of local area networking equipment. In order to permit us to focus our resources solely on developing and marketing our network security products, on April 17, 2000, we announced our plans to sell our local area networking assets and related networking divisions.

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

the need for our network security products and regulated information compliance systems to achieve market acceptance and produce a sustainable revenue stream;

our ability to manage costs and expenses;

our dependence on key personnel;

our ability to obtain financing on acceptable terms; and

our ability to offer greater value than our competitors.

Our business strategy may not successfully address these risks. If we fail to recognize significant revenues from the sales of our network security products and regulated information compliance systems, our business, financial condition and operating results would be materially adversely affected.

***We had a net loss of \$9.6 million and an accumulated deficit of \$44.2 million as of the year ending December 31, 2003. As a result, we must generate substantially greater revenues from sales in order to achieve profitability.***

We have incurred significant operating losses and are uncertain about our future operating results. For the year ended December 31, 2003, we incurred a net loss of \$9.6 million and had an accumulated deficit of approximately \$44.2 million at December 31, 2003. In addition, our revenues have declined from \$16.7 million in 2001, to \$7.8 million in 2002, and \$6.5 million in 2003. We need to generate and sustain substantially greater revenues from the sales of our products if we are to achieve profitability. If we are unable to achieve these greater revenues, our losses will continue indefinitely, and we may never achieve or sustain profitability or generate positive cash flow.

***We face intense competition from both start-up and established companies that may have significant advantages over us and our products.***

The market for network security solutions is intensely competitive. There are numerous companies competing with us in various segments of the data security markets, and their products may have advantages over our products in areas such as conformity to existing and emerging industry standards, interoperability with networking and other security products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support.

Our principle competitors in the network intrusion and detection market include Internet Security Systems, Inc., Cisco Systems, Inc., Symantec, Inc., Netscreen Technologies, Inc., Tipping Point Technologies Inc. and NFR Security, Inc. The market for regulated information compliance systems is relatively new. Our competitors in this market include a number of start up companies that have entered the market in the last two years. However, as this market develops, we expect increased competition from both start up and established companies. Our current and potential competitors may have one or more of the following significant advantages over us:

greater financial, technical and marketing resources;

better name recognition;

more comprehensive security solutions;

better or more extensive cooperative relationships; and

larger customer base.

Although we believe that our focus on network perimeters with market leading VPN/firewall control technology and network intrusion detection visibility technology that reduce the total cost of ownership provides us with an advantage with large organizations with complex security requirements, we cannot assure you that our products will achieve market acceptance or that we will be able to compete successfully with our existing or new competitors.

***Military actions may disrupt our business by reducing spending on our products, increasing our costs and affecting our international operations.***

United States military actions or other events occurring in response to or in connection with them, including future terrorist attacks, actual conflicts involving the United States or its allies or military or trade disruptions could impact our operations by:

reducing or delaying government or corporate spending on network security products;

increasing the cost and difficulty in obtaining materials or shipping products; and

affecting our ability to conduct business internationally.

Should these events occur, our business, operating results and financial condition could be materially and adversely affected.

***Our products can have long sales and implementation cycles, which may result in us incurring substantial expenses before realizing any associated revenues.***

The sale and implementation of our products to large companies and government agencies typically involves a lengthy education process and a significant technical evaluation and commitment of capital and other resources. This process is also subject to the risk of delays associated with customers' internal budgeting and other procedures for approving capital expenditures, deploying new technologies within their networks and testing and accepting new technologies that affect key operations. As a result, sales and implementation cycles for our products can be lengthy, and we may expend significant time and resources before we receive any revenues from a customer or potential customer. Our quarterly and annual operating results could be materially harmed if orders forecasted for a specific customer for a particular period are not realized.

***Our cash, cash equivalents, and investments declined from \$10.7 million to \$2.7 million during 2003. As a result of our expected continuing net cash outflows, we may not have sufficient cash to operate our business.***



As of December 31, 2003, we had cash, cash equivalents and investments in the amount of approximately \$2.7 million, down from approximately \$10.7 million as of December 31, 2002. Although we believe the additional \$5.0 million in gross proceeds we received in connection with a private placement of preferred stock and warrants we completed on March 25, 2004 will provide us with sufficient cash resources to finance our operations for the next twelve months, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite our actions to reduce costs and improve profitability, we expect our net operating losses and net operating cash outflows to continue through at least the first half of 2004. We do not currently have any further arrangements for financing, and we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, at the time when we need this financing. If our business does not generate sufficient cash flow from operations and sufficient financing resources are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

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

Since we began restructuring in 2002, we have incurred approximately \$0.7 million in restructuring charges, severance, and related expenses. The objective of our restructuring plan was to reduce our cost structure to a sustainable level that is consistent with our current cash resources and the general economic climate. We have also implemented other strategic initiatives to strengthen our operations, such as reductions in our work force and facilities and aligning our organization around our business objectives. Any further work force reductions could result in temporary reduced productivity of our remaining employees. Additionally, our customers and prospects may delay or forgo purchasing our products due to a perceived uncertainty caused by our restructuring and other changes. Failure to achieve the desired results of our initiatives could seriously harm our business, results of operations and financial condition.

***Consolidation in the network security industry may limit market acceptance of our products.***

Several of our competitors have acquired security companies with complementary technologies in the past, and we expect consolidation in the network security industry to continue in the future. These acquisitions may permit our competitors to accelerate the development and commercialization of broader product lines and more comprehensive solutions than we currently offer. Acquisitions of vendors or other companies with which we have a strategic relationship by our competitors may limit our access to commercially significant technologies. Further, business combinations in the network security industry are creating companies with larger market share, customer bases, sales forces, product offerings and technology and marketing expertise, which may make it more difficult for us to compete.

***Sales to government agencies accounted for 17% of our revenues for the year ended December 31, 2003. Sales to government customers involve unique risks, which could adversely impact our revenues.***

We derived 17.0% of our revenues from sales to various U.S. government entities for the year ended December 31, 2003. We expect to continue to derive a substantial portion of our revenues from U.S. government customers in the future. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruption due to appropriation and spending patterns and the government's right to cancel contracts and purchase orders for its convenience. General political and economic conditions, which we cannot accurately predict, directly and indirectly may affect the quantity and allocation of expenditures by federal departments. In addition, obtaining government contracts may involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, budgetary constraints, political agendas, extensive specification development and price negotiations and milestone requirements. Each government entity also maintains its own rules and regulations with which we must comply and which can vary significantly among departments. As a result, cutbacks or re-allocations in the federal budget or losses of government sales due to other factors could have a material adverse effect on our revenues and operating results.

***We derived 31.4% of our revenues from international sales for the year ended December 31, 2003. Our ability to sell our products internationally is subject to certain risks, which could harm our business.***

Sales to foreign customers accounted for approximately 31.4% of our revenues for the year ended December 31, 2003. We expect sales to foreign customers to continue to represent a significant portion of our revenues in the future. Our international operations are subject to many inherent risks that may adversely affect our business, financial condition and operating results, including:

political, social and economic instability;

trade restrictions;

increases in duty rates and other potentially adverse tax consequences;

exposure to different legal standards, particularly with respect to the protection of intellectual property;

burdens of complying with a variety of foreign laws;

unexpected changes in regulatory requirements;

import and export license requirements and restrictions of the United States and each other country where we operate;

fluctuations in currency exchange rates; and

changes in local purchasing practices, including seasonal fluctuations in demand.

***Sales through indirect channels accounted for 57% of our revenues for the year ended December 31, 2003. Our revenues will suffer if we do not expand our sales through, or receive the anticipated benefits from our sales through, indirect sales channels.***

We derived 57% of our revenues for the year ended December 31, 2003 from sales through indirect sales channels, such as distributors, value added resellers, system integrators, original equipment manufacturers and managed service providers. We believe we must expand our sales through these indirect channels in order to increase our revenues. Although we are actively pursuing a strategy to increase the percentage of our revenues generated through these indirect sales channels, we cannot assure you that our products will gain market acceptance in these indirect sales channels or that sales through these indirect sales channels will increase our revenues as expected. Further, many of our competitors are also trying to sell their products through these indirect sales channels, which could result in lower prices and reduced profit margins for sales of our products.

***We must adequately protect our intellectual property in order to prevent loss of valuable proprietary information.***

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and non-disclosure agreements to protect our proprietary technology. However, unauthorized parties may attempt to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our intellectual property. This is particularly true in foreign countries where the laws may not protect proprietary rights to the same extent as the laws of the United States and may not provide us with an effective remedy against unauthorized use. If our protection of our intellectual property proves to be inadequate or unenforceable, others may be able to use our proprietary developments without compensation to us, resulting in potential cost advantages to our competitors.

***We may incur substantial expenses defending ourselves against claims of infringement.***

There are numerous patents held by many companies relating to the design and manufacture of network security systems. Although we are not aware of any instances in which our products violate the intellectual property rights of others or inappropriately use their technology, it is possible that third parties in the future may claim that our products infringe on their intellectual property rights. Any claim, with or without merit, could consume our management's time, result in costly litigation, cause delays in sales or implementations of our products or require us to enter into royalty or licensing agreements. Royalty and licensing agreements, if required and available, may be on terms unacceptable to us or detrimental to our business. Moreover, a successful claim of product infringement against us or our failure or inability to license the infringed or similar technology on commercially reasonable terms could seriously harm our business.

***Fluctuations in our quarterly revenues may cause the price of our common stock to decline.***

Our operating results have varied significantly from quarter to quarter in the past, and we expect our operating results to vary from quarter to quarter in the future due to a variety of factors, many of which are outside of our control. Although our revenues are subject to fluctuation, significant portions of our expenses are not variable in the short term, and we cannot reduce them quickly to respond to decreases in revenues. Therefore, if revenues are below our expectations, this shortfall is likely to adversely and disproportionately affect our operating results. Accordingly we may not attain positive operating margins in future quarters. Any of these factors could cause our operating results to be below the expectations of securities analysts and investors, which likely would negatively affect the price of our common stock.

***The price of our common stock has been volatile in the past and may continue to be volatile in the future due factors outside of our control.***

The market price of our common stock has been highly volatile in the past and may continue to be volatile in the future. For example, since June 1, 2003, the market price of our common stock on The Nasdaq SmallCap Market has fluctuated between \$1.40 and \$5.54 per share. The market price of our common stock may fluctuate significantly in response to a number of factors, many of which are outside our control, including:

variations in our quarterly operating results;

changes in estimates of our financial performance by securities analysts;

changes in market valuations of our competitors;

announcements by us or our competitors of new products, significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;

product or design flaws, product recalls or similar occurrences;

additions or departures of key personnel;

sales of common stock in the future; and

fluctuations in stock market prices and volume, which can be particularly common among network security and other high technology companies.

***Our recent reductions in our work force may make it more difficult for us to attract and retain the personnel necessary to successfully operate our business.***

We rely upon the continued service of a relatively small number of key technical, sales and senior management personnel. Our future success depends on retaining our key employees and our continuing ability to attract, train and retain other highly qualified technical, sales and managerial personnel. We have employment agreements with relatively few of our key technical, sales and senior management personnel. As a result, our employees could resign with little or no prior notice. We may not be able to attract, assimilate or retain other highly qualified technical, sales and managerial personnel in the future, especially given our recent reductions in force. The loss of any of our key technical, sales and senior management personnel or our inability to attract, train and retain additional qualified personnel could seriously harm our business.

***Certain rights of the holders of 5% convertible preferred stock may hinder our ability to raise additional financing.***

We cannot issue shares of capital stock with rights senior to those of our existing preferred or incur certain indebtedness without the approval of at least a majority of the holders of our 5% convertible preferred stock. In addition, holders of the preferred stock who are not executive officers or directors have the right to purchase a pro rata portion of certain future issuances of securities by us. The combination of these provisions could hinder or delay our ability to raise additional debt or equity financing.

***You will experience substantial dilution upon the conversion of the shares of preferred stock and exercise of warrants that we issued in a private placement.***

On March 25, 2004, we completed a \$5,000,000 private placement in connection with which we issued 1,000,000 shares of our 5% Convertible Preferred Stock and warrants to acquire 556,619 shares of our common stock. The conversion price for the preferred stock and the exercise price of the warrants is \$3.144 per share. We also issued our placement agent a warrant for 64,408 shares of our common stock at an exercise price of \$3.144 per share. As a result, we expect the private placement to result in dilution to holders of our common stock upon conversion of the preferred stock and exercise of the warrants of 2,221,358 shares of common stock, or an approximately 43% increase in the number of shares of our common stock outstanding.

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

Upon the effectiveness of the registration statement related to this prospectus, the holders of preferred stock and warrants we issued in the private placement will be able to freely convert their shares of preferred stock and exercise their warrants and sell their underlying shares of common stock. For the four weeks ended on July 9, 2004, the average daily trading volume of our common stock on The Nasdaq SmallCap Market was 6,803 shares. Consequently, if holders of preferred stock or warrants elect to convert their shares or exercise their warrants and sell a material amount of their underlying shares of common stock on the open market, the increase in selling activity could cause a decline in the market price of our common stock. Furthermore, these sales, or the potential for these sales, could encourage short sales, causing additional downward pressure on the market price of our common stock.

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

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

***Our acquisition of complementary products or businesses may adversely affect our financial condition.***

We have made acquisitions in the past, and, in the future, we may acquire or invest in additional companies, business units, product lines or technologies to accelerate the development of products and sales channels complementary to our existing products and sales channels. Negotiation of potential acquisitions and integration of acquired products, technologies or businesses could divert our management's time and resources. Future acquisitions could cause us to issue equity securities that would dilute your ownership of us, incur debt or contingent liabilities, amortize intangible assets or write off in-process research and development, goodwill and other acquisition-related expenses that could seriously harm our financial condition and operating results. Further, if we are not able to properly integrate acquired products, technologies or businesses with our existing products and operations, train, retain and motivate personnel from the acquired business or combine potentially different corporate cultures, we may not receive the intended benefits of our acquisitions, which could adversely affect our business, operating results and financial condition.

