INTRUSION INC
Form 10QSB
November 13, 2006

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

FORM 10-QSB

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

Commission File Number 0-20191

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

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

1101 East Arapaho Road, Suite 200, Richardson, Texas 75081
(Address of principal executive offices)
(Zip Code)

(972) 234-6400
(Issuer s telephone number, including area code)

Not Applicable
Former name, if changed since last report)

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

Yes x   No o

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

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

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

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INTRUSION INC.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

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

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

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

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

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

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

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

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

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

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

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

2. Basis of Presentation

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

3. Inventories (In thousands)

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

4. Accounting for Stock-Based Compensation

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

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

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

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

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

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

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

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

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

Effect of Adopting SFAS No. 123(R)

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

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

Valuation Assumptions

The fair values of option awards were estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions (no options were granted during the three months ended September 30, 2006):

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

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

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

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

Stock Incentive Plan Activity

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

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

Stock Options Outstanding and Exercisable

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

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

* Includes effects of expected forfeitures

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

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

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

	Quarter Ended September 30, 2005		Nine Months September 30, 2005	
Net loss attributable to common stockholders	$	(525)	$	(3,491)
Deduct: Total stock-based compensation determined under fair value-based method for all awards	(283)		(589)	
Pro forma net loss attributable to common stockholders	$	(808)	$	(4,080)
Net loss per share attributable to common stockholders:				
as reported (basic and diluted)	$	(0.08)	$	(0.56)
pro forma (basic and diluted)	$	(0.12)	$	(0.65)
Weighted-average shares used in computation:				
Basic and diluted	6,586		6,270	

5. Net Loss Per Share

Basic net loss per share is computed by dividing net loss attributable to common stockholders for the period by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing the net loss attributable to common stockholders by the weighted average number of common shares and common stock equivalents outstanding for the period. Our common stock equivalents include all common stock issuable upon conversion of preferred stock and the exercise of outstanding options and warrants. The aggregate number of common stock equivalents excluded from the loss per share calculation for the three and nine month periods ended September 30, 2006 and 2005 are 3,721,769 and 3,247,451, respectively. Our common stock equivalents are not included in the diluted loss per share for the periods ended September 30, 2006 and 2005, as they are antidilutive.

6. Commitments and Contingencies

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

7. Preferred Stock and Common Stock

During the nine months ended September 30, 2006, no shares of our preferred stock were converted into common stock. At September 30, 2006, there are 259,696 shares of 5% preferred stock outstanding, 460,000 shares of Series 2 5% preferred stock outstanding and 468,735 shares of Series 3 5% preferred stock outstanding. In addition, an employee exercised stock options to purchase 834 shares of common stock during the nine months ended September 30, 2006.

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

This report contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements are generally accompanied by words such as plan, estimate, expect, believe, should, would, could, anticipate, may or other words that convey uncertainty of future events or outcomes. These forward-looking statemen and other statements made elsewhere in this report are made in reliance on the Private Securities Litigation Reform Act of 1995. These statements are subject to certain risks and uncertainties, such as the risk that we may have insufficient cash resources to fund our current operations, difficulties in forecasting future sales caused by current economic and market conditions, the effect of military actions on government and corporate spending on information security products, spending patterns of, and appropriations to, U.S. government departments, the impact of our cost reduction programs and our refocused product line, the difficulties and uncertainties in successfully developing and introducing new products, market acceptance of our products, the impact of sustained losses on our ability to successfully operate and grow our business, our stock price and our loss of Nasdaq eligibility, the highly competitive market for our products, the effects of sales and implementation cycles for our new products on our quarterly results, difficulties in accurately estimating market growth, the consolidation of the information security industry, the impact of changing economic conditions, business conditions in the information security industry, our ability to manage acquisitions effectively, our ability to manage discontinued operations effectively, the impact of market peers and their products as well as risks concerning future technology and others identified in our Annual Report on Form 10-KSB and other Securities and Exchange Commission filings. The section below entitled Factors That May Affect Future Results of Operations sets forth and incorporates by reference certain risks that could cause actual future results of the Company to differ materially from any such forward looking statements.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

