INTRUSION INC
Form 10-Q
November 13, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2003

OR

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

For the transition period from to

Commission File Number 0-20191

INTRUSION INC.

(Exact name of Registrant as specified in its charter)

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

1101 East Arapaho Road, Richardson, Texas 75081

(Address of principal executive offices)

(Zip Code)

(972) 234-6400

(Registrant s telephone number, including area code)

Not Applicable

Former name, if changed since last report)

* * * * * * * * * *

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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

The number of shares outstanding of the Registrant s Common Stock, $0.01 par value, on November 13, 2003 was 20,650,425.

INTRUSION INC.

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PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INTRUSION INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

		Sept 30, 2003 (Unaudited)		Dec 31, 2002 (Audited)
ASSETS				
Current Assets:				
Cash and cash equivalents	$	1,691	$	2,898
Short-term investments		2,950		7,825
Accounts receivable, less allowance for doubtful accounts $620 in 2003 and $934 in 2002		824		2,363
Inventories, net		1,489		1,411
Other assets		358		759
Total current assets		7,312		15,256
Property and equipment, net		492		1,597
Other assets		82		86
TOTAL ASSETS	$	7,886	$	16,939
LIABILITIES AND STOCKHOLDERS EQUITY				
Current Liabilities:				
Accounts payable and accrued expenses	$	2,737	$	2,905
Deferred revenue		893		1,650
Total current liabilities		3,630		4,555
Stockholders Equity:				
Preferred stock, $.01 par value, authorized shares 5,000, no shares issued and outstanding				
Common stock, $.01 par value, authorized shares 80,000, Issued shares 20,690 in 2003 and 20,686 in 2002, Outstanding shares 20,650 in 2003 and 20,646 in 2002		207		207
Common stock held in treasury, at cost 40 shares		(362)		(362)
Additional paid-in capital		47,371		47,371
Accumulated deficit		(42,732)		(34,604)
Accumulated other comprehensive loss		(228)		(228)
Total stockholders equity		4,256		12,384
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	7,886	$	16,939

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2002	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
Net sales	$ 1,556	$ 2,394	$ 4,515	$ 6,373
Cost of sales	895	1,322	2,991	4,173
Gross profit	661	1,072	1,524	2,200
Operating expenses:				
Sales and marketing	1,313	2,507	5,099	9,606
Research and development	860	1,398	2,684	4,762
General and administrative	374	693	1,222	2,016
Amortization of intangibles		199		598
Litigation settlement	450		450	
Severance costs	119		363	200
Operating loss	(2,455)	(3,725)	(8,294)	(14,982)
Other income		(7)	10	(7)
Interest income, net	43	83	156	281
Loss before income tax provision	(2,412)	(3,649)	(8,128)	(14,708)
Income tax benefit				(608)
Loss from continuing operations	(2,412)	(3,649)	(8,128)	(14,100)
Gain from discontinued operations, net of taxes				401
Net loss	$ (2,412)	$ (3,649)	$ (8,128)	$ (13,699)
Basic and diluted loss per share, continuing operations	$ (0.12)	$ (0.18)	$ (0.39)	$ (0.68)
Basic and diluted loss per share	$ (0.12)	$ (0.18)	$ (0.39)	$ (0.66)
Weighted average common shares outstanding, basic and diluted	20,650	20,645	20,649	20,640

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 30, 2003	**September 30, 2002**
Operating Activities:		
Loss from continuing operations	$ (8,128)	$ (14,100)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities of continuing operations:		
Depreciation and amortization	1,182	2,165
Provision for doubtful accounts	(314)	
Changes in operating assets and liabilities:		
Accounts receivable	1,853	2,063
Income taxes receivable		2,779
Inventories	(78)	2,317
Other assets	405	(372)
Accounts payable and accrued expenses	(168)	(2,321)
Deferred revenue	(757)	(117)
Net cash used in operating activities of continuing operations	(6,005)	(7,586)
Investing Activities:		
Purchases of short-term investments	(3,450)	(12,565)
Maturities of short-term investments	8,325	12,002
Net purchases of property and equipment	(78)	(56)
Net cash provided by (used in) investing activities of continuing operations	4,797	(619)
Financing Activities:		
Exercise of warrants and employee stock options		51
Issuance of shares in employee stock purchase plan	1	1
Net cash provided by financing activities of continuing operations	1	52
Net cash provided by discontinued operations		405
Effect of foreign currency translation adjustments on cash and cash equivalents		(88)
Net decrease in cash and cash equivalents	(1,207)	(7,836)
Cash and cash equivalents at beginning of period	2,898	15,783
Cash and cash equivalents at end of period	$ 1,691	$ 7,947

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Description of Business

We develop, market and support network intrusion detection systems (IDS) and VPN/firewall appliances that address vital security issues facing enterprise and government entities that rely on their networks for daily operations.

