INTRUSION INC
Form 10-Q
August 14, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from to

Commission File Number 0-20191

INTRUSION INC.

(Exact name of registrant as specified in its charter)

Delaware	**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

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the Registrant's Common Stock, $0.01 par value, on August 1, 2018 was 13,016,836.

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)

	June 30, 2018	December 31, 2017
ASSETS		
Current Assets:		
Cash and cash equivalents	$376	$ 224
Accounts receivable	1,068	962
Inventories	—	15
Prepaid expenses	418	89
Total current assets	1,862	1,290
Property and equipment, net	223	124
Other assets	38	38
TOTAL ASSETS	$2,123	$ 1,452
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current Liabilities:		
Accounts payable and accrued expenses	$1,379	$ 1,182
Dividends payable	520	447
Obligations under capital lease, current portion	56	44
Deferred revenue	947	406
Total current liabilities	2,902	2,079
Loan payable to officer	1,815	2,865
Obligations under capital lease, noncurrent portion	60	17
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, $0.01 par value: Authorized shares – 5,000		

Series 1 shares issued and outstanding — 200 Liquidation preference of $1,188 in 2018 and $1,163 in 2017	707	707
Series 2 shares issued and outstanding — 460 Liquidation preference of $1,356 in 2018 and $1,328 in 2017	724	724
Series 3 shares issued and outstanding — 289 Liquidation preference of $744 in 2018 and $728 in 2017	412	412
Common stock, $0.01 par value:		
Authorized shares — 80,000		
Issued shares — 13,027 as of June 30, 2018 and 12,808 as of December 31, 2017 Outstanding shares — 13,017 as of June 30, 2018 and 12,798 as of December 31, 2017	130	128
Common stock held in treasury, at cost – 10 shares	(362)	(362)
Additional paid-in capital	56,551	56,518
Accumulated deficit	(60,709)	(61,529)
Accumulated other comprehensive loss	(107)	(107)
Total stockholders’ deficit	(2,654)	(3,509)
TOTAL LIABILITIES AND STOCKHOLDERS’ DEFICIT	$ 2,123	$ 1,452

See accompanying notes.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	**June 30, 2017**	**June 30, 2018**	**June 30, 2017**
Revenue	$2,369	$1,543	$4,632	$3,102
Cost of revenue	926	632	1,778	1,215
Gross profit	1,443	911	2,854	1,887
Operating expenses:				
Sales and marketing	431	415	845	776
Research and development	200	594	503	1,179
General and administrative	290	282	585	613
Operating income (loss)	522	(380)	921	(681)
Interest expense, net	(48)	(58)	(101)	(108)
Net income (loss)	$474	$(438)	$820	$(789)
Preferred stock dividends accrued	(35)	(35)	(69)	(69)
Net income (loss) attributable to common stockholders	$439	$(473)	$751	$(858)
Net income (loss) per share attributable to common stockholders:				
Basic	$0.03	$(0.04)	$0.06	$(0.07)
Diluted	$0.03	$(0.04)	$0.05	$(0.07)
Weighted average common shares outstanding:				
Basic	13,017	12,798	12,982	12,772
Diluted	14,791	12,798	14,756	12,772

See accompanying notes.

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

	Six Months Ended June 30, 2018	**June 30, 2017**
Operating Activities:		
Net income (loss)	$820	$(789)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	65	109
Stock-based compensation	11	10
Penalties and waived penalties on dividends	22	15
Changes in operating assets and liabilities:		
Accounts receivable	(106)	256
Prepaid expenses and other assets	(329)	(14)
Inventories	15	—
Accounts payable and accrued expenses	201	135
Deferred revenue	541	543
Net cash provided by operating activities	1,240	265
Investing Activities:		
Purchases of property and equipment	(75)	(9)
Financing Activities:		
Proceeds from stock options exercised	71	11
Proceeds from loan from officer	150	1,330
Principal payments on loan from officer	(1,200)	(1,190)
Principal payments on capital leases	(34)	(74)
Net cash (used in) provided by financing activities	(1,013)	77
Net increase in cash and cash equivalents	152	333
Cash and cash equivalents at beginning of period	224	64
Cash and cash equivalents at end of period	$376	$397
SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES:		
Preferred stock dividends accrued	$69	$69
Purchase of leased equipment per capital lease	$89	$—

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 entity identification, high speed data mining, cybercrime and advanced persistent threat detection products. Our product families include:

- TraceCop™ for identity discovery and disclosure,
- Savant™ for high speed network data mining and analytics, and advanced persistent threat detection.

