SSP SOLUTIONS INC
Form 10-Q
May 20, 2002

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

FORM 10-Q

[LOGO OF SSP SOLUTIONS]

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002,
OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
COMMISSION FILE NO. 000-26227

SSP SOLUTIONS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| DELAWARE<br>(STATE OR OTHER JURISDICTION<br>OF INCORPORATION OR ORGANIZATION) | 33-0757190<br>(I.R.S EMPLOYER<br>IDENTIFICATION NO.) |

17861 CARTWRIGHT ROAD, IRVINE, CALIFORNIA 92614
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) (ZIP CODE)

(949) 851-1085
(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)

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 [X] No [ ]

As of May 15, 2002, the registrant had 20,664,832 shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SSP SOLUTIONS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

(UNAUDITED)

| | DECEMBER 31, 2001 | MARCH 31, 2002 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ 3,257 | $ 723 |
| Investment in trading securities | 1,360 | 442 |
| Accounts receivable (net of allowance for doubtful accounts of $254 as of December 31, 2001 and March 31, 2002) | 4,358 | 1,249 |
| Inventories | 436 | 370 |
| Prepaid expenses | 601 | 400 |
| Other current assets | 401 | 456 |
| Total current assets | 10,413 | 3,640 |
| Property and equipment, net | 361 | 230 |
| Other assets | 28 | 11 |
| Goodwill and other intangibles, net | 26,621 | 26,598 |
| | $ 37,423 | $ 30,479 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Current installments of long-term debt | $ 1,695 | $ 363 |
| Accounts payable | 9,495 | 7,780 |
| Accrued liabilities | 3,343 | 4,060 |
| Note payable to related party | 392 | |
| Deferred revenue | 203 | 197 |
| Accrued rent | 1,064 | 798 |
| Total current liabilities | 16,192 | 13,198 |
| Long-term debt, less current installments | 2,500 | 2,500 |
| Deferred revenue | 46 | |
| Accrued rent | 1,107 | 1,066 |
| Total liabilities | 19,845 | 16,764 |
| Stockholders equity: | | |
| Preferred stock, $.01 par value; Authorized 5,000,000 shares; no shares issued or outstanding | | |
| Common stock, $.01 par value; Authorized 100,000,000 shares; issued and outstanding 20,630,754 and 20,664,832 shares at December 31, 2001 and March 31, 2002, respectively | 206 | 207 |
| Additional paid-in capital | 118,608 | 118,364 |

| | | |
|---|---|---|
| Note receivable from stockholder | (500) | (500) |
| Deferred compensation | (1,193) | (786) |
| Accumulated deficit | (99,543) | (103,570) |
| Commitments & contingencies (Notes 8 & 11) | | |

See accompanying notes to condensed consolidated financial statements.

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SSP SOLUTIONS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

| | THREE MONTHS ENDED | |
|---|---|---|
| | MARCH 31, 2001 | MARCH 31, 2002 |
| Revenues: | | |
| Product | $ 4,144 | $ 1,453 |
| License and service | 334 | 656 |
| Total revenues | 4,478 | 2,109 |
| Costs and expenses: | | |
| Cost of sales product | 3,066 | 881 |
| Cost of sales license and service | 133 | 282 |
| Selling, general and administrative | 1,773 | 2,318 |
| Research and development | 1,843 | 2,489 |
| Amortization of intangibles | 23 | 23 |
| Operating loss | (2,360) | (3,884) |
| Other expense, net | 16 | 140 |
| Loss before income taxes | (2,376) | (4,024) |
| Provision for income taxes | | 3 |
| Net loss | $(2,376) | $ (4,027) |
| Net loss per share basic and diluted | $ (0.24) | $ (0.19) |
| Shares used in per share computations basic and diluted | 9,747 | 20,651 |

See accompanying notes to condensed consolidated financial statements.

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SSP SOLUTIONS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

(UNAUDITED)