Our Intrusion SecureNet network intrusion detection system provides users a broad and accurate detection technology, simple deployment options and a highly intuitive management interface. The SecureNet Sensor can be deployed on 10, 100, 250Mb/s and Gigabit networks as either an all-inclusive Hardware-Appliance or using Intrusion s Software-Appliance CD, which can turn certain standard network servers into IDS Sensors. Both Hardware-Appliances and Software-Appliances take advantage of the Intrusion SecureNet WBI Sensor web-browser management interface that can be accessed from anywhere in the enterprise. Centralized event monitoring and system management is done with the Intrusion SecureNet Provider, three-tier centralized management system.

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

We organized in Texas in September 1983 and reincorporated in Delaware in October 1995. For more than 15 years, we provided local area networking equipment and were known as Optical Data Systems or ODS Networks. On April 17, 2000, we announced plans to sell, or otherwise dispose of, our networking divisions, which included our Essential Communications Division (Essential) and our local area networking assets. This plan was completed during March 2002. We have accounted for these businesses as discontinued operations. On June 1, 2000, we changed our name from ODS Networks, Inc. to Intrusion.com, Inc., and our NASDAQ ticker symbol from ODSI to INTZ to reflect our focus on intrusion detection solutions. On November 1, 2001, we changed our name from Intrusion.com, Inc. to Intrusion Inc.

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

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 Article 10 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, 2002 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 periods ending September 30, 2003 are not necessarily indicative of the results that may be achieved for the full fiscal year or for any future period. The 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-K for the year ended December 31, 2002.

At September 30, 2003, the Company had approximately $4.6 million of unrestricted cash, cash equivalents and short-term investments, down from approximately $10.7 million as of December 31, 2002. The Company funded its operations and met cash requirements during the quarter by selling a portion of short-term investments. Although we believe that we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months based on our internal estimates and our operating plan, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. This plan is benefited by further cost reduction actions that have already been taken, which should reduce expenses in the fourth quarter 2003 and first quarter 2004. These reductions are primarily the result of a reduction in international sales personnel. Additionally, the Company plans to allocate resources to markets and opportunities that offer higher margins and larger sales dollars. Despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue at least through March 31, 2004. 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 financing. However, there is no assurance that financing will be available on acceptable terms or in a timely manner, if at all. 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.

The consolidated financial statements do not include any adjustments that might result from the outcome of any of the uncertainties discussed above.

3. Recent Accounting Pronouncements

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

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

4. Foreign Currency Translation

On January 1, 2003, the Company elected to change the functional currency of its foreign operations to the United States dollar. This change in functional currency is supported by the fact that all foreign operations are funded monthly in United States dollars and the majority of revenue contracts are denominated in United States dollars. Under United States dollar functional currency, the financial statements of foreign locations are remeasured from the recording currency to the United States dollar. The resulting remeasurement adjustment is recorded as foreign exchange gain or loss in the statement of operations. There is no translation adjustment to the separate component of stockholders equity or adjustment to comprehensive income. The effect of the change in functional currency had no material impact on results of operations. The accumulation of prior years translation adjustments remains on the balance sheet as a separate component of stockholders equity until part, or all, of the respective entities are disposed. During 2002, the financial statements were prepared using the local currency as the functional currency. All balance sheet accounts of foreign subsidiaries were translated at the current exchange rate as of the end of the accounting period. The resulting translation adjustment was previously recorded as a separate component of stockholders equity. Income statement items were previously translated at average currency exchange rates.