***The payment of accrued dividends on our 5% convertible preferred stock may strain our cash resources.***

Shares of our 5% convertible preferred stock accrue cash dividends equal to \$0.25 per share per annum. These dividends are payable in arrears on March 31 and September 30 of each year, commencing on September 30, 2004. Delaware law provides that we may only pay dividends out of our capital surplus or, if no surplus is available, out of our net profits for the fiscal year the dividend is declared and/or the preceding fiscal year. We have not had net profits for the last two fiscal years, and as of December 31, 2003 our capital surplus, defined as the amount by which our net assets exceed our stated capital, was approximately \$2.2 million. Therefore, we have only limited resources to pay these dividends. In addition, the payment of these dividends could strain our available cash resources, which could adversely affect our ability to operate or grow our business.

***Compliance with export regulations may hinder our sales to foreign customers.***

Certain of our data security products incorporate encryption and other technology that may require clearance and export licenses from the U.S. Department of Commerce under United States export regulations. Any inability to obtain these clearances or licenses or any foreign regulatory approvals, if required, on a timely basis could delay sales and have a material adverse effect on our operating results.

***Provisions of our charter documents and Delaware law may have anti-takeover effects.***



Certain provisions of our certificate of incorporation and bylaws, such as our ability to offer "blank check" preferred stock and the inability of our stockholders to act by written consent, could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. We are also subject to the provisions of Section 203 of the Delaware General Corporation Law, which restricts certain business combinations with interested stockholders and could inhibit a non-negotiated merger or other business combination.

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

As of May 31, 2004, our executive officers, directors and 5% stockholders beneficially own approximately 38.5% of our voting power. As a result, these stockholders will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us. These stockholders may use their influence to approve or take actions that may be adverse to your interests.

## **Item 2. Properties.**

Our headquarters are located in a two-story building in Richardson, Texas, with an aggregate of approximately 95,000 square feet of floor space. This facility includes our corporate administration, operations, marketing, research and development, sales and technical support personnel. We occupy this facility under a lease, the base term of which expires in February 2005, with two seven-year options to extend the lease term, subject to compliance with certain conditions.

Subsequent to December 31, 2003, we successfully renegotiated our lease agreement for our headquarters in Richardson, Texas, which decreased the amount of square feet we lease and extended the lease term for an additional five years. According to the new lease agreement, our Richardson, Texas headquarters will be located in the same building. However, we will lease approximately 30,000 square feet of floor space and the term of our lease will expire in February 2010.

Personnel of Essential were located in a 15,120 square foot leased property in Albuquerque, New Mexico. The lease was scheduled to expire in February 2009. In March 2002, we sold the assets of Essential (see Discontinued Operations). A condition of the sale was to give Essential personnel 60 days to exit the facility. Included in the total \$0.4 million gain on the sale of Essential in March 2002 was a \$0.3 million reserve to terminate the lease, which is the equivalent of 2 years' lease and maintenance of the facility. Successful termination of the Essential lease for less than \$0.3 million resulted in a \$0.1 million gain on disposition during the fourth quarter of 2002, for a total gain on Discontinued Operations for 2002 of \$0.5 million.

Approximately one-half of our security software research and development staff is located in a 6,464 square foot leased property in San Diego, California. This lease was renewed in August 2002 and will expire in August of 2004. Research and development personnel occupy this facility.

In addition, we lease small amounts of office space for sales and technical support personnel domestically and internationally in England, France, Germany and Malaysia. We believe that the existing facilities at December 31, 2003 will be adequate to meet our requirements through 2004. See Note 6 of Notes to Consolidated Financial Statements for additional information regarding our obligations under leases.

**Item 3. Legal Proceedings.**

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

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

There were no matters submitted to a vote of our security holders during the fourth quarter of 2003.

## PART II

**Item 5. Market for Intrusion's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Prior to December 4, 2002, our common stock traded on The Nasdaq National Market. Since that time our common stock has traded on the Nasdaq SmallCap Market, where it is currently listed under the symbol "INTZC", subject to the conditional listing parameters explained in Factors That May Affect Future Results of Operations. As of February 10, 2004, there were approximately 213 registered holders of record of the common stock. The following table sets forth, for the periods indicated, the high and low per share intra-day sales prices for the common stock, as reported by The Nasdaq Stock Market.

	2003		2002	
	High	Low	High	Low
First Quarter	\$ 0.50	\$ 0.15	\$ 2.15	\$ 1.20
Second Quarter	1.15	0.12	1.85	0.76
Third Quarter	1.20	0.56	1.12	0.01
Fourth Quarter	1.38	0.49	0.69	0.24

We have not declared or paid cash dividends on our capital stock in our two most recent fiscal years. We currently retain any earnings for use in our business and do not anticipate paying any cash dividends on our common stock in the foreseeable future. Future dividends on common stock, if any, will be determined by our Board of Directors. However, our 5% Convertible Preferred Stock accrues cash dividends equal to \$0.25 per share per annum. These dividends are payable in arrears, on March 31 and September 30 of each year, commencing on September 30, 2004.

All stock option plans under which our Common Stock is reserved for issuance have previously been approved by our shareholders. The following table provides summary information as of December 31, 2003 for all of our stock option plans (in thousands, except per share data). See Note 10 to our consolidated financial statements for additional discussion.

	Number of Shares of Common Stock to be Issued upon Exercise of Outstanding Options	Weighted Average Exercise Price of Outstanding Options, Excludes Warrants Rights	No. of Shares of Common Stock Remaining Available for Future Issuance
Equity compensation plans approved by security holders	1,496(1)	\$ 3.77	1,852(2)
Equity compensation plans not approved by security holders			
Total	1,496	3.77	1,852

(1) Included in the outstanding options are 1,278,945 from the 1995 Plan, 30,700 from the 1987 Plan, 178,000 from the 1995 Non-Employee Director Plan and 8,000 from previous director grants prior to 1995 Non-Employee Director Plan.

(2) Does not include Employee Stock Purchase Plan. At December 31, 2003, 319,626 shares were available for future issuance under this plan.

**Item 6. Selected Financial Data.**

The following selected consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this Form 10-K and the consolidated financial statements and notes thereto included in Item 15 of this Form 10-K. Continuing operations consisted of our information security business, which began operations in 1998. Discontinued operations are composed of our local area networking divisions, which were discontinued in April 2000 and Essential, which was discontinued in March 2001.

**Statement of Operations Data:**

(In thousands, except per share data)

	Year Ended December 31,				
	2003	2002	2001	2000	1999
Revenue	6,478	\$ 7,834	\$ 16,685	\$ 23,210	\$ 7,963
Cost of Revenue	3,988	6,147(5)	13,490	19,009	3,877
Gross profit	2,490	1,687	3,195	4,201	4,086
Operating expenses:					
Sales and marketing	6,230	11,789	23,550	27,740	12,236
Research and development	3,498	6,088	12,549	13,073	8,171
In-process research and development					
General and administrative	1,632	2,576	4,481	5,865	2,466
Amortization of intangibles		798	1,233	975	547
Impairment of intangibles		3,009(4)			
Litigation Settlement	450(6)				
Severance costs	472	200	4,673(2)		
Operating loss	(9,792)	(22,773)	(43,291)	(43,452)	(19,334)
Interest income, net	182	351	1,687	3,301	1,104
Other income (expense)	10	(7)	112	66,335(1)	
Income (loss) from continuing operations before income tax	(9,600)	(22,429)	(41,492)	26,184	(18,230)
Income tax provision (benefit)		(608)	(1,877)	1,999	
Income (loss) from continuing operations	(9,600)	(21,821)	(39,615)	24,185	(18,230)
Income (loss) from discontinued operations, net of tax		544(3)	(6,165)	(974)	6,190
Net income (loss)	(9,600)	(21,277)	\$ (45,780)	\$ 23,211	\$ (12,040)
Basic earnings (loss) per share, continuing operations	(0.46)	(1.06)	\$ (1.93)	\$ 1.23	\$ (0.98)
Diluted earnings (loss) per share, continuing operations	(0.46)	(1.06)	\$ (1.93)	\$ 1.18	\$ (0.98)
Basic earnings (loss) per share	(0.46)	(1.03)	\$ (2.23)	\$ 1.18	\$ (0.65)
Dilutive earnings (loss) per share	(0.46)	(1.03)	\$ (2.23)	\$ 1.13	\$ (0.65)

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Year Ended December 31,

Weighted average shares outstanding					
Basic	20,649	20,640	20,565	19,624	18,565
Diluted	20,649	20,640	20,565	20,478	18,565

**Balance Sheet Data:**

	<u>2003</u>		<u>2002</u>		<u>2001</u>		<u>2000</u>		<u>1999</u>
Working capital	2,410	\$	10,701	\$	25,240	\$	52,514	\$	66,578
Total assets	5,760		16,939		42,295		92,414		120,502
Total liabilities	2,976		4,555		8,797		13,627		38,925
Total stockholders' equity	2,784		12,384		33,498		78,787		81,577

- (1) Other income for the year ending December 31, 2000 is comprised primarily of a \$66.4 million pre-tax gain realized on the sale of Alteon WebSystems, Inc. common stock.
- (2) Restructuring costs for the year ending December 31, 2001 include the impairment of certain intangible assets associated with obsolete product lines and severance and lease termination costs for restructuring activities.
- (3) Gain on discontinued operations in 2002 relates to the original gain on sale of \$0.5 million along with \$0.1 million gain related to the successful early termination of the Essential lease for less than the associated provided reserve.
- (4) Impairment charge taken in December 2002 to write off all intangible assets related to the Mimestar acquisition.
- (5) Includes a \$1.0 million charge to write off SecureCom inventory no longer expected to be sold.
- (6) Results from the settlement of Morgan Newton lawsuit mediated during 2003.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Notes to the Consolidated Financial Statements.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.****"Safe Harbor" Statement under the Private Litigation Reform Act of 1995**

This Annual Report, other than historical information, may include forward-looking statements, including statements with respect to financial results, product introductions, market demand, sales channels, industry trends, sufficiency of cash resources and certain other matters. These statements are made under the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and involve risks and uncertainties which could cause actual results to differ materially from those in the forward-looking statements, including those discussed in the section entitled "Factors That May Affect Future Results of Operations" in Item 1 and elsewhere in this Annual Report on Form 10-K and other filings with the Securities and Exchange Commission.

This report may include various non-GAAP financial measures (as defined by SEC Regulation G), including our cash used in operations excluding costs associated with a litigation settlement and severance charges. Our management believes these measures provide useful information to investors about our financial condition and results of operations for the period presented by eliminating the affects of one-time and other transactions that can distort underlying operational results in order to provide greater comparability of our financial performance on a year-to-year basis. The most directly comparable GAAP financial measures and reconciliation of the difference between GAAP and non-GAAP financial measures can be found in the test of this report and our consolidated financial statements included in this report.

## Overview

We develop, market and support a family of network intrusion prevention and detection systems and regulated information compliance systems that address vital security issues facing organizations with mission critical business applications or housing classified, confidential, or customer information assets. We currently provide network security and regulated information compliance solutions under our SecureNet family of hardware and software solutions. 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. During the second quarter of 2000, we announced our plan to sell, or otherwise dispose of, our networking divisions, which included our Essential Communications division and our local area networking assets, and began accounting for these networking divisions as discontinued operations.

Our revenues have decreased over the past three years due primarily to the change in our product focus from networking hardware to network security software products and a decrease in sales volume related to this transition. As a result, our revenues have declined over the past three years from \$16.7 million in 2001, to \$7.8 million in 2002 and to \$6.5 million in 2003. To date, we have not encountered significant competition in the market, which has caused a decrease in our sales prices when compared to sales prices in previous years. Our networking hardware products carried much higher sales prices than do our network security products. Consequently, as we migrated away from the networking hardware business, our revenues from large network sales negatively impacted our gross sales figures. In addition, changing markets from networking hardware to security solutions, resulted in longer sales cycles and decreased total sales, as both volume and unit prices declined. To help counteract our declining revenues and bring our operations in line with our new strategic focus, we reduced our employee headcount and discontinued manufacturing operations. Our global headcount has declined over the past three years in an effort to reduce costs and align our efforts with our core software based products. As we migrated away from the networking and hardware based products, our global headcount declined from 149 employees in 2001, to 78 employees in 2002 and to 44 employees in 2003. As a result of our headcount reductions, we realized cost savings of \$9.0 million in 2002 and \$2.8 million in 2003. As a result of our migration to software-based solutions and the discontinuance of manufacturing operations, our margins have increased over the past three years from 19.1% in 2001, to 21.5% in 2002 and to 38.4% in 2003. We have also restructured our personnel and operations around the development and sale of our core software products. In addition, we have also been able to secure reduced lease space, which has helped reduce our operating expenses. We expect to realize approximately \$350,000 annually in cost savings related to our renegotiated lease. As a result of these efforts, we believe we have reduced operating expenses to a level that will remain constant going forward.

The reductions to our operating expenses, in particular research and development expenses, over the past few years have not significantly impacted our research and development efforts, as we continue to expand our product offerings. We are not allocating resources to hardware development, as in the past, and we are able to focus on new product offerings related to our software-based products. We expect our product offering to continue to expand as we continue to offer new and expanded products for the intrusion detection, intrusion prevention and regulated information compliance markets.

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

### **Critical Accounting Policies and Estimates**

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

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our 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 have been met: i) execution of a written agreement; ii) delivery of the product has occurred; iii) the fee is fixed and determinable; and iv) collectibility is probable. Bundled hardware and perpetual software product sales are recognized at time of delivery, as our licenses are not sold on a subscription basis. In the case of multiple product and service sales, we perform a Vendor Specific Objective Evidence analysis to appropriately determine the amount of revenue derived from each deliverable. If our license strategy changes and we begin to offer licenses on a subscription basis, we would perform this analysis in a similar manner. Under these circumstances, the revenue related to the license would be recognized ratably over the subscription period. Market values are easily obtained for all of our product offerings, as we have historical sales information on our product offerings. We defer and recognize maintenance and support revenue over the term of the contract period, which is generally one year.