| | THREE MONTHS ENDED | |
|---|---|---|
| | **MARCH 31, 2001** | **MARCH 31, 2002** |
| Cash flows from operating activities: | | |
| Net loss | $(2,376) | $(4,027) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Provision for losses on receivables | 61 | 12 |
| Depreciation and amortization | 218 | 156 |
| Deferred compensation | | 104 |
| Realized loss on trading securities | | 1 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 2,357 | 3,097 |
| Inventories | (33) | 66 |
| Prepaid expenses | 26 | 201 |
| Other current assets | (60) | (55) |
| Other assets | 139 | 17 |
| Accounts payable | 473 | (1,715) |
| Accrued liabilities | (97) | 717 |
| Accrued rent | | (307) |
| Deferred revenue | (52) | (52) |
| Net cash provided by (used in) operating activities | 656 | (1,785) |
| Cash flows used in investing activities: | | |
| Purchases of property and equipment | (38) | (2) |
| Proceeds from sale of trading securities | | 917 |
| Net cash provided by (used in) investing activities | (38) | 915 |
| Cash flows from financing activities: | | |
| Stock options exercised | 3 | 60 |
| Borrowings on revolving note payable | 5,395 | 1,103 |
| Repayment of insurance financing | (130) | (173) |
| Principal payments on revolving line of credit | (6,121) | (2,262) |
| Principal payments on note payable to related party | | (392) |
| Net cash used in financing activities | (853) | (1,664) |
| Net increase (decrease) in cash | (235) | (2,534) |
| Cash and cash equivalents at beginning of period | 4,120 | 3,257 |
| Cash and cash equivalents at end of period | $ 3,885 | $ 723 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |

| | | |
|---|---|---|
| Interest | $ 17 | $ 92 |
| Income taxes | | 3 |
| Supplemental disclosure of non-cash financing activities information: | | |
| Deferred Compensation | $ | $ 303 |

See accompanying notes to condensed consolidated financial statements.

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SSP SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2001 AND 2002
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

(1) GENERAL INFORMATION:

Condensed Consolidated Financial Statements

In the opinion of SSP Solutions, Inc. ( the Company ), the accompanying unaudited condensed consolidated financial statements contain all adjustments (which are normal recurring accruals) necessary to present fairly the financial position as of March 31, 2002; the results of operations for the three months ended March 31, 2001 and 2002; and the statements of cash flows for the three months ended March 31, 2001 and 2002. Interim results for the three months ended March 31, 2002, are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. The interim financial statements should be read in conjunction with the Company s consolidated financial statements for the year ended December 31, 2001, included in the Company s Form 10-K/A, filed in April 2002.

These condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company has incurred significant operating losses, has used cash in operating activities, has an accumulated deficit, and deficit working capital. The Company currently anticipates that existing resources will not be sufficient to satisfy contemplated working capital requirements for the next twelve months.

Liquidity and Capital Resources

At March 31, 2002, the Company had deficit working capital of $9,558 and the Company incurred a loss from operations for the three months then ended of $3,884. The Company expects to continue to incur substantial additional losses in 2002. Given the March 31, 2002 cash balance and the projected operating cash requirements, the Company anticipates that existing capital resources will not be adequate to satisfy cash flow requirements through December 31, 2002. The Company will require additional funding. The Company s cash flow estimates are based upon achieving certain levels of sales, reductions in operating expenses and liquidity available under the accounts receivable financing. Should sales be less than forecast, expenses be higher than forecast or the liquidity not be available under the accounts receivable financing or through additional financings of debt and/or equity, the Company will not have adequate resources to fund its operations. During the past quarter, the Company incurred defaults under both the Company s accounts receivable financing and the long-term convertible notes. The Company obtained waivers for its accounts receivable financing for defaults through March 31, 2002 and for the long-term convertible notes through January 1, 2003. However, there is no guarantee the lenders will continue to waive defaults in the future, should they occur, and the lenders may declare amounts owed by the Company due and payable. Subsequent to March 31, 2002, the Company remained in default under the accounts receivable financing and has not obtained a waiver of such default. The Company does not expect future fixed obligations to be paid from operations and intends to satisfy fixed obligations from additional financings, use of the accounts receivable financing, extending vendor payments, selling investments and issuing stock as payment on obligations.

The Company s current financial condition is the result of several factors including the following:

Operating results in 2001 and first quarter of 2002 were below expectations.

The events of September 11, 2001 affected the operations and delayed the decisions of the U.S. government. This caused sales the Company had anticipated to be delayed. The events may also affect potential investors and related terms of investment capital.

Sales of products through channels acquired in the acquisition ( Acquisition ) of BIZ Interactive Zone, Inc. ( BIZ ) are taking longer than originally anticipated to develop.

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Market demand for the Company s Xboard product (formerly known as CipherServer product line) did not materialize as anticipated and therefore the Company s 2001 sales were below forecast and the Company is not forecasting future sales of the Xboard product.

Reduced credit line availability and the unwillingness of vendors to sell additional products to the Company on account affected the sales volume of the Company s Pulsar subsidiary in 2001 and will continue to have an impact on sales volume in 2002.

Research and development expenses from the Acquisition increased costs.