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

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

Our end-user customers include:

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

Essentially, our end-users can be defined as any end-users requiring network security solutions for protecting their mission critical data.

We were organized in Texas in September 1983 and reincorporated in Delaware in October 1995. Our principal executive offices are located at 1101 East Arapaho Road, Suite 200, Richardson, Texas 75081, and our telephone number is (972) 234-6400. Our website URL is www.intrusion.com. References to the “Company”, “we”, “us”, “our”, “Intrusion” or “Intrusion Inc.” refer to Intrusion Inc. and its subsidiaries. TraceCop and Savant are trademarks of Intrusion Inc.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Item 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The December 31, 2017 balance sheet was derived from audited financial statements, but does not include all the disclosures required by accounting principles generally accepted in the United States. However, we believe that the disclosures are adequate to make the information presented not misleading. In our opinion, all the adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. The results of operations for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2017, filed with the U.S. Securities and Exchange Commission (the “SEC”) on March 29, 2018.

The Company calculates the fair value of its assets and liabilities which qualify as financial instruments and includes this additional information in the notes to consolidated financial statements when the fair value is different from the carrying value of these financial instruments. The estimated fair value of accounts receivable, accounts payable and accrued expenses, and dividends payable approximate their carrying amounts due to the relatively short maturity of these instruments. Loans payable to officer are with a related party and as a result do not bear market rates of interest. Management believes based on its current financial position that it could not obtain comparable amounts of third party financing, and as such cannot estimate the fair value of the loans payable to officer. None of these instruments are held for trading purposes.

On January 1, 2018 we adopted ASU No. 2014-09, *Revenue from Contracts with Customers*, as amended, using the modified retrospective approach. At the date of adoption there was no impact on the balance sheet or statement of operation. ASU No. 2014-09 did not have a material effect on the Company's financial position, results of operations or cash flows for the three and six month periods ended June 30, 2018.

3. Inventories (In thousands)

		June 30, 2018	December 31, 2017
Inventories consist of:			
Finished products		—	15
Net inventory	$	—	15

4. Loan Payable to Officer

On February 9, 2017, the Company entered into an unsecured revolving promissory note to borrow up to $3,400,000 from G. Ward Paxton, the Company's Chief Executive Officer (the "CEO Note"). Under the terms of the CEO Note, the Company may borrow, repay and reborrow on the loan as needed up to an outstanding principal balance due of $3,400,000 at any given time through March 2019.

On March 2, 2017, the Company amended the CEO Note described above on the same terms, with the Company being able to borrow, repay, and re-borrow on the note as needed up to an outstanding principal balance due of $3,700,000 at any given time through March 2019.

On February 8, 2018, the Company renewed the CEO Note on the same terms, with the Company being able to borrow, repay and reborrow on the CEO Note as needed up to an outstanding principal balance due of $3,700,000 at any given time through March 2020.

Amounts borrowed under the CEO Note accrue interest at a floating rate per annum equal to Silicon Valley Bank's ("SVB") prime rate plus 1% (6.00% at June 30, 2018). All outstanding borrowings and accrued but unpaid interest is due on March 31, 2020. As of June 30, 2018, the borrowings outstanding totaled $1,815,000 and accrued interest totaled $423,000.

5. Accounting for Stock-Based Compensation

During the three month periods ended June 30, 2018 and 2017, the Company granted 24,000 and 24,000, respectively, of stock options to employees or directors. The Company recognized $6,000 and $5,000, respectively, of stock-based compensation expense for the three month periods ended June 30, 2018 and 2017. During the six month periods ended June 30, 2018 and 2017, the Company granted 24,000 and 24,000, respectively, of stock options to employees and directors. The Company recognized $11,000 and $10,000, respectively, of stock-based compensation expense for the six month periods ended June 30, 2018 and 2017.

During the three month periods ended June 30, 2018 and 2017, 5,000 and zero options were exercised under the 2005 Plan, respectively. During the six month periods ended June 30, 2018 and 2017, 219,000 and 50,000 were exercised under the 2005 Plan, respectively.