5. Inventories (In thousands)

Inventories consist of:		**September 30, 2003**		**December 31, 2002**
Raw materials	$		$	70
Finished goods		1,105		1,157
Work in process		203		
Demonstration systems		181		184
Net inventory	$	1,489	$	1,411

6. Accounting for Stock-Based Compensation

We account for employee stock-based compensation under APB 25. The following table summarizes relevant information as to the reported results under our intrinsic value method of accounting for stock awards, with supplemental information as if the fair value recognition provision of SFAS 123 had been applied for the quarters ended September 30, 2003 and September 30, 2002 and the nine months ended September 30, 2003 and September 30, 2002 (in thousands, except per share data):

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	Quarter Ended September 30, 2003	Quarter Ended September 30, 2002	Nine Months September 30, 2003	Nine Months September 30, 2002
Net loss, as reported	$ (2,412)	$ (3,649)	$ (8,128)	$ (13,699)
Add (Deduct): Total stock-based compensation determined under fair value-based method for all awards	(3)	(51)	331	(488)
Pro forma net loss	$ (2,415)	$ (3,700)	$ (7,797)	$ (14,187)
Net loss per share:				
Basic, as reported	$ (0.12)	$ (0.18)	$ (0.39)	$ (0.66)
Basic, pro forma	$ (0.12)	$ (0.18)	$ (0.38)	$ (0.69)
Diluted, as reported	$ (0.12)	$ (0.18)	$ (0.39)	$ (0.66)
Diluted, pro forma	$ (0.12)	$ (0.18)	$ (0.38)	$ (0.69)
Weighted-average shares used in computation:				
Basic and diluted	20,650	20,645	20,649	20,640

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

7. Net Loss Per Share

We report two separate earnings per share (EPS) numbers, basic EPS and diluted EPS. Basic net loss per share is computed by dividing net loss 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 by the weighted average number of common shares and common stock equivalents outstanding for the period. Our common stock equivalents are not included in the diluted loss per share for the three and nine-month periods ended September 30, 2003 and 2002, as they are antidilutive. Such options are excluded due to incurring a net loss per share in the applicable period.

8. Discontinued Operations

In March 2002 we sold the assets of our last remaining discontinued operation, our Essential Communications division, for $1.0 million, generating a gain on sale of $0.4 million, which we have shown as a gain from discontinued operations in the accompanying financial statements.

A condition of the sale was to give Essential personnel 60 days to exit Essential s leased facility, the obligation for which we retained as part of the sale. Included in the gain on the sale of Essential was management s estimate of $0.3 million to terminate this lease agreement, which was equivalent to 2 years lease and maintenance of the facility. The contractual term of the lease

ran through February 2009. Successful termination of the lease during the fourth quarter of 2002 for less than $0.3 million resulted in additional gain on sale of $0.1 million.

The following represents a summary of gains and losses from discontinued operations (In thousands):

		Nine Months Ended September 30, 2002
Net sales	$	727
Cost of sales		323
Gross profit		404
Operating expenses		502
Operating loss		(98)
Gain on sale		499
Income before income taxes		401
Income tax benefit		
Income from discontinued operations	$	401

9. 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.

On March 22, 2002, Morgan Newton Company, L.P. (Morgan Newton   ) filed suit against us in Dallas County District Court, Case No. DV02-02339-C, alleging claims for breach of contract, promissory estoppel, and fraud. The claims arise out of an alleged oral representation to Morgan Newton concerning a request for quotation for the purchase of a large amount of Morgan Newton   s products. During the quarter ended September 30, 2003, Morgan Newton and Intrusion settled this matter, which resulted in a payment that is due to Morgan Newton during the fourth quarter of 2003. The amount due of $450,000 was recorded as litigation settlement during the quarter ended September 30, 2003 and is included in accrued expenses at September 30, 2003.

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, that involve risks and uncertainties, such as statements concerning: the 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, the impact of our cost reduction programs and our refocused product line, the difficulties and uncertainties in successfully developing and introducing new products, our ability to continue to meet operating expenses through current cash flow or additional financings, the continuance and strength of our relationship with Check Point, a market-leading virtual private network and firewall security software company, the highly competitive market for our products, 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-K and other Securities and Exchange Commission filings. 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 statements and other statements made elsewhere in this report are made in reliance on the Private Securities Litigation Reform Act of 1995. The section below entitled Factors That May Affect Future Results of Operations sets forth and incorporates by reference certain factors that could cause actual future results of the company to differ materially from these statements.

Overview

We develop, market and support network intrusion detection systems and VPN/firewall appliances that address vital security issues facing enterprise and government entities that rely on their networks for daily operations.