The Company currently has a need for a substantial amount of capital to meet its liquidity requirements. The amount of capital that the Company will need in the future will depend on many factors including, but not limited, to:

the ability to extend vendor payment terms

the market acceptance of products and services

the levels of promotion and advertising that will be required to launch new products and services and attain a competitive position in the market place

research and development plans

levels of inventory and accounts receivable

technological advances

competitors responses to the Company s products and services

relationships with partners, suppliers and customers

projected capital expenditures

reduction in the valuation of marketable investment securities

national and international economic conditions

defaults on financing that will impact the availability of borrowings

In addition to the Company s current deficit working capital situation, current operating plans show a shortfall of cash during 2002. The Company intends to mitigate its position through one or more of the following:

Additional equity capital The Company will seek additional equity capital, if available. Equity capital will most likely be issued at a discount to market and require the issuance of warrants causing a dilution to current stockholders. In addition, providers of new equity capital may require additional concessions in order for them to provide needed capital to the Company.

Additional convertible debt Depending upon the market conditions, the Company may issue additional debt instruments. The types of instruments demanded by the market would likely contain a provision for the issuance of warrants and may also be convertible into equity. On April 16, 2002, simultaneous with the filing of Form 10-K for 2001, the Company completed a private placement of $5,000 in the form of $4,000 in 10% secured convertible promissory notes, $653 in secured non-convertible promissory notes ($153 held by co-chairman Kris Shah and $500 held by co-chairman Marvin Winkler) and the pre-payment of a $500 note due from Kris Shah, less a discount of $153.

Off balance sheet financing The Company s operations are not relatively capital intensive. However, should the Company need to add equipment or decide to expand the facilities, the Company may use an operating lease transaction to acquire the use of capital assets. An operating lease would not appear on the Company s balance sheet and would be charged as an expense as payments accrue.

Receivables financing The Company plans to continue to finance receivables in conjunction with its Wells Fargo Business Credit ( WFBC ) agreements to generate cash. In the past the Company has triggered events of default under the terms of the WFBC agreements. The events of default have related to not forwarding misdirected payments to WFBC within the timeframe provided for in the WFBC agreements and not paying obligations to vendors as they become due. The Company has received waivers for all known instances of misdirected payments not being forwarded to WFBC in a timely manner. The Company received a waiver from WFBC through March 31, 2002, related to not paying vendor obligations in a timely manner. However, since March 31, 2002, the Company has continued to be delinquent in paying vendor obligations and is therefore currently in default of the WFBC agreements. The Company has not obtained a waiver from WFBC for this continuing default. Without waivers for existing or future defaults the Company may not have funds available under its credit line. There is no assurance that WFBC will provide waivers now or in the future.

Liquidate investments The Company will sell investments to generate cash. The market value of trading securities at December 31, 2001 and March 31, 2002, was $1,360 and $442, respectively. During the three months ended March 31, 2002, the Company generated $917 through the sales of these trading securities.

Vendor negotiations The Company is negotiating with vendors regarding payment of existing accounts payable over extended terms of forty eight (48) months with no interest. The Company has reached a verbal agreement with one large vendor and is working with remaining vendors. The Company previously executed term out agreements with a number of vendors that must now be further extended.

Project suspensions The Company may defer cash payments through suspension of development projects.

Issuance of stock as payment for existing and future obligations The Company anticipates paying $2,222 of accrued liabilities as of March 31, 2002, by the future issuance of common stock.

Issuance of stock to pay interest The Company may issue common stock to pay interest on long term debt.

Reductions in work force The Company may further reduce its workforce.

Should the Company not receive adequate financing, it could be forced to merge with another company or cease operations.

Ultimately, the Company s ability to continue as a going concern is dependent upon its ability to successfully launch its new products, increase revenue, improve operating efficiencies, sustain a profitable level of operations and attract new sources of capital.

BIZ Acquisition

On August 24, 2001, pursuant to an Agreement and Plan of Reorganization dated July 3, 2001 with BIZ, the Company completed the Acquisition, whereby BIZ became a wholly-owned subsidiary of the Company. In connection with the Acquisition, the Company issued an aggregate of 10,875 shares of its common stock in exchange for all of the outstanding shares of BIZ common stock and preferred stock. In addition, the Company reserved for issuance an aggregate of approximately 860 shares of its common stock for issuance upon exercise of BIZ options and warrants assumed by the Company.

The Acquisition has been accounted for under the purchase method of accounting in accordance with generally accepted accounting principles. The Company recorded a one-time charge for purchased in-process research and development ( IPR&D ) expenses of $1,600.