We generally recognize product revenue upon shipment of product. We accrue for estimated warranty costs and sales returns at the time of shipment based on our experience. Revenue from maintenance contracts is deferred and recognized over the contractual period the services are performed, generally one year. There is a risk that technical issues on new products could result in unexpected warranty costs and returns. However, as we migrate to more of a software-based business model, the warranty costs should continue to decline. To the extent that they do decline, our warranty reserve from current sales will decrease. To the extent that our warranty costs exceed our expectations, we will increase our warranty reserve to compensate for the additional expense expected to be incurred. We review these estimates periodically and determine the appropriate reserve percentage. However, to date, warranty costs and sales returns have not been material. Historically, our estimates for these items have not differed materially from actual results. Significant or subjective estimates associated with our revenue recognition policy include our estimate of warranty cost and sales returns.

We recognize software revenue from the licensing of our software products in accordance with Statement of Position (SOP) No. 97-2 Software Revenue Recognition , SOP 98-9 Modification of 97-2, Software Revenue Recognition, with respect to certain transactions and Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition whereby revenue from the licensing of our products is not recognized until all four of the following criteria have been met: (1) execution of a written agreement; (2) delivery of the product has occurred; (3) the fee is fixed and determinable; and (4) collectibility is probable. Bundled hardware and perpetual software product sales are recognized at time of delivery, as our licenses are not sold on a subscription basis. In the case of multiple product and service sales, we perform a Vendor Specific Objective Evidence analysis to appropriately determine the amount of revenue derived from each deliverable. If our license strategy changes and we begin to offer licenses on a subscription basis, we would perform this analysis in a similar manner. Under these circumstances, the revenue related to the license would be recognized ratably over the subscription period. Market values are easily obtained for all of our product offerings, as we have historical sales information on our product offerings. We defer and recognize maintenance and support revenue over the term of the contract period, which is generally one year.

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

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

Allowance for Doubtful Accounts and Returns

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our receivables are uncollaterized and we expect to continue this policy in the future. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Historically, our estimates for sales returns and doubtful accounts have not differed materially from actual results.

Inventory

We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required. Historically, our estimates for inventory obsolescence have not differed materially from actual results.

Stock-based Compensation

Beginning on January 1, 2006, we began accounting for stock options under the provisions of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123(R)), which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions for FAS 123(R), stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. We have used the Black-Scholes valuation model, to estimate fair value of our stock-based awards which requires various judgmental assumptions including estimating stock price volatility, forfeiture rates, and expected life. Our computation of expected volatility is based on a combination of historical and market-based implied volatility. In addition, we consider many factors when estimating expected forfeitures and expected life, including types of awards, employee class, and historical experience. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

We adopted FAS 123(R) using the modified prospective method which requires the application of the accounting standard as of January 1, 2006. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of FAS 123(R).

Results of Operations

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

	Three Months Ended		Nine Months Ended	
	Sept 30, 2006	Sept 30, 2005	Sept 30, 2006	Sept 30, 2005
Net product revenue	84.4 %	80.3 %	74.9 %	77.6 %
Net customer support and maintenance revenue	15.6	19.7	25.1	22.4
Total revenue	100.0	100.0	100.0	100.0
Cost of product revenue	43.5	39.9	38.0	41.3
Cost of customer support and maintenance revenue	1.3	0.4	4.8	1.1
Total cost of revenue	44.8	40.3	42.8	42.4
Gross profit	55.2	59.7	57.2	57.6
Operating expenses:				
Sales and marketing	32.4	40.3	58.7	50.0
Research and development	15.7	27.9	44.3	40.2
General and administrative	17.6	17.0	27.4	17.8
Severance and related costs				1.1
Operating loss	(10.5)	(25.5)	(73.3)	(51.3)
Other income (expense), net			(1.7)	0.0
Interest income, net	0.1	1.2	1.1	1.1
Loss before income tax provision	(10.4)	(24.3)	(73.9)	(50.2)
Income tax provision				
Net loss	(10.4)%	(24.3)%	(73.9)%	(50.2)%
Preferred stock dividends accrued	(2.5)	(2.2)	(3.5)	(2.6)
Beneficial conversion feature on preferred stock			)	(18.9)
Net loss attributable to common stockholders	(12.9)%	(26.5)%	(77.3)%	(71.7)%