Our Intrusion SecureNet network IDS provides users a broad and accurate detection technology, simple deployment options and a highly intuitive management interface. The SecureNet Sensor can be deployed on 10, 100, 250Mb/s and Gigabit networks as either an all-inclusive Hardware-Appliance or using Intrusion s Software-Appliance CD, which can turn certain standard network servers into IDS Sensors. Both Hardware-Appliances and Software-Appliances take advantage of the Intrusion SecureNet WBI Sensor web-browser management interface that can be accessed from anywhere in the enterprise. Centralized event monitoring and system management is done with the Intrusion SecureNet Provider, three-tier centralized management system.

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

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

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website URL is www.intrusion.com. References to we , us , our or Intrusion Inc. refer to Intrusion Inc. and its subsidiaries.

Critical Accounting Policies and Estimates

Management s discussion and analysis of financial condition and results of operations are based upon our 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, warranty obligations, restructuring, maintenance contracts and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

Revenue Recognition

We generally recognize product revenue upon shipment of product. We accrue for estimated warranty costs, sales returns and other allowances 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. To date, warranty costs and sales returns have not been material. There is a risk that technical issues on new products could result in unexpected warranty costs and 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 and SOP 98-9 Modification of 97-2, Software Revenue Recognition, with respect to certain transactions whereby revenue from the licensing of our products is not recognized until all four of the following conditions have been met: i) execution of a written purchase order, license agreement or contract; ii) shipment of the product has occurred; iii) the license fee is fixed and determinable; and iv) collectibility is probable. The Company defers and recognizes 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. Recognition of sales to distributors and related gross profits are deferred until the merchandise is resold by the distributors. 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. The deferred

revenue in the accompanying financial statements is offset by deferred cost of sales.

Allowance for Doubtful Accounts

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. 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.

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.

Results of Operations

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

	Three Months Ended		Nine Months Ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	57.5	55.2	66.2	65.5
Gross profit	42.5	44.8	33.8	34.5
Operating expenses:				
Sales and marketing	84.4	104.7	113.0	150.7
Research and development	55.3	58.4	59.4	74.7
General and administrative	24.0	28.9	27.1	31.6
Amortization of intangibles		8.3		9.4
Litigation Settlement	28.9		10.0	
Severance costs	7.7		8.0	3.1
Operating loss	(157.8)	(155.6)	(183.7)	(235.1)
Other income		(0.3)	0.2	(0.1)
Interest income, net	2.7	3.5	3.5	4.4
Loss before income tax provision	(155.1)	(152.4)	(180.0)	(230.8)

Income tax benefit				(9.5)
Loss from continuing operations	(155.1)	(152.4)	(180.0)	(221.2)
Gain from discontinued operations, net of taxes				6.3
Net loss	(155.1)	(152.4)	(180.0)	(215.0)

	Three Months Ended		Nine Months Ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
Domestic sales	76.8%	69.2%	64.2%	65.0%
Export sales to:				
Europe	16.9	17.7	26.1	23.6
Canada	0.6	2.3	0.6	3.9
Asia	5.6	10.6	9.0	6.7
Latin America	0.1	0.2	0.1	0.8
Net sales	100.0%	100.0%	100.0%	100.0%

Net Sales. Net sales for the quarter and nine months ended September 30, 2003 were $1.6 million and $4.5 million, respectively, compared to $2.4 million and $6.4 million, respectively, for the same periods of 2002. Sales from our first generation security products continued to decrease and our sales of SecureNet network intrusion detection products increased. The worldwide economic conditions continued to negatively impact our sales.

Export Sales. Export sales for the quarter and nine months ended September 30, 2003 were $0.4 million and $1.6 million respectively, compared to $0.7 million and $2.0 million, respectively, for the same period of 2002. The worldwide economic slow down coupled with our cost-cutting initiatives to concentrate our sales efforts on more profitable regions negatively impacted our export sales for the quarter.

Concentration of Sales. There were no significant concentrations of sales (i.e. greater than 10%) during the third quarter or first nine months of 2002 or 2003. We expect the lack of a concentration of sales to continue as we sell to various customers, and the concentration mix may vary depending upon the timing of certain sales. Although sales through direct and indirect channels to the U.S. Government entities totaled 19.1% and 13.2% of revenue for the three and nine-month periods ended September 30, 2003, respectively, sales to one U.S. government entity or sales through one indirect channel did not exceed 10% of revenue for either of the aforementioned periods.