We have signed distribution agreements with distributors in the United States, Europe and Asia. In general, these relationships are non-exclusive. Distributors typically maintain an inventory of our products. Under these agreements, we provide certain protection to the distributors for their inventory of our products for price reductions as well as products that are slow moving or have been discontinued by us. Historically, returns from our distributors and charges related to price reductions on inventory held by distributors have not been material. Recognition of sales to distributors and related gross profits are deferred until the distributors resell the merchandise. However, since we have legally sold the inventory to the distributor and we no longer have care, custody or control over the inventory, we recognize the trade accounts receivable and reduce inventory related to the sale at the time of shipment to the distributor. Revenue, offset by deferred cost of sales, is included in deferred revenue in the accompanying financial statements. Since the net balance in Deferred Revenue represents the sales price less the cost of the product maintained by the distributors, the deferred costs of these products are included in our obsolescence and slow-moving analysis and are written down according to their current value. This transaction, effectively recognizes expense for the write-down, if any, and increases the net liability in the deferred revenue account.

We generally recognize service revenue upon delivery of the contracted service. Service revenue, primarily including maintenance, training and installation are recognized upon delivery of the service and typically are unrelated to product sales. These services are not essential to the functionality of the delivered product. To date, training and installation revenue has not been material.

#### *Goodwill and Other Intangible Assets*

Effective January 1, 2002, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"), which requires companies to cease amortizing goodwill and certain intangible assets with indefinite useful lives. Instead, SFAS 142 requires that goodwill and intangible assets deemed to have indefinite useful lives be reviewed for impairment upon adoption of SFAS 142, annually thereafter, and upon the occurrence of any event that indicates potential impairments.

In accordance with SFAS 142, we discontinued recording goodwill amortization effective January 1, 2002.

SFAS 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for potential impairment, while the second phase (if necessary) measures the impairment. Goodwill is potentially impaired if the net book value of a reporting unit exceeds its estimated fair value. We have determined that we have one reporting unit. This methodology differs from the Company's previous policy, as permitted under accounting standards existing at that time, of using undiscounted cash flows on an enterprise-wide basis to determine if goodwill is recoverable.

The Company elected to perform its annual impairment review during the fourth quarter of each year, commencing in the fourth quarter of 2002. In connection with our annual impairment review, we determined that the value of goodwill was impaired. At the time of our impairment review, the remaining goodwill of \$0.4 million was associated with the MimeStar purchase transaction. Based on the decline in the market value of the Company as indicated by the decline in its stock price over the last year, it was determined that the goodwill carrying value should be zero at December 31, 2002. Therefore, an impairment charge of \$0.4 million was recorded and is included in impairment of intangibles in the accompanying consolidated statement of operations.

This is not considered to be a critical accounting policy at December 31, 2003, but was previously.

#### *Long-Lived Assets*

Effective January 1, 2002, we adopted the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," ("SFAS 121") and accounting and reporting provisions of Accounting Principles Bulletin Opinion 30, "Reporting the Results of Operations," for a disposal of a segment. The primary objective of SFAS 144 is to develop one accounting model based on the framework established in SFAS 121 for long-lived assets to be disposed of and significantly changes the criteria that would have to be met to classify an asset as held for sale. SFAS 144 also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date. Our adoption of SFAS 144 had no effect on the Company's financial position or results of operations.

We review long-lived assets, other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Conditions that would necessitate an impairment assessment include material adverse changes in operations, significant adverse differences in actual results in comparison with initial valuation forecasts prepared at the time of acquisition, a decision to abandon acquired products, services or technologies, or other significant adverse changes that would indicate the carrying amount of the recorded asset might not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset to undiscounted pre tax future net cash flows expected to be generated by that asset. An impairment loss is recognized for the amount by which the carrying amount of the assets exceeds the fair value of the assets. Long-lived assets held for sale are reported at the lower of cost or fair value less costs to sell.

As a result of the write-off of goodwill during the fourth quarter of 2002, we determined that a triggering event indicating potential impairment of the associated intangibles had occurred. At December 31, 2002, the remaining intangibles of \$2.6 million principally included purchased software associated with our acquisition of MimeStar, Inc. We determined that the undiscounted pre tax cash flows associated with this software was not likely to exceed the remaining carrying values. Due to technological changes that had taken place with respect to the core software code acquired, it was determined that the carrying value should be zero at December 31, 2002. Therefore, an impairment charge of \$2.6 million was recorded and is included in impairment of intangibles in the accompanying consolidated statement of operations.

This is not considered to be a critical accounting policy at December 31, 2003, but was previously.

*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.

**Results of Operations**

The following tables set forth, for the periods indicated, certain financial data as a percentage of net revenue.

	Year Ended December 31,		
	2003	2002	2001
Net product revenue	64.8%	65.1%	85.1%
Net customer support and maintenance revenue	35.2	34.9	14.9
<b>Total revenue</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Cost of product revenue	50.1	60.5	75.2
Cost of customer support and maintenance revenue	11.5	18.0	5.7
<b>Total cost of revenue</b>	<b>61.6</b>	<b>78.5</b>	<b>80.9</b>
<b>Gross profit</b>	<b>38.4</b>	<b>21.5</b>	<b>19.1</b>
Operating expenses:			
Sales and marketing	96.2	150.5	141.1
Research and development	54.0	77.7	75.2
General and administrative	25.2	32.9	26.9
Amortization of intangibles		10.2	7.4
Impairment of intangibles		38.4	
Litigation Settlement	6.9		
Severance costs	7.3	2.6	28.0
<b>Operating loss</b>	<b>(151.2)</b>	<b>(290.7)</b>	<b>(259.5)</b>
Interest income, net	2.8	4.5	10.1
Other income (expense)	0.2	(0.1)	0.7
<b>Loss from continuing operations before income tax</b>	<b>(148.2)</b>	<b>(286.3)</b>	<b>(248.7)</b>
Income tax benefit		(7.8)	(11.2)
<b>Loss from continuing operations</b>	<b>(148.2)</b>	<b>(278.5)</b>	<b>(237.4)</b>
Income (loss) from discontinued operations, net of tax		6.9	(36.9)
<b>Net loss</b>	<b>(148.2)</b>	<b>(271.6)</b>	<b>(274.4)</b>
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Domestic revenue	68.6%	66.6%	63.6%
Export revenue to:			
Europe	23.0	14.5	25.4
Canada	0.9	4.0	4.0
Asia	7.4	14.6	6.3
Latin America	0.1	0.3	0.7
<b>Net revenue</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**2003 compared with 2002**

***Net Revenue***

Net revenue decreased 17.3% to \$6.5 million in 2003 from \$7.8 million in 2002. This decline is related to the transition away from our hardware-based products, which carried higher sales prices and lower margins to our software-based products, which carry lower sales prices and higher margins. Our customer support and maintenance revenue decreased 16.6% from \$2.7 million in 2002 to \$2.3 million in 2003. This decline is mainly due to the expiration of maintenance contracts related to our legacy products and lower support and maintenance revenues associated with our lower priced software-based products. In addition, we believe the general worldwide economic downturn and reductions in corporate information technology spending negatively impacted our sales of SecureNet network intrusion detection products and PDS security appliance products. In 2003 total revenues related to our SecureNet product line increased 9.5% or \$0.4 million from \$4.2 million in 2002 to \$4.6 million in 2003, and our non-core product lines, including our PDS and SecureCom hardware products decreased 47.2% or \$1.7 million from \$3.6 million in 2002 to \$1.9 million in 2003. Our product revenues declined 17.7% from \$5.1 million in 2002 to \$4.2 million in 2003. This decrease was the result of our strategic decision to move away from our lower margin higher priced legacy product offerings.

Export sales in 2003 decreased to \$2.0 million, or 31.4% of net revenue, compared to \$2.6 million, or 33.4% of net revenue in 2002 primarily due to a continued economic decline and decrease in international technology spending. As part of our headcount reductions, we have focused most of our sales personnel on the domestic market. Although we do expect to continue to derive a significant portion of our revenues from international sales, we do not rely on any one country, region or customer for these sales. Sales of our products internationally may be subject to exchange risk, which may cause our products to effectively increase in price, if the exchange rate moves significantly and the dollar gains value over the foreign currency.

Historically, due to the timing of our sales cycle, a significant portion of our monthly sales occurs in the second half of the month. Accordingly, our receivables increase at the end of each month, which causes a higher accounts receivable balance at month end. This monthly trend also causes an inflated comparative relationship between revenue and accounts receivable. We believe that this trend will continue because monthly sales forecast and planning meetings are held in the first week of every month, the middle of the month is focused on sales calls to customers and the later half of the month on closing sales. The monthly trend was exaggerated at December 2003, due to unusually high sales volume occurring in the last half of the month.

***Gross Profit***

Gross profit increased 47.6% to \$2.5 million in 2003 from \$1.7 million in 2002. As a percentage of net revenue, gross profit increased to 38.4% for 2003 from 21.5% in 2002. This increase is primarily associated with a more profitable product mix in 2003. Gross profit on products increased from 7.1% in 2002 to 22.7% in 2003 due to the shift in a more profitable product mix, namely our software-based products. Gross profit on customer support and maintenance increased from 48.4% in 2002 to 67.4% in 2003. The increase in gross profit on customer support and maintenance was mainly due to lower hardware related repair costs in conjunction with our strategic decision to move towards software-based solutions. As we continue to migrate from our older hardware-based products to our newer software-based products, we expect our margins to continue to increase.

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

### ***Sales and Marketing***

Sales and marketing expenses decreased 47.2% to \$6.2 million in 2003 from \$11.8 million in 2002 as we restructured our sales force, including headcount reductions, to respond to the decline in sales. As a percentage of net revenue, sales and marketing expenses decreased to 96.2% in 2003 from 150.5% in 2002. We expect sales and marketing expenses to decrease in 2004 compared to 2003 as we recognize the full benefit from restructuring actions taken throughout 2002, 2003 and early 2004. Due to the renegotiation of our corporate lease and the benefit from the allocation to sales and marketing, we expect a positive impact on sales and marketing expenses of \$0.1 million in 2004. We also expect sales and marketing expenses, as a percentage of net revenue, to decrease in 2004 compared to 2003.

### ***Research and Development***

Research and development expenses decreased 42.5% to \$3.5 million, or 54.0% of net revenue, in 2003 compared to \$6.1 million, or 77.7% of net revenue, in 2002 as we reduced headcount in our engineering department to respond to the decline in sales and eliminated engineering efforts with regards to our SecureCom product family. Our research and development costs are expensed in the period in which they are incurred. We expect research and development expenses to decrease in 2004 compared to 2003 as we recognize the full benefit from restructuring actions taken throughout 2002 and 2003. Due to the renegotiation of our corporate lease and the benefit from the allocation to research and development, we expect a positive impact on research and development expenses of \$0.2 million in 2004. We expect research and development, as a percentage of net revenue, also to decrease in 2004 compared to 2003.

### ***General and Administrative***

General and administrative expenses, excluding amortization, impairment, severance and litigation settlement expenses, decreased 36.6% to \$1.6 million in 2003 from \$2.6 million in 2002 as we reduced headcount in our support functions to reduce costs. As a percentage of net revenue, general and administrative expenses decreased to 25.2% in 2003 from 32.9% in 2002. We expect general and administration expenses to remain constant in 2004 compared to 2003. Due to the renegotiation of our corporate lease, we expect a positive impact on general and administrative expenses of \$0.1 million in 2004.

### ***Amortization and Impairment of Intangibles***

Due to the impairment charge taken during 2002 to write all intangible assets down to zero at December 31, 2002, no amortization expense or impairment was recognized during 2003. Amortization of intangibles was \$0.8 million in 2002 prior to the adoption of SFAS No. 142, whereby goodwill was not amortized throughout the year. We took an impairment charge during December 2002 to write all intangible assets related to our acquisition of MimeStar, Inc. down to zero as a result of our annual SFAS 142 goodwill impairment test and other impairment reviews conducted during the fourth quarter of 2002. The total charge for the write-down was \$3.0 million. Total amortization and charges for impairment was \$3.8 million for 2002.

### ***Litigation Settlement***

During the third quarter of 2003, Intrusion settled a pending lawsuit with Morgan Newton. As a result of the settlement, Intrusion paid \$0.5 million during the fourth quarter of 2003 to fully satisfy this claim. There is no other litigation pending against Intrusion. There was no litigation settlement charge in 2002. Please see further discussion in note 6 to our consolidated financial statements.

### *Severance Costs*

In connection with our continued shift to our new intrusion detection and security appliance product lines during 2003, and as such, we streamlined operations and activities that are not aligned with these core markets and strategies. We recorded severance charges of \$0.5 million for severance as a result of reductions in force. All severance obligations related to the 2003 charge were paid prior to December 31, 2003 and we were not receiving any benefits from those severed individuals after December 31, 2003.

Pursuant to the restructuring action discussed above and those taken in 2002, we reduced operating expenses, excluding severance charges, litigation settlement charges, impairment charges and amortization, 26.2% from \$3.2 million in the first quarter of 2003 to \$2.4 million in the fourth quarter of 2003. During 2003, our gross margins increased from first quarter to fourth quarter due to product mix shift as we migrate to our more profitable software-based products, therefore, headcount reductions had no impact on margins during 2003 and are not expected to have an impact on our margins in the future.

### *Interest Income, Net*

Net interest income decreased 48.1% to \$0.2 million in 2003 from \$0.4 million in 2002 primarily due to a decrease in average cash and interest-bearing investment balances and lower interest rates. We do not expect net interest income to decrease in 2004 compared to 2003 as we expect our average cash and interest-bearing investment balances to increase in 2004 when compared to 2002, related to our private placement in the first quarter of 2004 and an expected increase in revenue in 2004. However, we do expect interest rates to remain low, resulting in a lower return on investment. Net interest income will vary in the future based on our cash flow and rate of return on investments.