	Three Months Ended		Nine Months Ended	
	Sept 30, 2006	Sept 30, 2005	Sept 30, 2006	Sept 30, 2005
Domestic revenues	93.0 %	91.0 %	89.5 %	89.4 %
Export revenues to:				
Europe	5.5	7.3	8.1	7.5
Canada	1.0	0.2	1.3	0.5
Asia	0.4	1.4	1.0	2.5
Latin America	0.1	0.1	0.1	0.1
Net revenues	100.0 %	100.0 %	100.0 %	100.0 %

Net Revenues. Net revenues for the quarter and nine months ended September 30, 2006 decreased to $1.7 million and $3.8 million, respectively, compared to $2.0 million and $4.9 million for the same periods in 2005, primarily because of longer than anticipated sales cycles revolving around new product introductions as we continued our strategic move to concentrate on our entity identification and regulated information compliance and data privacy products. Product revenues decreased $0.1 million and $0.9 million, respectively, for the quarter and nine months ended September 30, 2006 compared to the same periods in 2005. Customer support and maintenance revenue for the quarter and nine months decreased $0.1 million and $0.1 million, respectively compared to the same periods in 2005.

Concentration of Revenues. Revenues from sales to various U.S. government entities totaled $1.3 million, or 73.8% of revenues, for the quarter ended September 30, 2006 compared to $1.5 million, or 77.0% of revenues, for the same period in 2005. Revenues from sales to various U.S. government entities totaled $2.7 million, or 71.8% of revenues, for the nine months ended September 30, 2006 compared to $3.6 million, or 73.4% of revenues, for the same period in 2005. Although, we expect our concentration of revenues to vary among customers in future quarters depending upon the timing of certain sales, we anticipate that sales to government customers will continue to account for a significant portion of our revenues in future quarters. 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 to appropriation and spending patterns and the government s reservation of the right to cancel contracts and purchase orders for its convenience. Although we do not believe that the cancellation of any particular order would have a material adverse effect on our financial results or that any of our revenues with government customers are subject to renegotiation, 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.

Gross Profit. Gross profit was $1.0 million or 55.2% of net revenues for the quarter ended September 30, 2006, compared to $1.2 million or 59.7% of net revenues for the quarter ended September 30, 2005. Gross profit was $2.2 million or 57.2% of net revenues for the nine months ended September 30, 2006, compared to $2.8 million or 57.6% of net revenues for the nine months ended September 30, 2005. Gross profit margins as a percentage of net revenues decreased from the same period in the prior year due to a shift in product mix. Gross profit on product revenues for the quarter and nine months ended September 30, was 50.3% and 46.9%, respectively, in 2005 and 48.4% and 49.3%, respectively, in 2006. Gross profit on customer support and maintenance revenues for the quarter and nine months ended September 30, decreased from 97.9% and 95.0%, respectively, in 2005 to 91.5% and 80.8%, respectively, in 2006, as more costs associated with maintenance contracts were incurred during 2006.

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

Sales and Marketing. Sales and marketing expenses decreased to $0.6 million for the quarter ended September 30, 2006, compared to $0.8 million for the quarter ended September 30, 2005. Sales and marketing expenses decreased to $2.2 million for the nine months ended September 30, 2006, compared to $2.4 million for the nine months ended September 30, 2005. Sales and marketing expenses may vary as a percentage of net sales in the future; however, we believe that these costs will trend constant to downward through the end of the year due to reductions in personnel and discretionary sales and marketing expenditures.

Research and Development. Research and development expenses decreased to $0.3 million for the quarter ended September 30, 2006 compared to $0.6 million for the quarter ended September 30, 2005. Research and development expenses decreased to $1.7 million for the nine months ended September 30, 2006, compared to $2.0 million for the nine months ended September 30, 2005. Research and development costs are expensed in the period incurred. Research and development expenses may vary as a percentage of net sales in the future; however, we believe that the downward trend in costs may continue through the end of the year as a result of additional engineering expenses incurred as cost of sales on development contracts.

General and Administrative. General and administrative expenses remained consistent at $0.3 million for the quarter ended September 30, 2006 compared to $0.3 million for the quarter ended September 30, 2005. General and administrative expenses increased to $1.0 million for the nine months ended September 30, 2006, compared to $0.9 million for the nine months ended September 30, 2005. This increase was primarily due to stock-based compensation expense totaling $120 thousand recognized in 2006 under SFAS123(R). It is expected that general and administrative

expenses will remain fairly constant through the end of the year because of cost containment efforts. General and administrative expense may vary as a percentage of net sales in the future.