Gross Profit. Gross profit was $0.7 million or 42.5% of net sales for the quarter ended September 30, 2003, compared to $1.1 million or 44.8% of net sales for the quarter ended September 30, 2002. For the nine months ended September 30, 2003, gross profit decreased to $1.5 million or 33.8% of net sales compared to $2.2 million or 34.5% of net sales for the same period in the prior year. Gross profit as a percentage of net sales is impacted by several factors, including shifts in product mix, changes in channels of distribution, sales volume, fluctuations in manufacturing costs, pricing strategies, and fluctuations in sales of integrated third-party products.

Sales and Marketing. Sales and marketing expenses decreased to $1.3 million for the quarter ended September 30, 2003, compared to $2.5 million for the quarter ended September 30, 2002. Sales and marketing expenses decreased to $5.1 million for the nine months ended September 30, 2003 compared to $9.6 million for the same period of 2002. Sales and marketing expenses decreased in the quarter and nine months ended September 30, 2003, compared to the same periods of 2002, primarily due to the reorganization of our sales and marketing departments and other cost reduction initiatives. We expect sales and marketing expenses to continue to decline in the fourth quarter of 2003, in comparison to the third quarter of 2003 as we recognize the full benefit of our cost reduction initiatives. Sales and marketing expenses may vary as a percentage of net sales in the future.

Research and Development. Research and development expenses decreased to $0.9 million for the quarter ended September 30, 2003, compared to $1.4 million for the quarter ended September 30, 2002. Research and development costs for the nine months ended September 30, 2003 decreased to $2.7 million compared to $4.8 million for the same period in 2002. Research and development costs are expensed in the period incurred. Research and development expenses decreased in the quarter and nine months ended September 30, 2003, compared to the same periods in 2002 as we reduced the research and development workforce and focused more of our development efforts on our core security products SecureNet Network Intrusion Detection Systems and security appliances. Research and development expenses may vary as a percentage of net sales in the future.

General and Administrative. General and administrative expenses decreased to $0.4 million for the quarter ended September 30, 2003, compared to $0.7 million for the quarter ended September 30, 2002. General and administrative expensed decreased to $1.2 million for the nine months ending September 30, 2003, compared to $2.0 million for the nine months ending September 30, 2002. General and administrative expenses decreased in the quarter and nine months ending September 30, 2003 compared to the same periods of 2002, primarily due to restructuring activities in 2003, including reductions in personnel, and other cost reduction initiatives. It is expected that general and administrative expenses will remain relatively constant throughout the remainder of the year. General and administrative expense may vary as a percentage of net sales in the future.

Amortization. Amortization expenses ceased at December 31, 2002 due to the impairment charge taken during December 2002 to write down the balance of all intangible assets to zero.

Severance Costs. Severance costs of $0.1 million for the three-month period ended September 30, 2003 and $0.4 million for the nine-month period ended September 30, 2003 consists of severance expense as a result of additional reductions in force. There were no severance charges for the three-month period ended September 30, 2002 and $0.2 million for the nine-month period ended September 30, 2002.

Litigation Settlement. Litigation settlement charges relate to the litigation settlement agreement between Intrusion and Morgan Newton as discussed in Part II, Item 1 of this report. Charges of $0.5 million, which were paid in October, were recognized and accrued during the quarter ended September 30, 2003. This settlement concludes all obligations related to this litigation settlement. There were no litigation settlement charges for the quarter or nine-month period ended September 30, 2002.

Interest. Net interest income decreased to $0.0 million for the quarter ended September 30, 2003, compared to $0.1 million for the same period in 2002. Net interest income decreased to $0.2 million for the nine months ended

September 30, 2003, compared to $0.3 million for the nine months ended September 30, 2002. The net interest income decreases were primarily due to the reduced overall cash balances and decreased rates of return. 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, 2003 is approximately $1.7 million of cash and cash equivalents and $2.9 million of short-term investments. As of September 30, 2003 working capital was $3.7 million compared to $14.4 million as of September 30, 2002.

Cash used in continuing operations for the nine months ended September 30, 2003 was $6.0 million, primarily due to an operating loss from continuing operations of $8.1 million, the provision for doubtful accounts and an increase in inventories, as well as decreases in accounts payable and accrued expenses and deferred revenue, which are offset by depreciation expense and decreases in accounts receivable and other assets, compared to cash used in operations of $7.6 million for the nine months ended September 30, 2002, primarily due to an operating loss from continuing operations of $14.1 million, which is offset by a decrease in income taxes receivable, accounts receivable and inventories. 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, 2003 was $4.8 million, which consisted primarily of purchases and maturities of short-term investments, compared to cash used in investing activities of $0.6 million for the nine months ended September 30, 2002, which also consisted primarily of purchases and maturities of short-term investments.