### *Income Taxes*

Our effective income tax rate was 0% in 2003 as a valuation allowance has been recorded for the entire amount of the net deferred tax asset due to uncertainty of realization. Our effective income tax rate was an income tax benefit of 2.9% in 2002. We have fully utilized our net operating loss carryback.

### **2002 compared with 2001**

#### *Net Revenue*

Net revenue decreased 53.0% to \$7.8 million in 2002 from \$16.7 million in 2001. This decrease is related to the decline in sales of SecureCom and other products, which are approaching end-of-life, coupled with a longer sales cycle related to our newer products. Our customer support and maintenance revenue increased 10.2% from \$2.5 million in 2001 to \$2.7 million in 2002. We expect this trend to continue as we continue to populate the marketplace with our products. In addition, we believe the general worldwide economic downturn and reductions in corporate information technology spending negatively impacted our sales of SecureNet network intrusion detection products and PDS security appliance products. In 2002 total revenues related to our SecureNet product line decreased 35.4% or \$2.3 million from \$6.5 million in 2001 to \$4.2 million in 2002, and our non-core product lines, including our PDS and SecureCom hardware products decreased 64.7% or \$6.6 million from \$10.2 million in 2001 to \$3.6 million in 2002. Our product revenues declined 64.1% from \$14.2 million in 2001 to \$5.1 million in 2002.

Export sales in 2002 decreased to \$2.6 million, or 33.4% of net revenue, compared to \$6.1 million, or 36.4% of net revenue in 2001 primarily due to a continued economic decline and decrease in international technology spending. As part of our headcount reductions, we have focused most of our sales personnel on the domestic market. Although we do expect to continue to derive a significant portion of our revenues from international sales, we do not rely on any one country, region or customer for these sales. Sales of our products internationally may be subject to exchange risk, which may cause our products to effectively increase in price, if the exchange rate moves significantly and the dollar gains value over the foreign currency.

### ***Gross Profit***

Gross profit decreased 47.2% to \$1.7 million in 2002 from \$3.2 million in 2001. As a percentage of net revenue, gross profit increased to 21.5% for 2002 from 19.1% in 2001. This increase is primarily associated with a more profitable product mix in 2002.

Cost of revenue in 2002 includes a \$1.0 million fourth quarter write-off of SecureCom inventory as demand has shifted to our new intrusion detection and security appliance product lines. Absent of this write-off, gross profit would have been \$2.7 million or 33.8% as a percentage of net revenue.

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

### ***Sales and Marketing***

Sales and marketing expenses decreased 50.0% to \$11.8 million in 2002 from \$23.6 million in 2001 as we restructured our sales force, including headcount reductions, to respond to the decline in sales. As a percentage of net revenue, sales and marketing expenses increased to 150.5% in 2002 from 141.1% in 2001. We expect sales and marketing expenses to decrease in 2003 compared to 2002 as we recognize the full benefit from restructuring actions taken throughout 2002 and early 2003. We also expect sales and marketing expenses, as a percentage of net revenue, to decrease in 2003 compared to 2002.

### ***Research and Development***

Research and development expenses decreased 51.5% to \$6.1 million, or 77.7% of net revenue, in 2002 compared to \$12.5 million, or 75.2% of net revenue, in 2001 as we reduced headcount in our engineering department to respond to the decline in sales and eliminated engineering efforts with regards to our SecureCom product family. Our research and development costs are expensed in the period in which they are incurred. We expect research and development expenses to decrease in 2003 compared to 2002 as we recognize the full benefit from restructuring actions taken throughout 2002 and early in 2003. In addition, the lease agreement for our research and development facility in San Diego, California was renewed in September 2002 at a lower monthly rate for fewer square feet to accommodate the reduction in our research and development workforce. We expect research and development, as a percentage of net revenue, to decrease in 2003 compared to 2002.



***General and Administrative***

General and administrative expenses, excluding amortization expenses, decreased 42.5% to \$2.6 million in 2002 from \$4.5 million in 2001 as we reduced headcount in our support functions to reduce costs. As a percentage of net revenue, general and administrative expenses increased to 32.9% in 2002 from 26.9% in 2001. We expect general and administration expenses to decrease in 2003 compared to 2002 as we recognize the full benefit of restructuring actions taken throughout 2002 and early in 2003. In addition to the restructuring impact, amortization expense of \$0.8 million incurred in 2002 related to the intangible assets that were written off in December 2002 will not be incurred in 2003.

***Amortization and Impairment of Intangibles***

Amortization of intangibles decreased 35.3% to \$0.8 million in 2002 from approximately \$1.2 million in 2001, due to the adoption of SFAS No. 142 whereby goodwill was not amortized throughout the year. We took an impairment charge during December 2002 to write all intangible assets related to our acquisition of MimeStar, Inc. down to zero as a result of our annual SFAS 142 goodwill impairment test and other impairment reviews conducted during the fourth quarter. The total charge for the write-down was \$3.0 million. Total amortization and charges for impairment was \$3.8 million for 2002.

***Severance Costs***

In connection with our continued shift to our new intrusion detection and security appliance product lines during 2002, and as such, we streamlined operations and activities that are not aligned with these core markets and strategies. We recorded severance charges of \$0.2 million as a result of reductions in force. All severance obligations related to 2002 were paid prior to December 31, 2002 and we were not receiving any benefits from those severed individuals after December 31, 2002.

Pursuant to the action discussed above and those taken in 2001, we reduced operating expenses, excluding severance charges and amortization, 37.3% from \$6.5 million in the first quarter of 2002 to \$4.1 million in the fourth quarter of 2002.

***Interest Income, Net***

Net interest income decreased 79.2% to \$0.4 million in 2002 from \$1.7 million in 2001 primarily due to a decrease in average cash and interest-bearing investment balances and lower interest rates. We expect net interest income to decrease in 2003 compared to 2002 as we expect our average cash and interest-bearing investment balances to decline for 2003 when compared to 2002. In addition, we expect interest rates to remain low, resulting in a lower return on investment. Net interest income will vary in the future based on our cash flow and rate of return on investments.

***Income Taxes***

Our effective income tax rate was a benefit of 2.9% in 2002 compared to an income tax benefit of 4.8% in 2001. We have fully utilized our net operating loss carryback.

***Discontinued Operations***

In March 2002 we sold Essential for \$1 million generating a gain on sale of \$0.5 million. Terms of the sale included transferring \$0.7 million in net property, plant and equipment, \$0.1 million in current liabilities and product maintenance obligations for which \$0.4 million was recorded in deferred revenue.

A condition of the sale was to give Essential personnel 60 days to exit Essential's leased facility, the obligation for which we retained as part of the sale. Included in the gain on the sale of Essential was management's estimate of \$0.3 million to terminate this lease agreement, which was equivalent to two years' lease and maintenance of the facility. The contractual term of the lease ran through February 2009. Successful termination of the lease during the fourth quarter of 2002 for less than \$0.3 million resulted in additional gain on sale of \$0.1 million.

### **Liquidity and Capital Resources**

Our principal sources of liquidity at December 31, 2003 were \$1.0 million of cash and cash equivalents and \$1.7 million of short-term investments. As of December 31, 2003, we do not hold investments with a stated maturity beyond one year. Working capital at December 31, 2003 was \$2.4 million compared to \$10.7 million as of December 31, 2002.

Net cash used in continuing operations in 2003 was \$7.9 million, primarily due to an operating loss of \$9.6 million for the year, a decrease in accounts payable, and accrued expenses of \$0.7 million and a decrease in deferred revenue of \$0.9 million, offset by depreciation of \$1.4 million, and decreases in accounts receivable of \$1.4 million, other assets of \$0.3 million and inventories of \$0.1 million. Future fluctuations in accounts receivable, inventory balances and accounts payable will be dependent upon several factors, including but not limited to quarterly sales, timely collection of accounts receivable, and the accuracy of our forecasts of product demand and component requirements.

During 2003, our cash, cash equivalents and investments declined \$8.0 million from \$10.7 million on December 31, 2002 to \$2.7 million on December 31, 2003. During 2003 we continued to streamline our operations to better align our workforce with industry trends. This realignment caused our operating expenses, excluding severance charges, litigation settlement charges, impairment charges and amortization to reduce from \$3.2 million in the first quarter of 2003 to \$2.4 million in the fourth quarter of 2003. Based on our current expectations, the Company will incur operating losses and further usage of cash resources during the first half of 2004.

Net cash provided by investing activities in 2003 was \$6.0 million, which consisted of the net maturity and sale of \$6.1 million of available for sale securities and the net purchase of property and equipment of \$0.1 million.

At December 31, 2003, we did not have any material commitments for capital expenditures. Operating lease commitments of \$1.1 million are detailed below. During 2003, we funded our operations through the use of available cash, cash equivalents and investments.

As of December 31, 2003, we had cash, cash equivalents and investments in the amount of approximately \$2.7 million, down from approximately \$10.7 million as of December 31, 2002. However, throughout 2003, we reduced expenses. As a result, our cash used in operations, excluding the litigation settlement and severance charges, in the fourth quarter was approximately \$1.4 million. Including litigation settlement and severance charges, our cash used in operations in the fourth quarter of 2003 was \$1.9 million. On March 25, 2004, we closed a \$5.0 million private placement of 5% Convertible Preferred Stock and warrants, the proceeds of which we intend to use for general corporate and working capital purposes. Based on fourth quarter actual results and our cash burn rate excluding the effects of litigation settlement and severance charges, we believe that our current cash resources, which include the private placement we completed first quarter of 2004, are sufficient to finance our operations and expected capital expenditures for the next twelve months. The sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our cost and improve our profitability, we expect our operating losses and net operating cash outflows to continue through at least the first half of 2004. We do not currently have any further arrangements for financing, and we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, at the time when we need such funding. If our business does not generate sufficient cash flow from operations and sufficient financings are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

We intend to explore the possible acquisitions of businesses, products and technologies that are complementary to our existing business. We are continuing to identify and prioritize additional security technologies, which we may wish to develop, either internally or through the licensing or acquisition of products from third parties. While we engage from time to time in discussions with respect to potential acquisitions, there can be no assurances that any such acquisitions will be made or that we will be able to successfully integrate any acquired business. In order to finance such acquisitions, it may be necessary for us to raise additional funds through public or private financings. Any equity or debt financings, if available at all, may be on terms, which are not favorable to us and, in the case of equity financings, may result in dilution to our stockholders.

Subsequent to December 31, 2003, we successfully renegotiated our lease agreement for our headquarters in Richardson, Texas, which decreased the amount of square feet we leased and extended the lease term for an additional five years. According to the new lease agreement, our Richardson, Texas headquarters will be located in the same building. However, we will reduce the amount of space that we lease from approximately 95,000 square feet to approximately 30,000 square feet of floor space and the term of our new lease will expire in February 2010.

#### **Contractual Obligations**

The following table compares the information concerning the future contractual obligations under our operating leases based on the renegotiated lease agreement for our headquarters location. We have no other significant contractual obligations at December 31, 2003.

Future minimum lease payments consisted of the following on December 31, 2003 (in thousands):

	<b>Contractual Obligations at December 31, 2003</b>	<b>Renegotiated Contractual Obligations dated back to December 31, 2003</b>
2004	\$ 944	\$ 563
2005	197	428
2006		376
2007		378
2008		393
2009 and thereafter		477
	<b>\$ 1,141</b>	<b>\$ 2,615</b>

#### Off-Balance Sheet Arrangements

As of December 31, 2003, we did not have any significant off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K.

#### Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

**Foreign Exchange.** Our revenue originating outside the U.S. in 2003, 2002 and 2001 was 31.4%, 33.4% and 36.4% of total revenues, respectively. Revenues generated from the European region in 2003, 2002 and 2001 were 23.0%, 14.5% and 25.4% of total revenues, respectively. Revenues generated from the Asia region in 2003, 2002 and 2001 were 7.4%, 14.6% and 6.3% of total revenues, respectively. International sales are generated primarily from our foreign sales subsidiaries in the local countries and are typically denominated in U.S. dollars. These subsidiaries incur substantially all of their expenses in the local currency.

Our international business is subject to risks typical of an international business, including differing economic conditions, changes in political climate, differing tax structures, import and export regulations, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, our results could be materially adversely impacted by changes in these or other factors. The effect of foreign exchange rate fluctuations on our business in 2003, 2002 and 2001 was not material.

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

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

Investments in fixed rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have seen a decline in market value due to changes in interest rates. Our investment securities are held for purposes other than trading. The weighted-average interest rate on investment securities at December 31, 2003 was 5.8%. The fair value of investments held at December 31, 2003 approximated amortized cost.

#### Item 8. Financial Statements and Supplementary Data.

The information required by this item is included in Part IV Item 15(a)(1 and 2).

**Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.**

On March 11, 2003, we appointed KBA Group LLP to serve as our independent public accountants, replacing our former independent public accountants Ernst & Young LLP, effective immediately. This appointment was ratified by our stockholders at our 2003 annual meeting. The decision to change independent auditors was approved by our Board of Directors upon the recommendation and approval of our Audit Committee.

Ernst & Young LLP's reports on our consolidated financial statements for the fiscal years ended December 31, 2002 and 2001 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the fiscal years ended December 31, 2002 and 2001 and the interim period prior to its dismissal, there were no disagreements with Ernst & Young LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to Ernst & Young LLP's satisfaction, would have caused them to make reference to the subject matter in connection with their reports on our consolidated financial statements and supporting schedules for such years; and there were no reportable events, as listed in Item 304(a)(1)(v) of Regulation S-K.

We provided Ernst & Young LLP with a copy of the foregoing disclosures. A copy of Ernst & Young LLP's letter, dated March 11, 2003, stating their agreement with such statements is attached as Exhibit 16.1 to our Current Report on Form 8-K filed with the SEC on March 11, 2003.