Interest. Net interest income decreased to $2 thousand for the quarter ended September 30, 2006 compared to $23 thousand for the same period in 2005. Net interest income decreased to $43 thousand for the nine months ended September 30, 2006 compared to $56 thousand for the same period in 2005. These decreases were primarily caused by lower cash and short-term investment balances in the periods. Net interest income may vary in the future based on our cash flow and rate of return on investments.

Liquidity and Capital Resources

Our principal source of liquidity at September 30, 2006 is approximately $0.3 million of cash and cash equivalents. At September 30, 2006 working capital was $0.2 million compared to $2.4 million at September 30, 2005.

Cash used in operations for the nine months ended September 30, 2006 was $2.9 million, primarily due to a net loss of $2.8 million, a decrease in accounts payable and accrued expenses of $0.2 million, a reduction in deferred revenue of $0.2 million, an increase in accounts receivable of $0.5 million and a reduction in the provision for doubtful accounts of $13 thousand. This cash decrease was partially offset by stock-based compensation of $0.4 million, depreciation expense of $80 thousand, a decrease in inventories of $134 thousand and a decrease in prepaid expenses and other assets of $128 thousand. Cash used in operations for the nine months ended September 30, 2005 was $1.7 million, primarily due to a net loss of $2.4 million, a decrease in accounts payable and accrued expenses of $0.3 million, a reduction in the provision for doubtful accounts of $0.3 million and a reduction in deferred revenue of $0.1 million. This cash decrease was partially offset by depreciation expense of $0.1 million, a decrease in accounts receivable of $0.6 million, a decrease in inventories of $0.4 million and a decrease in prepaid expenses and other assets of $0.2 million. Future fluctuations in inventory balances, accounts receivable and accounts payable will be dependent upon several factors, including, but not limited to, quarterly sales, our strategy in building inventory in advance of receiving orders from customers, and the accuracy of our forecasts of product demand and component requirements.

Cash provided by investing activities in the nine months ended September 30, 2006 was $3 thousand of net purchases of property and equipment offset by maturities of short-term investments of $0.5 million, compared to cash used in investing activities of $0.6 million for the nine months ended September 30, 2005, which consisted primarily the purchase of short-term investments of $2.4 million and net purchases of property and equipment of $0.1 million, which was offset partially by maturities of short-term investments of $1.9 million.

Cash used in financing activities in the nine months ended September 30, 2006 was $0.1 million, primarily consisting of the payment of dividends on preferred stock, compared to cash provided by financing activities in the nine months ended September 30, 2005 was $2.4 million, consisting of net financing proceeds from a private placement of $2.5 million, partially offset by payment of dividends on preferred stock of $137 thousand.

At September 30, 2006, the Company did not have any material commitments for capital expenditures.

During the nine months ended September 30, 2006, the Company funded its operations through the use of cash and cash equivalents.

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

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

Off-Balance Sheet Arrangements.

As of September 30, 2006, we did not have any significant off-balance sheet arrangements, as defined by Item 303(c)(2) of Regulation S-B.

Factors That May Affect Future Results of Operations

Numerous factors may affect our business and future results of operations. These factors include current economic and market conditions, the effect of military actions on government and corporate spending on information security products, spending patterns of, and appropriations to, U.S. government departments, technological changes, competition and market acceptance, acquisitions, product transitions, timing of orders, manufacturing and suppliers, reliance on outsourcing vendors and other partners, intellectual property and licenses, third-party products, dependence on government customers, international operations, intellectual property issues, liquidity and cash resources and effects of restructuring plans and cost reductions. The discussion below addresses some of these and other factors. For a more thorough discussion of these and other factors that may affect our business and future results, see the discussion under the caption Factors That May Affect Future Results of Operations in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

Our cash, cash equivalents, and investments decreased from $3.3 million at December 31, 2005 to $0.3 million at September 30, 2006 due to results of operations. If our net cash outflows continue, we may not have sufficient cash to operate our business.