The total purchase price and allocation among the fair value of tangible and intangible assets and liabilities (including purchased in-process research and development) are summarized as follows:

| | |
|---|---|
| Tangible assets | $ 3,231 |
| Liabilities | 3,047 |
| Net tangible assets | 184 |
| Identifiable intangible assets: | |
| In-process research and development | 1,600 |
| Completed technology | 6,200 |

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| | |
|---|---|
| Strategic relationships | 2,800 |
| Goodwill | 53,882 |
| Deferred compensation | 29 |
| | $64,695 |

The Company believes the assumptions used in determining the income forecast associated with the IPR&D products were reasonable. No assurance can be given, however, that the underlying assumptions used to estimate the income forecast, the ultimate revenues and costs on such projects, or the events associated with such projects, will transpire as estimated. During the fourth quarter of 2001, the Company terminated its development on one of the technologies classified as IPR&D. To date, the Company has spent approximately $1,112 on the IPR&D projects and the estimated cost to complete the two on-going projects is $4,025.

As the markets for the Company s products are characterized by rapidly changing technology, evolving industry standards, and the frequent introduction of new products and enhancements, it is reasonably possible that the estimates of the anticipated future gross revenues, the remaining estimated economic life, or both, will be reduced within the next year. Reasonably possible is defined as more than remote but less than likely. As a result, the remaining goodwill of $25,930 related to the Acquisition at March 31, 2001, may be reduced within the next year.

Goodwill and Other Intangibles

The Company adopted Statements of Financial Accounting Standards, ( Statement ) 141 and 142, Business Combinations and Goodwill and Other Intangible Assets for the Acquisition that was completed on August 24, 2001. In accordance with Statement 142 goodwill is not amortized for business acquisitions that were completed after June 30, 2001, but rather will be evaluated at least annually for impairment. Other identifiable intangible assets acquired from business acquisitions that were completed after June 30, 2001, are amortized over their estimated useful lives. Accordingly, the Company has not recorded amortization of goodwill related to the Acquisition.

The Company has begun performing the first step of the required impairment tests as required by Statement 142, but has not yet determined the effect, if any, the impairment tests will have on its results of operations and financial condition. If impairment is indicated as a result of these tests, the Company will record such impairment in its 2002 annual financial statements as a cumulative effect of a change in accounting principle effective January 1, 2002.

As required under Statement 142 the Company performed an analysis of undiscounted cash flows under Statement 121 in order to evaluate the recoverability of the intangible asset related to Pulsar Data Systems, Inc. ( Pulsar ). Based on this analysis the Company determined that the carrying value of the remaining identifiable intangible was recoverable. Therefore, the Company will continue amortizing the Pulsar related intangible over its estimated useful life.

The Company amortizes intangible assets relating to businesses acquired and costs in excess of the fair value of net assets of businesses acquired using the straight-line method over the estimated useful lives of the intangible assets. The straight-line amortization reflects the consumption pattern of the economic benefit of the intangible assets.

During the fourth quarter of 2001, the Company determined that certain identifiable technology and developed technology acquired in connection with the Acquisition were no longer going to be pursued. Additionally, the Company delayed or indefinitely reduced the projected revenues from the Acquisition. Accordingly, the Company performed analyses for identifiable intangible assets and goodwill in accordance with Statement 121 and Accounting Principle Board Opinion No. 17.

In evaluating identifiable intangibles assets, the Company utilized a discounted cash flow analysis and, due to the uncertainties surrounding the Company s ability to fund its operations, concluded all identified intangibles assets associated with the Acquisition should be written-off. In evaluating the goodwill associated with the Acquisition, the Company utilized a fair value approach. The fair value was measured utilizing the most recent indicator of fair value, which was the secured convertible promissory notes (note 12). Consequently, the Company recorded an impairment charge of $36,299 in the fourth quarter of 2001 related to all identifiable intangible assets and developed technology, as well as a portion of the goodwill acquired in connection with the Acquisition. After this impairment charge, goodwill is the only remaining intangible asset.

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Amortization of identifiable intangible assets was $23, for the three months ended March 31, 2001 and 2002.

(2) INVESTMENTS

The Company has an investment that is classified as trading securities. The securities consist of Class A common stock of Wave Systems Corp. ( Wave ) received in the Acquisition. The investment is presented and recorded in accordance with Statement 115. Management determines the appropriate classification of its investments in debt and marketable equity securities at the time of purchase and reevaluates such designation as of each balance sheet date. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders equity. Trading securities are carried at fair value with the unrealized gains and losses, net of applicable taxes, reported in earnings in the statement of operations. The cost of securities sold is based upon the specific identification method. As of December 31, 2001 and March 31, 2002, the Company owned 607 shares with a value of $1,360 and 181 shares with a value of $442, respectively.

(3) INVENTORIES

A summary of inventories follows:

| | December 31, 2001 | March 31, 2002 |
|---|---|---|
| Raw materials | $ 112 | $ 93 |
| Work-in-process | 8 | 8 |
| Finished goods | 316 | 269 |