During the fiscal years ended December 31, 2002 and 2001 and through the date of our dismissal of Ernst & Young, LLP, we did not consult KBA Group LLP with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of the audit opinion that might be rendered on our consolidated financial statements, or any other matters or reportable events listed in Items 304(a)(2)(i) and (ii) of Regulation S-K.

**Item 9A. Controls and Procedures**

We have carried out an evaluation, under the supervision and the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of December 31, 2003 pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed is recorded, processed, summarized and reported in a timely manner.

We have carried out an evaluation, under the supervision and participation of our management, including our Chief Executive Officer and Chief Financial Officer, of any changes in our internal controls over financial reporting that occurred during the quarterly period ended December 31, 2003, and our Chief Executive Officer and Chief Financial Officer have concluded that there was no change during the quarterly period ended December 31, 2003 that has a materially affected or is reasonably expected to materially affect our internal control over financial reporting.

**PART III**

Certain information required by Part III is omitted from this Form 10-K because we will file a definitive Proxy Statement for our 2004 annual meeting of stockholders pursuant to Regulation 14A (the "Proxy Statement") no later than 120 days after the end of the fiscal year covered by this Form 10-K, and certain information to be included therein is incorporated herein by reference.

**Item 10. Directors and Executive Officers of Intrusion Inc.**

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

**Item 11. Executive Compensation.**

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

*Compensation Committee Interlocks and Insider Participation*

The members of the Compensation Committee of our Board of Directors for the entire 2003 fiscal year were J. Fred Bucy, Jr. (Chairman) and Donald M. Johnston, each of whom is an independent director. James F. Gero, who became a director in October of 2003, also served on the Compensation Committee in 2003. Finally, James Buchanan, served as a director and member of the Compensation Committee until his death in October 2003.

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

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

As part of the private placement, we entered into a Registration Rights Agreement, pursuant to which we are required to file a registration statement to register the shares of common Stock issuable upon the conversion of the preferred stock and upon the exercise of the warrants issued to the investors in the private placement. If we fail to file the registration statement by April 24, 2004 or to have the registration statement declared effective by July 24, 2004, we may be subject to the payment of liquidated damages equal to 2% of the aggregate purchase price paid to us in the private placement for each thirty-day period, pro rated for any shorter period, that the filing or effectiveness of the registration statement is delayed. In accordance with this obligation, we filed a registration statement on Form S-3 including these shares of common stock on April 20, 2004. The registration statement includes the 128,817 shares of common stock underlying the preferred stock and warrants purchased by Mr. Gero in the private placement as well as 125,000 shares previously acquired by Mr. Gero in a private transaction with a third party.

**Item 12. Security Ownership of Certain Beneficial Owners and Management.**

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

**Item 13. Certain Relationships and Related Transactions.**

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

**Item 14. Principal Accountant Fees and Services**

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

## PART IV

**Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K.**

(a)

**1. Consolidated Financial Statements.**

The following consolidated financial statements of Intrusion Inc. and subsidiaries, are submitted as a separate section of this report (See F-pages), and are incorporated by reference in Item 8:

	<b>Page No.</b>
Report of Independent Auditors	F-1
Consolidated Balance Sheets at December 31, 2003 and 2002	F-3
Consolidated Statements of Operations for the years ended December 31, 2003, 2002 and 2001	F-4
Consolidated Statements of Stockholders' Equity for the years ended December 31, 2003, 2002 and 2001	F-5
Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2002 and 2001.	F-6
Notes to Consolidated Financial Statements	F-7

**2. Financial Statement Schedules.**

	<b>Page No.</b>
Schedule II Valuation and Qualifying Accounts	S-1

All other schedules are omitted because they are either not required or not applicable or the required information is shown in the Consolidated Financial Statements or Notes thereto.

(b)

**Reports on Form 8-K.**

During the quarter ended December 31, 2003, we filed the following reports on Form 8-K:

Report on Form 8-K (Item 5) filed on November 7, 2003, announcing Intrusion's intent to appeal Nasdaq's delisting notification; and

Report on Form 8-K (Item 5) filed on October 27, 2003, announcing the election of James F. Gero to the board of directors.



(c)

**Exhibits**

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

Exhibit Number	Description of Exhibit
2.1(5)	Certificate of Ownership and Merger Merging Intrusion.com, Inc. into Intrusion Inc.
3.1(5)	Amended and Restated Certificate of Incorporation of the Registrant.
3.2(7)	Certificate of Amendment to Certificate of Incorporation of Registrant
3.3(8)	Certificate of Designation for the Registrant's 5% Convertible Preferred Stock
3.4(4)	Bylaws of the Registrant.
4.1(9)	Specimen Common Stock Certificate.
4.2(8)	Specimen 5% Convertible Preferred Stock Certificate
4.3(8)	Form of Warrant to Purchase Shares of Common Stock
4.4(8)	Warrant to Purchase Common Stock dated March 25, 2004, issued by the Registrant to Black Point Partners
4.5(8)	Registration Rights Agreement dated as of March 25, 2004, by and among the Registrant and the entities listed on Schedule A thereto
4.6(8)	Form of Lock-Up Agreement
10.1(1)	1983 Incentive Stock Option Plan of the Registrant, as amended.
10.2(1)	1987 Incentive Stock Option Plan of the Registrant, as amended.
10.3(1)	Form of Indemnification Agreement.
10.4(5)	1995 Stock Option Plan of the Registrant as amended April 26, 2001.
10.5(2)	1995 Non-Employee Directors Stock Option Plan of the Registrant (amended and restated as of January 10, 2002).
10.7(9)	Lease Agreement between CalWest Industrial Holdings Texas, L.P. and Intrusion Inc.
10.8(8)	Securities Purchase Agreement dated as of March 25, 2004, by and among the Registrant and the purchasers listed on Exhibit A thereto.
10.9(4)	Amended and Restated 401(k) Savings Plan of the Registrant.
10.10(4)	1997 Employee Stock Purchase Plan of the Registrant, as amended January 17, 2001.
10.11(3)	Employment Agreement with Aaron Bawcom dated February 4, 2003
10.12(6)	Intrusion Inc. 401(k) Savings Plan Summary of Material Modifications.
21(5)	List of Subsidiaries of Registrant
23.1(10)	Consent of Ernst & Young LLP, Independent Auditors.
23.2(10)	Consent of KBA Group LLP, Independent Auditors
31.1(10)	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
31.2(10)	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
32.1(10)	Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2(10)	Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

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

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- (3) Filed as an Exhibit to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2003, which Exhibit is incorporated herein by reference.
- (4) Filed as an Exhibit to the Registrants' Annual Report on Form 10-K, for the fiscal year ended December 31, 2000.
- (5) Filed as an Exhibit to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2001, which Exhibit is incorporated herein by reference.
- (6) Filed as an Exhibit to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, which Exhibit is incorporated herein by reference.
- (7) Filed as an Exhibit to the Registrant's Definitive Proxy Statement on Schedule 14A in connection with the solicitation of proxies for its Special Meeting of Stockholders held March 18, 2004, which Exhibit is incorporated herein by reference.
- (8) Filed as an Exhibit to the Registrant's Current Report on Form 8-K dated March 26, 2004, which Exhibit is incorporated by reference.
- (9) Previously filed.
- (10) Filed herewith.



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**ANNUAL REPORT ON FORM 10-K  
ITEM 15(a)(1)  
FINANCIAL STATEMENTS  
YEARS ENDED DECEMBER 31, 2003, 2002 and 2001  
INTRUSION INC.  
RICHARDSON, TEXAS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Intrusion Inc.

We have audited the accompanying consolidated balance sheet of Intrusion Inc. and subsidiaries (the "Company") as of December 31, 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. Our audit also included the financial statement schedule appearing under Item 15(a)(2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Intrusion Inc. and subsidiaries at December 31, 2003, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, appearing under Item 15(a)(2) for the year ended December 31, 2003, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

KBA Group LLP  
Dallas, Texas  
January 30, 2004, except for Note 13, to which the date is March 25, 2004

F-1

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Intrusion Inc.

We have audited the accompanying consolidated balance sheets of Intrusion Inc. and subsidiaries (the "Company") as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years then ended. Our audits also included the financial statement schedule included in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Intrusion Inc. and subsidiaries at December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for each of the years then ended, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and other Intangible Assets."

/s/Ernst & Young LLP

Dallas, Texas  
January 28, 2003

**INTRUSION INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except par value amounts)

	December 31,	
	2003	2002
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 974	\$ 2,898
Short-term investments	1,705	7,825
Accounts receivable, net of allowance for doubtful accounts and returns of \$574 in 2003 and \$934 in 2002	972	2,363
Inventories	1,286	1,411
Prepaid expenses	449	759
	5,386	15,256
Property and Equipment:		
Machinery and equipment	2,424	10,845
Furniture and fixtures	77	1,441
Leasehold improvements	178	998
	2,679	13,284
Accumulated depreciation and amortization	(2,382)	(11,687)
	297	1,597
Other assets	77	86
	77	86
<b>TOTAL ASSETS</b>	<b>\$ 5,760</b>	<b>\$ 16,939</b>
<b>Liabilities and Stockholders' Equity</b>		
Current Liabilities:		
Accounts payable, trade	\$ 1,080	\$ 1,159
Accrued vacation expense	303	341
Accrued warranty expense	200	300
Other accrued expenses	605	1,105
Deferred revenue	788	1,650
	2,976	4,555
<b>TOTAL LIABILITIES</b>	<b>2,976</b>	<b>4,555</b>
Stockholders' Equity:		
Preferred stock, \$0.01 par value:		
Authorized shares 5,000		
No shares issued and outstanding		
Common stock, \$0.01 par value:		
Authorized shares 80,000		
Issued shares 20,690 in 2003 and 20,686 in 2002		
Outstanding shares 20,650 in 2003 and 20,646 in 2002	207	207

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	<b>December 31,</b>	
	<u>          </u>	<u>          </u>
Additional paid-in-capital	47,371	47,371
Common stock held in treasury, at cost 40 shares	(362)	(362)
Accumulated deficit	(44,204)	(34,604)
Accumulated other comprehensive loss	(228)	(228)
	<u>          </u>	<u>          </u>
Total stockholders' equity	2,784	12,384
	<u>          </u>	<u>          </u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 5,760</b>	<b>\$ 16,939</b>
	<u>          </u>	<u>          </u>

See accompanying notes.

F-3



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

	Year Ended December 31,		
	2003	2002	2001
Net product revenue	\$ 4,200	\$ 5,102	\$ 14,206
Net customer support and maintenance revenue	2,278	2,732	2,479
	6,478	7,834	16,685
Total revenue			
Cost of product revenue	3,245	4,738	12,542
Cost of customer support and maintenance revenue	743	1,409	948
	3,988	6,147	13,490
Total cost of revenue			
Gross profit	2,490	1,687	3,195
Operating expenses:			
Sales and marketing	6,230	11,789	23,550
Research and development	3,498	6,088	12,549
General and administrative	1,632	2,576	4,481
Amortization of intangibles		798	1,233
Impairment of intangibles		3,009	
Litigation settlement	450		
Severance costs	472	200	4,673
	(9,792)	(22,773)	(43,291)
Operating loss			
Interest income, net	182	351	1,687
Other income (expense), net	10	(7)	112
	(9,600)	(22,429)	(41,492)
Loss from continuing operations before income taxes			
Income tax benefit		(608)	(1,877)
	(9,600)	(21,821)	(39,615)
Loss from continuing operations			
Income (loss) from discontinued operations, net of income taxes		544	(6,165)
	(9,600)	(21,277)	(45,780)
Net loss			
	\$ (0.46)	\$ (1.06)	\$ (1.93)
Loss per share, continuing operations (basic and diluted)			
	\$ (0.46)	\$ (1.03)	\$ (2.23)
Net loss per share (basic and diluted)			
	20,649	20,640	20,565
Weighted average shares outstanding (basic and diluted)			

See accompanying notes.

**INTRUSION INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(In thousands)

YEAR ENDED DECEMBER 31,	2003	2002	2001
<b>NUMBER OF SHARES ISSUED</b>			
Balance, beginning of year	20,686	20,649	20,525
Issuance of common stock under warrants, stock options and purchase plans	4	37	124
Balance, end of year	20,690	20,686	20,649
<b>NUMBER OF SHARES OUTSTANDING</b>			
Balance, beginning of year	20,646	20,609	20,485
Issuance of common stock under warrants, stock options and purchase plans	4	37	124
Balance, end of year	20,650	20,646	20,609
<b>COMMON STOCK</b>			
Balance, beginning of year	\$ 207	\$ 206	\$ 205
Issuance of common stock under warrants, stock options and purchase plans		1	1
Balance, end of year	\$ 207	\$ 207	\$ 206
<b>ADDITIONAL PAID-IN-CAPITAL</b>			
Balance, beginning of year	\$ 47,371	\$ 47,320	\$ 46,916
Issuance of common stock under warrants, stock options and purchase plans		51	396
Tax benefit derived from exercise of employee stock options			8
Balance, end of year	\$ 47,371	\$ 47,371	\$ 47,320
<b>TREASURY SHARES</b>			
Balance, beginning of year	\$ (362)	\$ (362)	\$ (362)
Purchase of treasury shares			
Balance, end of year	\$ (362)	\$ (362)	\$ (362)
<b>ACCUMULATED OTHER COMPREHENSIVE LOSS</b>			
Balance, beginning of year	\$ (228)	\$ (339)	\$ (425)
Foreign currency translation adjustment(a)		111	86
Balance, end of year	\$ (228)	\$ (228)	\$ (339)
<b>RETAINED EARNINGS (ACCUMULATED DEFICIT)</b>			
Balance, beginning of year	\$ (34,604)	\$ (13,327)	\$ 32,453
Net loss(b)	(9,600)	(21,277)	(45,780)
Balance, end of year	\$ (44,204)	\$ (34,604)	\$ (13,327)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>\$ 2,784</b>	<b>\$ 12,384</b>	<b>\$ 33,498</b>

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YEAR ENDED DECEMBER 31,	2003	2002	2001
<hr/>	<hr/>	<hr/>	<hr/>
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<b>TOTAL COMPREHENSIVE LOSS(a+b)</b>	\$ (9,600)	\$ (21,166)	\$ (45,694)

See accompanying notes.