As of September 30, 2006, we had cash, cash equivalents and investments in the amount of approximately $0.3 million, down from approximately $3.3 million as of December 31, 2005. Our existing cash resources, line of credit and revenues for the remainder of 2006 and 2007, may not provide sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. Therefore, it is possible that we will need to seek additional debt or equity financing to fund our operations for the next year. Despite actions to reduce our costs and improve our profitability, our operating losses and net operating cash outflows may continue through the fourth quarter of 2006 and into 2007. As a result, we may not be able to achieve the revenue and gross margin objectives necessary to achieve positive cash flow or profitability without obtaining additional equity financing. We do not currently have any arrangements for additional financing and we may not be able to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. 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. We may not have sufficient availability under our credit line when we need additional funds. We had approximately $487,000 available to borrow on our credit line as of September 30, 2006. Furthermore, we may not be able to secure additional debt or equity financing on terms that are acceptable to us, or at all, on a timely basis. Therefore, 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 Common Stock is Traded on the Over-the-Counter Bulletin Board, Which may involve certain risks not present in all securities and May Make it More Difficult For Investors to Resell Their Shares Due to Suitability Requirements.

Our common stock is currently traded on the Over the Counter Bulletin Board (OTCBB) where we expect it to remain for the foreseeable future. Bulletin Board Securities are over-the-counter securities and, although the NASD oversees the OTCBB, the OTCBB is not part of the NASDAQ market. Market makers of Bulletin Board securities are unable to use electronic means to interact with other dealers to execute trades, which can cause delays in the time it takes to interact with the market place. Moreover, the market for such securities is often limited, the stocks are more volatile, and the risks to investors are greater. Consequently, broker-dealers often decline to trade in OTCBB stocks. These factors may reduce the potential market for our common stock by reducing the number of potential investors. This may make it more difficult for investors in our common stock to sell shares to third parties or to otherwise dispose of them. This could cause our stock price to decline.

If we fail to respond to rapid technological changes in the network security, data protection, regulated information compliance, entity identification and spyware prevention industries, we may lose customers or our products may become obsolete.

The network security, data protection, regulated information compliance, entity identification and spyware prevention industries are characterized by frequent product introductions, rapidly changing technology and continued evolution of industry standards. We must introduce upgrades to our products rapidly in response to customer needs, such as new computer viruses or other novel external attacks on computer networks as well as the adoption privacy and data protection laws. In addition, the nature of the network security, data protection, regulated information compliance, entity identification and spyware prevention industries 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 products that meet changing customer requirements and evolving industry and legal standards. The development of technologically advanced network security, data protection, regulated information compliance, entity identification and spyware prevention 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, the introduction of new products or product enhancements by us or our competitors or the adoption of new or amended privacy or data protection laws may shorten the life cycle of our existing products or cause our existing products to become obsolete.

Our revenues have decreased to $3.8 million for the first nine months of 2006 from $4.9 million for the same period in 2005 and have generally decreased since 2003 in connection with a shift to sales of our newer product lines. If our network intrusion detection, regulated information compliance, spyware prevention and entity identification products do not achieve market acceptance, our revenues will suffer.

We have continued to transition our sales strategy from our lower margin SecureCom and PDS security appliance products to the development and sales of our higher margin network intrusion detection/prevention, regulated information compliance, entity identification and spyware 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 remained relatively constant at approximately $6.0 million in 2004 and 2005 but have declined in the first half of 2006 compared to the same period in 2005 due to a longer than expected sales cycle.

Our new network security products, regulated information compliance systems, entity identification and spyware products have only been in the market place for a limited period of time and may have longer sales cycles than our previous products. Customer response to these products may not receive 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, we sold our local area networking assets and related networking divisions in a series of sales from 2000 to 2002.

As a result of these sales, we now depend exclusively on revenues generated from the sale of our network security products, which have received limited market acceptance. Moreover, we have only recently introduced our regulated compliance and data privacy systems and our spyware prevention and entity identification products. Although initial response to these products has been positive, the market for these products has only begun to emerge and sales of these products may not occur as quickly as we expect. Consequently, we resemble a developmental stage company and will face the following inherent risks and uncertainties:

- the need for our network security products, regulated information compliance systems, data privacy protection systems, entity identification products and spyware prevention products to achieve market acceptance and produce a sustainable revenue stream;

- our ability to manage costs and expenses;

- our dependence on key personnel;

- our ability to obtain financing on acceptable terms; and

- our ability to offer greater value than our competitors.