Valuation Assumptions

The fair values of employee and director option awards were estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

	For Three Months Ended June 30, 2018	**For Three Months Ended June 30, 2017**	**For Six Months Ended June 30, 2018**	**For Six Months Ended June 30, 2017**
Weighted average grant date fair value	$ 0.99	$ 0.26	$ 0.99	$ 0.26
Weighted average assumptions used:				
Expected dividend yield	0.0 %	0.0 %	0.0 %	0.0 %
Risk-free interest rate	2.93 %	1.77 %	2.93 %	1.77 %
Expected volatility	131.0 %	75.0 %	131.0 %	75.0 %
Expected life (in years)	5.0	5.0	5.0	5.0

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. Options granted to non-employees are valued using the fair market value on each measurement date of the option.

6. Contract Assets and Contract Liabilities

Contract assets represent contract billings for sales per contracts with customers and are classified as current. Our contract assets include our accounts receivables. During the three months ended June 30, 2018, contract assets decreased $175,000 due to cash receipts exceeding new contract assets. For the six months ended June 30, 2018, contract assets increased $106,000 due to recognized contract assets exceeding cash receipts.

Contract liabilities consist of deferred revenue from advanced payments on revenues that have not been recognized on a contract. The Company classifies deferred revenue as current or non-current on the expected timing of sales recognition. For the three months ended June 30, 2018, the Company recognized revenue of $219,000 from its contract liabilities balance at March 31, 2018 due to revenue recognition in accordance with contract terms and was offset advance payments of $1.1 million. For the six month ended on June 30, 2018, advance payments increased $1.1 million offset by recognizing revenue of $549,000.

7. Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) attributable to common stockholders for the period by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing the net income (loss) attributable to common stockholders by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period. Our common stock equivalents include all common stock issuable upon conversion of preferred stock and the exercise of outstanding options and warrants. The aggregate number of common stock equivalents excluded from the diluted loss per share calculation for the three month periods ended June 30, 2018 and 2017 are 291,868 and 2,883,965 as they are antidilutive. The aggregate number of common stock equivalents excluded from the diluted income (loss) per share calculation for the six month periods ended June 30, 2018 and 2017 are 285,967 and 3,072,573 as they are antidilutive.

8. Concentrations

Our operations are concentrated in one area—security software/entity identification. Sales to the U.S. Government through direct and indirect channels totaled 88.4% of total revenues for the second quarter of 2018 compared to 72.2% of total revenues for the second quarter of 2017. During the second quarter of 2018, approximately 73.7% of total revenues were attributable to four government customers compared to approximately 54.2% of total revenues attributable to three government customers in the second quarter of 2017. There was one individual commercial customer in the second quarter of 2018 attributable for 10.2% of total revenue compared to 25.9% of total revenue to one individual commercial customer for the same period in 2017. Our similar product and service offerings are not viewed as individual segments, as our management analyzes the business as a whole and expenses are not allocated to each product offering.

9. Commitments and Contingencies

We are subject from time to time to various legal proceedings and claims that arise during the ordinary course of our business. We do not believe that the outcome of those "routine" legal matters should have a material adverse effect on our consolidated financial position, operating results or cash flows; however, we can provide no assurances that legal claims that may arise in the future will not have such a material impact on the Company.

10. Dividends Payable

During the quarter ended June 30, 2018, we accrued $13,000 in dividends payable to the holders of our 5% Preferred Stock, $14,000 in dividends payable to the holders of our Series 2 5% Preferred Stock and $8,000 in dividends payable to the holders of our Series 3 5% Preferred Stock. As of June 30, 2018, we have $520,000 in accrued and unpaid dividends.

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. These dividends continue to accrue on all our outstanding shares of preferred stock, regardless of whether we are legally able to pay them. If we are unable to pay dividends on our preferred stock, we will be required to accrue an additional late fee penalty of 18% per annum on the unpaid dividends for the Series 2 Preferred Stock and Series 3 Preferred Stock. Our CEO, CFO and one outside board member who are holders of our Series 2 and Series 3 Preferred Stock have waived any possible late fee penalties. In addition to this late penalty, the holders of our Series 2 Preferred Stock and Series 3 Preferred Stock could elect to present us with written notice of our failure to pay dividends as scheduled, in which case we would have 45 days to cure such a breach. In the event that we failed to cure the breach, the holders of these shares of preferred stock would then have the right to require us to redeem their shares of preferred stock for a cash amount calculated in accordance with their respective certificates of designation. If we were required to redeem all shares of Series 2 Preferred Stock and Series 3 Preferred Stock as of August 1, 2018, the aggregate redemption price we would owe would be $2.4 million.

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

Forward Looking Statements

This Quarterly Report on Form 10-Q, including, without limitation, the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such forward-looking statements are generally accompanied by words such as "estimate," "expect," "believe," "should," "would,