F-5

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

	Year Ended December 31,		
	2003	2002	2001
<b>Operating Activities:</b>			
Loss from continuing operations	\$ (9,600)	\$ (21,821)	\$ (39,615)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:			
Depreciation and amortization	1,400	2,955	4,369
Impairment of intangible assets		3,009	3,109
Deferred income tax expense			1,923
Changes in operating assets and liabilities:			
Accounts receivable	1,391	2,843	1,681
Income tax receivable		2,779	(1,036)
Inventories	125	3,605	3,343
Other assets	319	(137)	851
Accounts payable and accrued expenses	(717)	(3,095)	(3,905)
Deferred revenue	(862)	(8)	374
<b>Net cash used in operating activities of continuing operations</b>	<b>(7,944)</b>	<b>(9,870)</b>	<b>(28,906)</b>
<b>Investing Activities:</b>			
Purchases of short-term investments	(3,475)	(16,290)	(14,369)
Maturities of short-term investments	9,595	13,117	34,798
Purchases of property and equipment	(100)	(151)	(680)
<b>Net cash provided by (used in) investing activities of continuing operations</b>	<b>6,020</b>	<b>(3,324)</b>	<b>19,749</b>
<b>Financing Activities:</b>			
Exercise of warrants and employee stock options		51	405
Other		1	(3)
<b>Net cash provided by financing activities of continuing operations</b>		<b>52</b>	<b>402</b>
Net cash provided by discontinued operations		146	4,107
Effect of foreign currency translation adjustment on cash and cash equivalents		111	86
<b>Net decrease in cash and cash equivalents</b>	<b>(1,924)</b>	<b>(12,885)</b>	<b>(4,562)</b>
Cash and cash equivalents at beginning of year	2,898	15,783	20,345
<b>Cash and cash equivalents at end of year</b>	<b>\$ 974</b>	<b>\$ 2,898</b>	<b>\$ 15,783</b>

See accompanying notes.

**INTRUSION INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of Business**

We develop, market and support a family of network intrusion detection and prevention systems and regulated information compliance systems that address vital security issues facing organizations with mission critical applications or housing classified, confidential or customer information assets. Our growth strategy is focused on three primary network security product lines intrusion detection systems ("IDS"), intrusion prevention systems ("IPS"), and regulated information compliance systems ("RICS"). We have sold our network security products to over 300 customers including many fortune 500 companies, departments of the U.S. Government, and Managed Security Service Providers ("MSSP").

We are headquartered in Richardson, Texas and have 44 employees, including 17 in sales and marketing, and 15 in engineering. Our principal executive offices are located at 1101 East Arapaho Road, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our Web site is [www.intrusion.com](http://www.intrusion.com) and our common stock is traded on the NASDAQ Small Cap Market under the symbol "INTZC".

We 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 include our Essential Communications Division ("Essential") and our local area networking assets. In accordance with these plans, we have accounted for these businesses as discontinued operations. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our NASDAQ ticker symbol from ODSI to INTZ to reflect our focus on intrusion detection solutions. On November 1, 2001, we changed our name from Intrusion.com, Inc. to Intrusion Inc.

References to "we", "us", "our" or "Intrusion Inc." refer to Intrusion Inc. and its subsidiaries.

As of December 31, 2003, we had cash, cash equivalents and investments in the amount of approximately \$2.7 million, down from approximately \$10.7 million as of December 31, 2002. However, throughout 2003, we reduced expenses. As a result, our cash used in operations, excluding the litigation settlement and severance charges in the fourth quarter was approximately \$1.4 million. Including litigation settlement and severance charges, our cash used in operations in the fourth quarter of 2003 was \$1.9 million. On March 25, 2004, we closed a \$5.0 million private placement of 5% Convertible Preferred Stock and warrants (See Note 13). With this additional financing, we believe that we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. The sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. Moreover, despite actions to reduce our cost and improve our profitability, we expect our operating losses and net operating cash outflows to continue through at least the first half of 2004. We do not currently have any further arrangements for financing, and we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, at the time when we need such funding. If our business does not generate sufficient cash flows from operations and sufficient financings are not available, we may not be able to operate or grow our business, pay our expenses when due or fund our other liquidity needs.

## 2. Summary of Significant Accounting Policies

### *Principles of Consolidation*

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

### *Cash and Cash Equivalents*

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

### *Short-term Investments*

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

### *Risk Concentration*

Financial instruments, which potentially subject us to concentrations of credit risk, are primarily cash and cash equivalents, investments and accounts receivable. We place our investments in U.S. government obligations, corporate securities and money market funds. Substantially all of our cash, cash equivalents and investments are maintained with two major U.S. financial institutions.

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

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

***Accounts Receivable, Allowance for Doubtful Accounts and Returns***

Trade accounts receivable are stated at the amount we expect to collect. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Management considers the following factors when determining the collectibility of specific customer accounts: customer credit-worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If the financial condition of our customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, we provide for estimated uncollectible amounts through a charge to earnings and a credit to a valuation allowance. Balances that remain outstanding after we have used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable.

***Inventories***

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

***Property and Equipment***

Property and equipment is stated at cost less accumulated depreciation and is depreciated on a straight-line basis over the estimated useful lives of the assets. Such lives vary from 3 to 20 years. Leasehold improvements are amortized over the shorter of their useful lives or the terms of the leases. Repair and maintenance costs are expensed as incurred. Depreciation and amortization expense totaled approximately \$1.4, \$2.2 and \$3.1 million for the years ended December 31, 2003, 2002 and 2001, respectively.

***Goodwill and Other Intangible Assets***

Effective January 1, 2002, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets", which requires companies to cease amortizing goodwill and certain intangible assets with indefinite useful lives. SFAS 142 requires that goodwill and intangible assets deemed to have indefinite useful lives be reviewed for impairment upon adoption of SFAS 142, annually thereafter, and upon the occurrence of any event that indicates potential impairments.

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In accordance with SFAS 142, we discontinued recording goodwill amortization effective January 1, 2002. Operating results, excluding the effect of amortization expense related to goodwill, for the years ended December 31, 2003, 2002 and 2001 is as follows (in thousands, except per share data):

	2003	2002	2001
Net loss	\$ (9,600)	\$ (21,277)	\$ (45,780)
Add back: Goodwill amortization net of income taxes			578
	\$ (9,600)	\$ (21,277)	\$ (45,202)
Pro forma net loss	\$ (9,600)	\$ (21,277)	\$ (45,202)
Net loss per share:			
As reported (basic and diluted)	\$ (0.46)	\$ (1.03)	\$ (2.23)
Pro forma (basic and diluted)	\$ (0.46)	\$ (1.03)	\$ (2.20)

SFAS 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for potential impairment, while the second phase (if necessary) measures the impairment. Goodwill is potentially impaired if the net book value of a reporting unit exceeds its estimated fair value. We have determined that we have one reporting unit. This methodology differs from our previous policy, as permitted under accounting standards existing at that time, of using undiscounted cash flows on an enterprise-wide basis to determine if goodwill is recoverable.

We elected to perform our annual impairment review during the fourth quarter of each year, commencing in the fourth quarter of 2002. In connection with our annual impairment review, we determined that the value of goodwill was impaired. At the time of our impairment review, the remaining goodwill of \$0.4 million was associated with the MimeStar purchase transaction (see Note 3). Based on the decline in our market value as indicated by the decline in our stock price during 2002, we determined that the goodwill carrying value should be zero at December 31, 2002. Therefore, an impairment charge of \$0.4 million was recorded and is included in impairment of intangibles in the accompanying consolidated statement of operations.

### *Long-Lived Assets*

Effective January 1, 2002, we adopted the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and accounting and reporting provisions of Accounting Principles Bulletin Opinion 30, "Reporting the Results of Operations," for a disposal of a segment. The primary objective of SFAS 144 is to develop one accounting model based on the framework established in SFAS 121 for long-lived assets to be disposed of and significantly changes the criteria that would have to be met to classify an asset as held for sale. SFAS 144 also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date. Our adoption of SFAS 144 had no effect on our financial position or results of operations.



We review long-lived assets, other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Conditions that would necessitate an impairment assessment include material adverse changes in operations, significant adverse differences in actual results in comparison with initial valuation forecasts prepared at the time of acquisition, a decision to abandon acquired products, services or technologies, or other significant adverse changes that would indicate the carrying amount of the recorded asset might not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset to undiscounted pre tax future net cash flows expected to be generated by that asset. An impairment loss is recognized for the amount by which the carrying amount of the assets exceeds the fair value of the assets. Long-lived assets held for sale are reported at the lower of cost or fair value less costs to sell.

As a result of the write-off of goodwill during the fourth quarter of 2002, we determined that a triggering event indicating potential impairment of the associated intangibles had occurred. At December 31, 2002, the remaining intangibles of \$2.6 million principally included purchased software associated with the MimeStar purchase transaction (see Note 3). We determined that the undiscounted pre-tax cash flows associated with this software was not likely to exceed the remaining carrying value. Due to technological changes that had taken place with respect to the core software code acquired, it was determined that the carrying value should be zero at December 31, 2002. Therefore, we recorded an impairment charge of \$2.6 million, which is included in impairment of intangibles in the accompanying consolidated statement of operations.

#### ***Foreign Currency Translation***

Beginning with fiscal year 2003, we determined that our international subsidiaries should use the United States dollar as their functional currency, as allowed under SFAS No. 52, "Foreign Currency Translation". Although, our international offices pay operating expenses in their local currency, they are fully funded by us in United States dollars, and we exchange the United States dollars locally to settle operating expenses incurred. As outlined in SFAS 52, assets and liabilities are translated at the exchange rate in effect at the balance sheet date, and income and expense accounts at average exchange rates during the year. Resulting translation adjustments totaling approximately \$50,000 were recorded as operating expenses in the statement of operations during 2003.

#### ***Accounting for Stock Options***

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure". SFAS 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation", to provide alternative methods of transition to SFAS 123's fair value method of accounting for stock-based employee compensation.

SFAS 148 also amends the disclosure provisions of SFAS 123 and APB Opinion No. 28, "Interim Financial Reporting," to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While SFAS 148 does not amend SFAS 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of SFAS 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of SFAS 123 or the intrinsic value method of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, if the exercise price of an employee's stock option equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is recognized. However, if the exercise price of an employee's stock option is less than the market price of the underlying stock on the date of grant, compensation expense is recorded for the difference in the exercise price and the market price. As allowed by SFAS 123, we have elected to continue to utilize the accounting method prescribed by APB 25 and have adopted the disclosure requirements of SFAS 123 and SFAS 148.

The following table summarizes relevant information as to the reported results under our intrinsic value method of accounting for stock awards, with supplemental information as if the fair value recognition provision of SFAS 123 had been applied for the years ended December 31, 2003, 2002 and 2001 (in thousands, except per share data):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net loss, as reported	\$ (9,600)	\$ (21,277)	\$ (45,780)
Deduct: Total stock-based compensation determined under fair value-based method for all awards	(256)	(667)	(1,897)
<b>Pro forma net loss</b>	<b>\$ (9,856)</b>	<b>\$ (21,944)</b>	<b>\$ (47,677)</b>
Net loss per share:			
As reported (basic and diluted)	\$ (0.46)	\$ (1.03)	\$ (2.23)
Pro forma (basic and diluted)	\$ (0.48)	\$ (1.06)	\$ (2.32)
Weighted-average shares used in computation:			
Basic and diluted	20,649	20,640	20,565

As required, the pro forma disclosures above include options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 for providing pro forma disclosures may not be representative of the effects on reported operating results for future years until all options outstanding are included in the pro forma disclosures. For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options are amortized to expense primarily over the vesting period. See Note 10 for further discussion of our stock-based employee compensation.

***Net Loss Per Share***

We report two separate earnings per share ("EPS") numbers, basic EPS and diluted EPS with additional disclosure made between continuing and discontinued operations. Basic net loss per share is computed by dividing net loss for the year by the weighted average number of common shares outstanding for the year. Diluted net loss per share is computed by dividing the net loss for the year by the weighted average number of common shares and common stock equivalents outstanding for the year. Our common stock equivalents are not included in the diluted loss per share for the years ended December 31, 2003, 2002 and 2001, as they are anti-dilutive. Such options are excluded due to incurring a net loss per share during the applicable years.

***Revenue Recognition***

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

We recognize software revenue from the licensing of our software products in accordance with Statement of Position ("SOP") No. 97-2 "Software Revenue Recognition", SOP 98-9 "Modification of 97-2, Software Revenue Recognition, with respect to certain transactions" and Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition" whereby revenue from the licensing of our products is not recognized until all four of the following have been met: i) execution of a written agreement; ii) delivery of the product has occurred; iii) the fee is fixed and determinable; and iv) collectibility is probable. Bundled hardware and software product sales are recognized at time of delivery, as our licenses are not sold on a subscription basis. In the case of product sales, which include maintenance and customer support, a Vendor Specific Objective Evidence analysis would be performed to appropriately determine the amount of revenue derived from each deliverable. All of our product offering and service offering market values are easily determined based on current and prior stand-alone sales. We defer and recognize maintenance and support revenue over the term of the contract period, which is generally one year.

We generally recognize service revenue upon delivery of the contracted service. Service revenue, primarily including maintenance, training and installation are recognized upon delivery of the service and typically are unrelated to product sales. These services are not essential to the functionality of the delivered product. To date, training and installation revenue has not been material. These revenues are included in net customer support and maintenance revenues in the statement of operations.