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

We incurred a net loss of $2.8 million for the nine months ended September 30, 2006 and have an accumulated deficit of $54.9 million as of September 30, 2006. As a result, we must generate substantially greater revenues from sales in order to achieve profitability and grow our business.

We have incurred significant operating losses and are uncertain about our future operating results. For the nine months ended September 30, 2006, we incurred a net loss of $2.8 million and had an accumulated deficit of approximately $54.9 million as of September 30, 2006. We need to generate and sustain substantially greater revenues from the sales of our products if we are to achieve profitability and grow our business. 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 principal competitors in the network intrusion prevention and detection market include IBM (Internet Security Systems, Inc.), Cisco Systems, Inc., Symantec, Inc., Network Associates, Inc., Tipping Point Technologies, a division of 3Com Corporation, and NFR Security, Inc. Our competitors in the regulated information compliance market include Vontu, Port Authority, Vericept, Reconnex, Tablus and a small number of start-up companies that entered the space within the last two years. Regarding the spyware prevention market, we currently directly and indirectly compete with a number of host-based spyware detection systems, such as Ad-Aware, Spybot S&D and Spy Sweeper and some inline proxy solutions such as Blue Coat Systems, Inc. Our current and potential competitors may have one or more of the following significant advantages over us:

- greater financial, technical and marketing resources;

- better name recognition;

- more comprehensive security solutions;
- better or more extensive cooperative relationships; and
- larger customer base.

Although we believe our products compare favorably to our competitors products and create a sustainable business model, 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 for our products, increasing our costs and affecting our international operations.

We derive a substantial portion of our revenue from sales to United States government entities, including sales to various Army bases. As a result, 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, armed service or corporate spending on our 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 entities typically involves a lengthy education process and a significant technical evaluation and commitment of capital and other resources. This process is also subject to the risk of delays associated with customers internal budgeting and other procedures for approving capital expenditures, deploying new technologies within their networks and testing and accepting new technologies that affect key operations. As a result, sales and implementation cycles for our products can be lengthy, and we may expend significant time and resources before we receive any revenues from a customer or potential customer. Our quarterly and annual operating results could be materially harmed if orders forecasted for a specific customer for a particular period are not realized.

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

Since we began restructuring in 2002, we have incurred approximately $1.1 million in restructuring charges, severance, and related expenses. 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. We expect consolidation in the network security industry to continue in the future. These acquisitions may permit our competitors to accelerate the development and commercialization of broader product lines and more comprehensive solutions than we currently offer. Acquisitions of vendors or other companies with which we have a strategic relationship by our competitors may limit our access to commercially significant technologies. Further, business combinations in the network security industry are creating companies with larger market shares, customer bases, sales forces, product offerings and technology and marketing expertise, which may make it more difficult for us to compete.

Sales to government entities accounted for 71.8% of our revenues for the nine months ended September 30, 2006 and 70.7% of our revenues for the year ended December 31, 2005. Sales to government customers involve unique risks, which could adversely impact our revenues.

We derived 71.8% of our revenues from sales to various U.S. government entities for the nine months ended September 30, 2006, and 70.7% of our revenues from these sales for the year ended December 31, 2005. 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, 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 10.5% of our revenues from international sales in the nine months ended September 30, 2006, and 10.7% of our revenues from these sales for the year ended December 31, 2005. Our ability to sell our products internationally is subject to certain risks which could harm our business.

Sales to foreign customers accounted for approximately 10.7% of our revenues for the year ended December 31, 2005, and 10.5% of our revenues for the nine months ended September 30, 2006. 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 19.2% of our revenues for the nine months ended September 30, 2006 and 36.2% of our revenue for the year ended December 31, 2005. 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 19.2% of our revenues for the nine months ended September 30, 2006, and 36.2% of our revenue for the year ended December 31, 2005, 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.

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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. 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 to factors outside of our control.

The market price of our common stock has been highly volatile in the past and may continue to be volatile in the future. For example, for the nine-month period ending September 30, 2006, the market price of our common stock fluctuated between $0.25 and $2.87 per share. The market price of our common stock may fluctuate significantly in response to a number of factors, many of which are outside our control, including:

- variations in our quarterly operating results;
- changes in estimates of our financial performance by securities analysts;
- changes in market valuations of our competitors;
- announcements by us or our competitors of new products, significant contracts, acquisitions, strategic relationships, joint ventures or capital commitments;
- product or design flaws, product recalls or similar occurrences;
- additions or departures of key personnel;
- sales of common stock in the future; and
- fluctuations in stock market prices and volume, which can be particularly common among network security and other high technology companies.

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

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

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock and exercise of warrants that we issued in recent private placements.

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 of November 1, 2006, there were 259,696 shares of 5% preferred stock, representing approximately 413,003 shares of common stock upon conversion, and warrants to purchase 621,027 shares of common stock outstanding.

In addition, on March 28, 2005, we completed a $2,663,000 private placement in connection with which we issued 1,065,200 shares of our Series 2 5% Convertible Preferred Stock and warrants to acquire 532,600 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 60,390 shares of common stock. The conversion price for the preferred stock is $2.50 per share and the exercise price of the warrants is $2.77 per share. As of November 1, 2006, there were 460,000 shares of Series 2 5% preferred stock, representing 460,000 shares of common stock upon conversion, and warrants to purchase 592,990 shares of common stock outstanding.

Finally, on December 2, 2005, we completed a $1,230,843 private placement in connection with which we issued 564,607 shares of our Series 3 5% preferred stock and warrants to acquire 282,306 shares of our common stock. We also issued two affiliates of our placement agent warrants to purchase an aggregate of 27,531 shares of common stock. The conversion price of the preferred stock is $2.18 per share and the exercise price of the warrants is $2.58 per share. As of November 1, 2006, there were 468,735 shares of Series 3 5% preferred stock, representing 468,735 shares of common stock upon conversion, and warrants to purchase 309,837 shares of common stock outstanding.

On November 1, 2006, we had 7,046,213 shares of common stock outstanding. We expect the private placements discussed above to result in a further dilution to holders of our common stock upon conversion of the preferred stock and exercise of the warrants of 2,865,592 shares of common stock, or an approximately 40.7% increase in the number of shares of our common stock outstanding.

Further, the occurrence of certain events entitle holders of our Series 3 5% preferred stock to require us to redeem their shares for a number of shares of our common stock equal to the redemption price divided by 75% of the ten-day average of the volume weighted average price of our common stock ending on the day immediately preceding the holder s election to redeem, subject to a floor of $0.87 per share. Holders of our Series 2 5% preferred stock have similar redemption rights without a floor. The redemption price for the shares of Series 3 5% preferred stock equals the sum of (1) the greater of $2.834 and the volume weighted average price of our common stock on the trading day immediately preceding the redemption event multiplied by $2.18 divided by the conversion price of the Series 3 5% preferred stock then in effect plus (2) any accrued but unpaid dividends on the Series 3 5% preferred stock plus (3) any unpaid liquidated damages or other amounts payable to the holders of the Series 3 5% preferred stock. The redemption price for the shares of Series 2 5% preferred stock equals the sum of (1) the greater of $3.25 and the volume weighted average price of our common stock on the trading day immediately preceding the redemption event multiplied by $2.50 divided by the conversion price of the Series 2 5% preferred stock then in effect plus (2) any accrued but unpaid dividends on the Series 2 5% preferred stock plus (3) any unpaid liquidated damages or other amounts payable to the holders of the Series 2 5% preferred stock. As a result, assuming we have paid all liquidated damages and other amounts to the holders, accrued but unpaid dividends on October 27, 2006 of $17,000, a volume weighted average price of $0.29, which was the ten-day volume weighted average closing price of our common stock on October 27, 2006, and our 7,046,213 shares of common stock outstanding on October 27, 2006, we would issue approximately 13,107,000 shares of our common stock if a specified redemption event occurs and all holders of Series 3 5% preferred stock and Series 2 5% preferred stock elected to redeem their shares for common stock. This would represent an increase of approximately 186% in the number of shares of our common stock as of October 27, 2006.

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

The holders of the shares of our 5% preferred stock and warrants we issued on March 25, 2004, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on August 6, 2004. As of October 27, 2006, 740,304 shares of preferred stock had converted into 1,177,327 shares of common stock.