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

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

We have signed distribution agreements with distributors in the United States, Europe and Asia. In general, these relationships are non-exclusive. Distributors typically maintain an inventory of our products. Under these agreements, we provide certain protection to the distributors for their inventory of our products for price reductions as well as products that are slow moving or have been discontinued by us. Historically, returns from our distributors and charges related to price reductions on inventory held by distributors have not been material. Recognition of sales to distributors and related gross profits are deferred until the distributors resell the merchandise. However, since we have legally sold the inventory to the distributor and we no longer have care, custody or control over the inventory, we recognize the trade accounts receivable and reduce inventory related to the sale at the time of shipment to the distributor. Revenue, offset by deferred cost of sales, is included in deferred revenue in the accompanying financial statements. Net deferred revenue related to distributors at December 31, 2003 and 2002 was approximately \$0.1 million and \$0.3 million, respectively. This balance is comprised of the net amounts related to the accounts receivable of \$0.1 million and \$1.0 million and inventory held by distributors of \$0.1 million and \$0.7 million for 2003 and 2002, respectively.

#### ***Advertising Costs***

Advertising expense is charged to operations in the period in which such costs are incurred. Total advertising included in sales and marketing expenses was \$0.03 million, \$0.02 million and \$0.5 million for the years ended December 31, 2003, 2002 and 2001, respectively.

#### ***Research and Development Costs***

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

Software development costs are included in research and development and are expensed as incurred. SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," requires that software development costs incurred subsequent to reaching technological feasibility be capitalized, if material. If the process of developing a new product or major enhancement does not include a detailed program design, technological feasibility is determined only after completion of a working model. To date, the period between achieving technological feasibility and the general availability of such software has been short, and the software development costs qualifying for capitalization have been insignificant.

#### ***Severance Charges***

In connection with our continued shift to our new intrusion detection and security appliance product lines during 2001, 2002 and 2003, we streamlined operations and activities that are not aligned with these core markets and strategies. In 2001, this shift in demand resulted in a charge of \$3.1 million to recognize impairment of intangible assets (primarily developed technology) related to our SecurityAnalyst and Secure Enterprise product lines. We also recorded \$1.3 million for severance charges and \$0.2 million for early termination of lease space in the year ended December 31, 2001. For the year ended December 31, 2002, the severance charge recorded was \$0.2 million. In 2003, the continued shift in demand resulted in a charge of \$0.5 million for severance as a result of reductions in force. All severance obligations were paid prior to December 31, 2003, and we were not receiving further benefit from the severed individuals after December 31, 2003. In addition to the severance charges in 2003, contractual severance payments were made in January 2004, resulting in additional severance of \$0.1 million being incurred at that time.

#### ***Use of Estimates***

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

#### ***Reclassifications***

Certain 2002 amounts have been reclassified to conform to the 2003 presentation.

#### ***Income Taxes***

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

### 3. Business Combinations and Acquisition of Assets

On September 25, 1998, we completed an acquisition of certain assets from Science Applications International Corporation ("SAIC"), a privately held company in San Diego, California. We acquired certain assets of the Computer Misuse and Detection System ("CMDS") Division of SAIC and certain other information security products under development. In exchange for the CMDS assets, the information security products under development and \$1.5 million dollars in cash, we issued to SAIC 1.6 million shares of the Company's common stock and warrants to purchase an additional 1.5 million shares of its common stock. Two separate warrants each grant SAIC the right to purchase 750,000 shares of Intrusion Inc. common stock. The first warrant had an exercise price of \$8.00 per share and a term of 18 months and was exercised on March 23, 2000. The second warrant had an exercise price of \$10.50 per share and a term of 24 months and was exercised on September 22, 2000. Our acquisition has been accounted for as a purchase of software, in-process research and development and certain other assets. The transaction value of approximately \$6.9 million less the \$1.5 million cash received was allocated to the net assets acquired based on their estimated fair market value. Assets acquired included approximately \$1.1 million of in-process research and development, \$0.1 million of other intangible assets and approximately \$4.2 million of purchased software to be amortized over seven years on a straight-line basis. In June 2001, we recorded a restructuring charge of \$2.6 million to recognize the impairment of the remaining net book value of this intangible asset. See "Long-Lived Assets" in Note 2.

On September 30, 1999, we entered into a technology licensing agreement with RSA Security Inc. under which we are the exclusive licensee of RSA's Kane Security Products in North America and Europe. The Kane Security Products include the Kane SecurityAnalyst, a security assessment tool, and the Kane Security Monitor, a host-based intrusion detection tool. We are responsible for marketing, sales, support, maintenance and development for Kane Security software. In June 2001, we recorded a restructuring charge of \$0.4 million to recognize the impairment of the remaining net book value of this intangible asset. See "Goodwill and Other Intangible Assets" in Note 2.

On June 30, 2000, we acquired MimeStar, Inc., a Virginia corporation. MimeStar developed an advanced, network based intrusion detection system called SecureNet Pro . The acquisition, accounted for using the purchase method, was affected by the merger of a wholly owned subsidiary of the Company ("Merger Sub") with and into MimeStar, pursuant to an Agreement and Plan of Merger, by and among the Company, MimeStar, the Merger Sub and the sole stockholder of MimeStar (the "Merger"). Pursuant to the Merger, the stockholder of MimeStar received \$4 million in cash and 95,969 shares of the Company's common stock (which was valued at approximately \$1 million on the date of the Merger). Transaction costs for this acquisition totaled approximately \$100,000. The acquisition costs of \$5.1 million were capitalized as approximately \$3.6 million of purchased software, approximately \$0.5 million of goodwill and approximately \$1.0 million of other intangibles. In December 2002, we recorded impairment charges totaling \$3.0 million under SFAS 142 and SFAS 144 to recognize the impairment of the remaining net book values of these intangible assets. See "Goodwill and Other Intangible Assets" and "Long-Lived Assets" in Note 2.

**4. Balance Sheet Detail (in thousands)****Inventories**

	December 31,	
	2003	2002
Raw materials	\$	\$ 70
Finished products	851	1,157
Work in process	261	
Demonstration systems	174	184
	<u>\$ 1,286</u>	<u>\$ 1,411</u>

**Other Accrued Expenses**

	December 31,	
	2003	2002
Accrued sales commissions	\$ 99	\$ 188
Accrued travel expenses	48	220
Accrued payroll	110	112
Accrued property taxes	144	187
Accrued taxes other	60	300
Other	144	98
	<u>\$ 605</u>	<u>\$ 1,105</u>

**5. Goodwill and Intangible Assets, Net**

Amortization of intangibles for continuing operations is comprised of the following for the years ended December 31, 2003, 2002 and 2001 (in thousands):

	2003	2002	2001
Goodwill	\$	\$	\$ 64
Purchased software		527	811
Other intangible assets		271	358
		<u>\$ 798</u>	<u>\$ 1,233</u>
Total amortization	\$	\$ 798	\$ 1,233

Prior to the adoption of SFAS 142, goodwill was amortized using the straight-line method over 7 years. Purchased software and other intangible assets were amortized using the straight-line method over their useful lives of 7 years.

As discussed in Note 2, all intangibles were deemed to be fully impaired at December 31, 2002. As such, included in accumulated amortization at December 31, 2002 for goodwill, purchased software and other intangibles are impairment charges of \$0.4 million, \$2.3 million and \$0.3 million, respectively.

## 6. Commitments and Contingencies

### *Leases*

We lease office space for our corporate headquarters in Richardson, Texas under an operating lease, the base term of which expires in February 2005, with two seven-year options to extend the term of the lease, subject to compliance with certain conditions. We lease office space in San Diego, California for a portion of our security software research and development staff under an operating lease that expires in August 2004. In addition, we lease office space for our U.S. and international sales and engineering offices. Total rental expense of \$1.1 million, \$1.4 million and \$1.9 million was charged to operations during 2003, 2002, and 2001, respectively.

Subsequent to December 31, 2003, we successfully renegotiated our lease agreement for our headquarters in Richardson, Texas, which decreased the amount of square feet we leased and extended the lease term for an additional five years (See Note 13). According to the new lease agreement, our Richardson, Texas headquarters will be located in the same building. However, our lease will now expire in February 2010.

The following table sets forth certain information concerning our contractual obligations at December 31, 2003 and outlines the expected future payments to be made under such obligations and commitments. The following table also shows the information concerning future contractual obligations based on the renegotiated lease agreement for our headquarters.

Future minimum lease payments consisted of the following on December 31, 2003 (in thousands):

	Contractual Obligations at December 31, 2003	Renegotiated Contractual Obligations dated back to December 31, 2003
2004	\$ 944	\$ 563
2005	197	428
2006		376
2007		378
2008		393
2009 and thereafter		477
	\$ 1,141	\$ 2,615

### *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.



On March 22, 2002, Morgan Newton Company, L.P. ("Morgan Newton") filed suit against us in Dallas County District Court, Case No. DV02-02339-C, alleging claims for breach of contract, promissory estoppel, and fraud. The claims arose out of an alleged oral representation to Morgan Newton concerning a request for quotation for the purchase of a large amount of Morgan Newton's products. Morgan Newton did not specify the amount of damages it was seeking in the lawsuit. During the third quarter of 2003, the case was settled out of court. In accordance with the settlement, Intrusion paid Morgan Newton \$450 thousand during the fourth quarter of 2003. The settlement amount of this claim is recorded as litigation settlement in the statement of operations for 2003. This claim has been completely satisfied at December 31, 2003 and should have no further financial impact on our operating results.

We are not aware of any material claims outstanding or pending against Intrusion at December 31, 2003.

## **7. Discontinued Operations**

In the second quarter of 2000, we discontinued our networking operations and accordingly have shown the networking operations as discontinued in the accompanying financial statements.

During the first quarter of 2001, we closed the sale of our legacy local area networking division generating a gain of \$2.1 million, which was used to reduce the estimated net realizable value of the net assets of the remaining discontinued operations of our Essential communications division. During the second quarter of 2001, in response to unfavorable market conditions and efforts to sell Essential, we recorded additional charges to write down the net assets of Essential to reflect an estimated net realizable value of \$0.8 million. The \$5.0 million second quarter charge included \$0.8 million for operating losses expected to be incurred between July and the end of the first quarter of 2002, by which time we expected to have exited, disposed of or otherwise transitioned a majority of our ownership in Essential.

In March 2002 we sold Essential for \$1.0 million, generating a gain on sale of \$0.5 million. Terms of the sale included transferring \$0.7 million in net property, plant and equipment, \$0.1 million in current liabilities and product maintenance obligations for which \$0.4 million was recorded in deferred revenue.

A condition of the sale was to give Essential personnel 60 days to exit Essential's leased facility, the obligation for which we retained as part of the sale. Included in the gain on the sale of Essential was management's estimate of \$0.3 million to terminate this lease agreement, which was equivalent to 2 years' lease and maintenance of the facility. The contractual term of the lease ran through February 2009. Successful termination of the lease during the fourth quarter of 2002 for less than \$0.3 million resulted in additional gain on sale of \$0.1 million.

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The following represents a summary of net income (loss) from discontinued operations for the years ended December 31, 2003, 2002 and 2001 (in thousands):

	2003	2002	2001
Net sales	\$	\$ 727	\$ 4,693
Cost of sales		323	2,970
Gross profit		404	1,723
Operating expenses		503	4,774
Operating loss		(99)	(3,051)
Gain on sale		643	
Net realizable value adjustment			(3,025)
Income (loss) before income taxes		544	(6,076)
Income tax expense (benefit)			89
Income (loss) from discontinued operations	\$	\$ 544	\$ (6,165)

The net realizable value adjustment was recorded in the second quarter of 2001 and was in response to unfavorable market conditions and efforts to sell Essential. The adjustment reduced the carrying value of Essential to \$0.8 million.

### 8. Employee Benefit Plans

#### *Employee Stock Purchase Plan*

On April 24, 1997, we adopted an Employee Stock Purchase Plan (the "Purchase Plan") under which 0.5 million shares of common stock have been reserved for issuance. Eligible employees may designate not more than 10% of their compensation to be deducted each pay period for the purchase of common stock under the Purchase Plan. The Purchase Plan was amended January 17, 2001 to increase the maximum number of shares that can be purchased per participant from 500 shares to 1,000 shares per offering. Each participant may purchase up to 2,000 shares in any one calendar year. On January 31 and July 31 of each calendar year, shares of common stock are purchased with the employees' payroll deductions over the immediately preceding six months at a price per share of 85% of the lesser of the market price of the common stock on the purchase date or the market price on the first day of the six-month period. The Purchase Plan will terminate no later than April 24, 2007. A total of 180,374 shares have been issued under the Purchase Plan as of December 31, 2003.

#### *Employee 401(k) Plan*

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

The Plan was amended on January 10, 2002 to allow employees to contribute from 1% to 25% of their annual compensation to the Plan, limited to a maximum amount as set by the Internal Revenue Service. This limit was increased from 19%. A feature was also added to the Plan to allow participants who are over the age of 50 to contribute an additional amount of their salary per year, as defined annually by the Internal Revenue Service. We match employee contributions at the rate of \$0.25 per each \$1.00 of contribution on the first 4% of compensation. Matching contributions to the Plan were approximately \$17,000, \$44,500, and \$110,000 in 2003, 2002 and 2001, respectively.

## 9. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. There are no deferred tax liabilities as of December 31, 2003 and 2002. Significant components of our deferred tax assets as of December 31, 2003 and 2002 are as follows (in thousands):

	December 31	
	2003	2002
Foreign subsidiaries net operating loss carryforward	\$ 374	\$ 374
Net operating loss carryforwards	26,743	21,230
Book over tax depreciation	900	273
Intangibles	1,478	1,602
Equity Investments	458	458
Vacation accrual	111	125
Allowance for doubtful accounts and returns	164	342
Warranty accrual	73	110
Inventory allowance	469	2,505
Other	689	931
	<u>31,459</u>	<u>27,950</u>
Deferred tax assets	31,459	27,950
Valuation allowance for deferred tax assets	(31,459)	(27,950)
	<u>\$</u>	<u>\$</u>
Deferred tax assets, net of allowance	\$	\$

Deferred tax assets are required to be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of the future benefits related to the deferred tax assets is dependent on many factors, including the Company's ability to generate taxable income within the near to medium term. Management has considered these factors in determining the valuation allowance for 2003 and 2002.

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Significant components of the benefit for income taxes for the years ended December 31, 2003, 2002 and 2001 are as follows (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Income tax provision (benefit)			
Federal:			
Current	\$	\$ (608)	\$ (4,050)
Deferred			3,063
State:			
Current			(136)
Deferred			(1,140)
Foreign:			
Current			475
	<u>\$</u>	<u>\$ (608)</u>	<u>\$ (1,788)</u>

Income tax benefit is included in the consolidated financial statements for the years ended December 31, 2003, 2002 and 2001 as follows (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Continuing Operations	\$	\$ (608)	\$ (1,877)
Discontinued Operations			89
	<u>\$</u>	<u>\$ (608)</u>	<u>\$ (1,788)</u>

The differences between the provision for income taxes and income taxes computed using the federal statutory rate for the years ended December 31, 2003, 2002, and 2001 are as follows (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Reconciliation of income tax benefit to statutory rate:			
Income tax benefit at statutory rate	\$ (3,264)	\$ (7,660)	\$ (16,649)
State income taxes, net of federal income tax benefit	(256)	(38)	(829)
Change in valuation allowance	3,509	7,448	18,570
Goodwill amortization			578
Tax credit carryforwards			(607)
Other	11	(358)	(2,851)
	<u>\$</u>	<u>\$ (608)</u>	<u>\$ (1,788)</u>

At December 31, 2003, we had federal net operating loss carryforwards of \$86.4 million for income tax purposes that begin to expire in 2008 and are subject to the ownership change limitations under Internal Revenue Code Section 382. We also had \$100.9 million of state net operating loss carryforwards. Net operating loss carryforwards of the foreign subsidiaries of \$0.7 million at December 31, 2003 are available indefinitely for offset only against taxable income generated by the foreign subsidiaries.

We made no federal tax payments during 2003 and 2002, and received federal income tax refunds of \$3.2 million in 2002 (none in 2003) for income taxes paid in previous years.

#### **10. Stock, Stock Options and Warrants**

At December 31, 2003, we had four stock-based compensation plans, which are described below. These plans were developed to retain and attract key employees and directors.

In 1987, an additional Incentive Stock Option Plan was established, which provides for the issuance of options to our key employees of the Company to purchase our common stock. The 1987 Incentive Stock Option Plan was terminated on January 26, 1997. The 1987 plan provided for the issuance of up to 1.2 million shares of common stock upon exercise of options granted pursuant to the plan. Options to purchase a total of 30,700 shares of common stock are outstanding with no options remaining available for issuance for the 1987 plan.

In 1995, we adopted our 1995 Stock Option Plan (the "1995 Plan"), which provides for the issuance of up to 1.6 million shares of common stock upon exercise of options granted pursuant to the 1995 Plan. On April 19, 2000, our stockholders approved an 850,000-share increase, and on April 26, 2001, our stockholders approved an additional 850,000-share increase to the 1995 Plan. Therefore, the overall number of shares available for issuance pursuant to the plan was increased to 3.3 million 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. At December 31, 2003, options to purchase a total of 1,278,945 shares of common stock are outstanding and options for 1,770,182 shares remain available for future grant.

In 1995, we adopted the 1995 Non-Employee Director Stock Option Plan (the "1995 Non-Employee Director Plan") which provided for the issuance of up to 160,000 shares of common stock upon exercise of options granted pursuant to the 1995 Non-Employee Director Plan. On April 25, 2002, our stockholders approved an amendment to the 1995 Non-Employee Director Plan. This amendment increased the number of shares available for option to 260,000 shares, replaced the automatic grant feature prospectively from 20,000 shares on the fifth anniversary to 10,000 shares annually and reduced the vesting schedule from five years to three years for options granted prospectively. The 1995 Non-Employee Director Plan provides for the issuance of non-qualified stock options to non-employee directors. No shares have been exercised under the 1995 Non-Employee Director Plan. Options to purchase a total of 178,000 shares of common stock are outstanding and options for 82,000 shares remain available for issuance. Since inception, 220,000 shares have been granted to directors pursuant to the 1995 Non-Employee Director Plan, of which, 42,000 have been cancelled.

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Common shares reserved for future issuance, including outstanding options, under all of the stock option plans and employee stock purchase plans total approximately 3.7 million shares at December 31, 2003.

	<b>Outstanding Options</b>	<b>Available for Future Grant</b>
1987 Plan	30,700	
1995 Plan	1,278,945	1,770,182
1995 Non-Employee Director Plan	178,000	82,000
Employee Stock Purchase Plan		319,626
Director Grants prior to Plan	8,000	
<b>Total</b>	<b>1,495,645</b>	<b>2,171,808</b>

The Compensation Committee of our Board of Directors determines 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 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).

A summary of our stock option activity and related information for the years ended December 31, 2003, 2002 and 2001, is as follows:

	<b>2003</b>		<b>2002</b>		<b>2001</b>	
	<b>Number of Options (in thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options (in thousands)</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options (in thousands)</b>	<b>Weighted Average Exercise Price</b>
Outstanding at beginning of year	1,685	\$ 4.89	1,989	\$ 6.71	1,589	\$ 10.03
Granted	650	0.51	930	1.31	1,578	4.05
Exercised					(55)	2.75
Cancelled	(839)	3.48	(1,234)	5.14	(1,123)	7.85
<b>Outstanding at end of year</b>	<b>1,496</b>	<b>3.77</b>	<b>1,685</b>	<b>4.89</b>	<b>1,989</b>	<b>6.71</b>
Options exercisable at end of year	803	\$ 5.83	565	\$ 8.46	622	\$ 9.28

F-24

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Information related to stock options outstanding at December 31, 2003, is summarized below:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Outstanding at 12/31/03 (in thousands)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable at 12/31/03 (in thousands)	Weighted Average Exercise Price
\$0.19-\$1.01	624	8.63 years	\$ 0.51	103	\$ 0.43
1.05-9.50	673	7.16 years	3.17	517	3.29
11.44-23.25	199	4.79 years	16.05	183	16.08
	<b>1,496</b>	<b>7.46 years</b>	<b>3.77</b>	<b>803</b>	<b>5.83</b>

Pro forma information regarding net loss and net loss per share, as disclosed in Note 2, has been determined as if we had accounted for employee stock-based compensation plans and other stock options under the fair value method of SFAS 123. The fair value for these options was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted average assumptions used for grants under the option plans:

	2003	2002	2001
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	2.4%	3.1%	4.3%
Expected volatility	147.0%	140.0%	130.0%
Expected life (in years)	3.3	3.4	3.0

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. In addition, because SFAS 123 is applicable only to options granted subsequent to December 31, 1994, the pro forma information does not reflect the pro forma effect of all of our previous stock option grants, and thus the pro forma information is not necessarily indicative of future amounts until SFAS 123 is applied to all outstanding stock options.

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Information relating to the fair value of option grants made during 2003, 2002 and 2001 is as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Options granted (with exercise price equal to fair value of common stock):			
Number of options (in thousands)	600	898	1,578
Weighted average exercise price per share	\$ 0.49	\$ 1.34	\$ 4.05
Weighted average fair value of stock options grants per Black-Sholes option valuation model	\$ 0.41	\$ 1.08	\$ 3.02
Options granted (with exercise price greater than fair value of common stock):			
Number of options (in thousands)	50	32	
Weighted average exercise price per share	\$ 0.69	\$ 0.57	
Weighted average fair value of stock options grants per Black-Sholes option valuation model	\$ 0.49	\$ 0.41	

**11. Loss per Share**

	<u>For the Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Numerator:			
Net loss	\$ (9,600)	\$ (21,277)	\$ (45,780)
Numerator for basic and diluted loss per share	\$ (9,600)	\$ (21,277)	\$ (45,780)
Loss from continuing operations	\$ (9,600)	\$ (21,821)	\$ (39,615)
Numerator for basic and diluted loss per share, continuing operations	\$ (9,600)	\$ (21,821)	\$ (39,615)
Denominator:			
Denominator for basic loss per share weighted average common shares outstanding	20,649	20,640	20,565
Effect of dilutive securities:			
Stock options and warrants			
Denominator for diluted loss per share adjusted weighted average common shares outstanding	20,649	20,640	20,565
Loss per share, continuing operations (basic and diluted)	\$ (0.46)	\$ (1.06)	\$ (1.93)
Loss per share (basic and diluted)	\$ (0.46)	\$ (1.03)	\$ (2.23)

Total stock options and warrants outstanding in 2003, 2002 and 2001 that are not included in the diluted earnings per share computation due to the antidilutive effect are 1.5 million, 1.7 million and 2.0 million, respectively. Such options are excluded due to us incurring a net loss per share in those years.



## 12. Segments, Major Customers and Geographic Information

The Company's continuing operations are concentrated in one area security software and appliances. There were no sales to customers in 2003, 2002 or 2001 that exceeded 10% of total sales for that year. Our similar product and service offerings are not viewed as individual segments, as the Company's management analyzes the business as a whole and expenses are not allocated to each product offering.

Export sales (based on our customers location), primarily to Europe, Asia, Latin America and Canada, were \$2.0 million in 2003, \$2.6 million in 2002 and \$6.1 million in 2001. No significant long-lived assets are deployed outside of the United States. The Company's foreign operations act only as sales support offices in that region.

## 13. Subsequent Events

Subsequent to December 31, 2003, we successfully renegotiated our lease agreement for our headquarters in Richardson, Texas, which decreased the amount of square feet we lease and extended the lease term for an additional five years. In accordance with the new lease agreement, our Richardson, Texas headquarters will be located in the same building. However, we will reduce the amount of space that we lease from approximately 95,000 square feet to approximately 30,000 square feet of floor space and the term of our new lease will expire in February 2010.

On March 25, 2004, we completed a \$5.0 million private placement of 5% Convertible Preferred Stock and warrants. In the private placement, the company sold 1,000,000 shares of preferred stock at a price of \$5.00 per share, which convert into 6,361,323 shares of common stock at an initial conversion price of \$0.786 per share, and warrants to purchase 2,226,459 shares of common stock at an exercise price of \$0.786 per share. In connection with the closing of this private placement, we issued warrants to purchase 257,633 shares of our common stock at an exercise price of \$0.786 per share to our financial advisor for the private placement.

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

Had the per share amounts been adjusted to give retroactive effect for the reverse split, net loss per share, continuing operations (basic and diluted) for the years ended December 31, 2003, 2002 and 2001 would have been \$1.86, \$4.23 and \$7.71, respectively. Net loss per share (basic and diluted) for the years ended December 31, 2003, 2002 and 2001 would have been \$1.86, \$4.12 and \$8.90, respectively.

## Supplemental Financial Data

## Summarized Quarterly Data (Unaudited)

	2003				
	Q1	Q2	Q3	Q4	Total
	(In thousands, except per share amounts)				
Product revenue	\$ 892	\$ 768	\$ 1,045	\$ 1,495	\$ 4,200
Customer support and maintenance revenue	584	715	511	468	2,278
Total revenue	1,476	1,483	1,556	1,963	6,478
Gross profit	472	392	660	966	2,490
Net loss	(2,782)	(2,934)	(2,413)	(1,471)	(9,600)
Net loss per share Basic and diluted	(0.13)	(0.14)	(0.12)	(0.07)	(0.46)
	2002				
	Q1	Q2	Q3	Q4(1)	Total
	(In thousands, except per share amounts)				
Continuing Operations:					
Product revenue	\$ 1,946	\$ 926	\$ 1,342	\$ 888	\$ 5,102
Customer support and maintenance revenue	568	539	1,052	573	2,732
Total revenue	2,514	1,465	2,394	1,461	7,834
Gross profit	805	323	1,072	(513)	1,687
Net loss	(5,394)	(4,657)	(3,649)	(7,577)	(21,277)
Net loss per share Basic and diluted	(0.26)	(0.23)	(0.18)	(0.37)	(1.03)
Discontinued Operations:					
Income, net of tax	401			143	544
Net income per share Basic and diluted	0.02	0.00	0.00	0.01	0.03

- (1) Net loss from Continuing Operations includes a fourth quarter 2002 charge of \$3.0 million to recognize the impairment of the remainder of intangible assets related to MimeStar along with a \$1.0 million charge related to obsolete inventory. See Note 2.

**Intrusion Inc. and Subsidiaries**  
**Item 15(a)(2)**  
**Schedule II Valuation and Qualifying Accounts**  
**(In thousands)**

	<u>Balance at Beg. of Period</u>	<u>Charged to Costs and Expense</u>	<u>Additions (Deductions)</u>	<u>Balance at End of Period</u>
Year ended December 31, 2001				
Deducted from asset accounts:				
Allowance for doubtful accounts and returns	\$ 919	\$	\$ (122)(1)	\$ 797
Year ended December 31, 2002				
Deducted from asset accounts:				
Allowance for doubtful accounts and returns	\$ 797	\$ 137	\$	\$ 934
Year ended December 31, 2003				
Deducted from asset accounts:				
Allowance for doubtful accounts and returns	\$ 934	\$ 31	\$ (391)(1)	\$ 574

(1) Net of uncollectible accounts written off.

QuickLinks

INTRUSION INC. INDEX

PART I

Item 1. Business.

Item 2. Properties.

Item 3. Legal Proceedings.

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

PART II

Item 5. Market for Intrusion's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Item 6. Selected Financial Data.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Item 8. Financial Statements and Supplementary Data.

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.

Item 9A. Controls and Procedures

PART III

Item 10. Directors and Executive Officers of Intrusion Inc.

Item 11. Executive Compensation.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

Item 13. Certain Relationships and Related Transactions.

Item 14. Principal Accountant Fees and Services

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K.

SIGNATURES

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

INTRUSION INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (In thousands, except par value amounts)

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

INTRUSION INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (In thousands)

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

INTRUSION INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Intrusion Inc. and Subsidiaries Item 15(a)(2) Schedule II Valuation and Qualifying Accounts (In thousands)