The holders of the shares of Series 2 5% preferred stock and warrants we issued on March 28, 2005, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on May 5, 2005. As of October 27, 2006, 605,200 shares of Series 2 5% preferred stock had converted into 605,200 shares of common stock.

The holders of the shares of Series 3 5% preferred stock and warrants we issued on December 2, 2005, may freely convert their shares of preferred stock and exercise their warrants and sell the underlying shares of common stock pursuant to an effective registration statement we filed on January 5, 2006. As of October 27, 2006, 95,872 shares of Series 3 5% preferred stock had converted into 95,872 shares of common stock.

For the four weeks ended on October 27, 2006, the average daily trading volume of our common stock was 36,080 shares. Consequently, if holders of preferred stock or warrants elect to convert their remaining shares or exercise their warrants and sell a material amount of their underlying shares of common stock on the open market, the increase in selling activity could cause a decline in the market price of our common stock. Furthermore, these sales, or the potential for these sales, could encourage short sales, causing additional downward pressure on the market price of our common stock.

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

Shares of our 5% preferred stock accrue cash dividends equal to $0.25 per share per annum, payable in arrears on March 31 and September 30 of each year, shares of our Series 2 5% preferred stock accrue cash dividends equal to $0.125 per share per annum, payable in arrears on the first business day of March, June, September and December of each year and shares of our Series 3 5% preferred stock accrue cash dividends equal to $0.109 per share per annum, payable in arrears on the first business day of March, June, September and December of each year. The amount of the dividends on our Series 2 5% preferred stock may increase to $0.45 per share per annum and the amount of the dividends on our Series 3 5% preferred stock may increase to $0.3294 per share per annum upon the occurrence of certain event entitling the holders of these shares to redemption.

During 2005, we paid $123 thousand in dividends related to our 5% convertible preferred stock and $63 thousand in dividends related to our Series 2 5% preferred stock. At September 30, 2006, we had $32,551 dividends accrued related to our 5% preferred stock, $4,726 related to our Series 2 5% preferred stock, and $4,199 related to our Series 3 5% preferred stock.

Delaware law provides that we may only pay dividends out of our capital surplus or, if no surplus is available, out of our net profits for the fiscal year the dividend is declared and/or the preceding fiscal year. We have not had net profits for the last two fiscal years ended as of December 31, 2005. However, we did have sufficient capital surplus, defined as the amount by which our net assets exceed our stated capital, based on par value of our outstanding shares as provided by Delaware law. Although we are currently able to pay accrued dividends on our outstanding shares of preferred stock, we cannot assure you that our net assets will continue to exceed our stated capital or that we will have net profits in order to pay these dividends in the future. These dividends continue to accrue on our outstanding shares of preferred stock, regardless of whether we are legally able to pay them. The accrual of these dividends may adversely affect our operating results. Moreover, the payment of these dividends could strain our available cash resources, which could adversely affect our ability to operate or grow our business.

In addition, our inability to pay dividends could require us to redeem outstanding shares of Series 2 5% preferred stock and Series 3 5% preferred stock for shares of our common stock issued at a price equal to 75% of the average of the volume weighted average price of our common stock for the ten days ending on the day immediately preceding an election to redeem, subject, in the case of the Series 3 5% preferred stock, to a floor of $0.87. As a result, the issuance, or potential issuance, of these additional shares of common stock could cause our stock price to decline. Furthermore, our inability to pay dividends could adversely affect our ability to raise equity financing in the future if required.

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

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

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

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

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

Certain provisions of our certificate of incorporation and bylaws, such as our ability to offer blank check preferred stock and the inability of our common 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 preferred stockholders exercise significant control over our company and may approve or take actions that may be adverse to your interests.

As of October 27, 2006, our executive officers, directors and preferred stockholders beneficially own approximately 23.5% 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 the approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us or providing us with additional financing if required. These stockholders may use their influence to approve or take actions that may be adverse to your interests.

Item 3. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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

Item 6. EXHIBITS

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

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

S I G N A T U R E S

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

	INTRUSION INC.
Date: November 13, 2006	/s/ G. Ward Paxton G. Ward Paxton Chairman, President & Chief Executive Officer (Principal Executive Officer)
Date: November 13, 2006	/s/ Michael L. Paxton Michael L. Paxton Vice President, Chief Financial Officer, Treasurer & Secretary (Principal Financial & Accounting Officer)