Cash provided by financing activities in the nine months ended September 30, 2003 was $1.0 thousand, as there were four thousand shares issued through the employee stock purchase plan during the period, compared to $52.0 thousand during the nine months ended September 30, 2002, which was primarily the result of the exercise of employee stock options.

At September 30, 2003, the Company did not have any material commitments for capital expenditures.

During the nine months ended September 30, 2003, the Company funded its operations through the use of cash and cash equivalents.

Based on the Company s financial projections, the Company expects that cash on hand, along with short-term investments, and cash from its operations will be sufficient to fund operations for the next 12 months. However, that plan is dependent upon decreases in operating expenses. The Company funded its operations and met cash requirements during the quarter by selling a portion of short-term investments. Although we believe that we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months based on our internal estimates and our operating plan, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. This plan is benefited by further cost reduction actions that have already been taken, which should reduce expenses in the fourth quarter 2003 and first quarter 2004. These reductions are primarily the result of a reduction in international sales personnel. Additionally, the Company plans to allocate resources to markets and opportunities that offer higher margins and larger sales dollars. Despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue at least through

March 31, 2004. 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 financing. However, there is no assurance that financing will be available on acceptable terms or in a timely manner, if at all. 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.

We intend to explore the possible acquisitions of businesses, products and technologies that are complementary to our existing business. We are continuing to identify and prioritize additional security technologies, which we may wish to develop, either internally or through the licensing or acquisition of products from third parties. While we engage from time to time in discussions with respect to potential acquisitions, there can be no assurances that any such acquisitions will be made or that we will be able to successfully integrate any acquired business. In order to finance such acquisitions 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.

Factors That May Affect Future Results of Operations

Numerous factors may affect our business and future results of operations. These factors include, but are not limited to, current economic and market conditions, the effect of military actions on government and corporate spending on information security products, 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-K for the year ended December 31, 2002.

Sufficiency of Cash Flow. At September 30, 2003, the Company had approximately $4.6 million of unrestricted cash, cash equivalents and short-term investments, down from approximately $10.7 million as of December 31, 2002. The Company funded its operations and met cash requirements during the quarter by selling a portion of short-term investments. Although we believe that we have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months based on our internal estimates and our operating plan, the sufficiency of our cash resources may depend to a certain extent on general economic, financial, competitive or other factors beyond our control. This plan is benefited by further cost reduction actions that have already been taken, which should reduce expenses in the fourth quarter 2003 and first quarter 2004. These reductions are primarily the result of a reduction in international sales personnel. Additionally, the Company plans to allocate resources to markets and opportunities that offer higher margins and larger sales dollars. Despite actions to reduce our costs and improve our profitability, we expect our operating losses and net operating cash outflows to continue at least through March 31, 2004. 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 financing. However, there is no assurance that financing will be available on acceptable terms or in a timely manner, if at all. 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.

Technological Changes. The market for our products is characterized by frequent product introductions, rapidly changing technology and continued evolution of new industry standards. The market for security products requires our products to be compatible and interoperable with products and architectures offered by various vendors, including other security products, networking products, workstation and personal computer architectures and computer and network operating systems. Our success will depend to a substantial degree upon our ability to develop and introduce in a timely manner new products and enhancements to our existing products that meet changing customer requirements and evolving industry standards. The development of technologically advanced products is a complex and uncertain process requiring high levels of innovation as well as the accurate anticipation of technological and market trends. There can be no assurance that we will be able to identify, develop, manufacture, market and support new or enhanced products successfully in a timely manner. Further, we or our competitors may introduce new products or product enhancements that shorten the life cycle of or make obsolete our existing product lines, any of which could have a material adverse effect on our business, operating results and financial condition.

Market Acceptance. We are pursuing a strategy to increase the percentage of our revenue generated through indirect sales channels including distributors, value added resellers, system integrators, original equipment manufacturers and managed service providers. There can be no assurance that our products will gain market acceptance in these indirect sales channels. Further, competition among security companies to sell products through these indirect sales channels could result in significant price competition and reduced profit margins.

We are also pursuing a strategy to further differentiate our product line by introducing complementary security products and incorporating new technologies into our existing product line. There can be no assurance that we will successfully introduce these products or that such products will gain market acceptance. We anticipate competition from networking companies, network security companies and others in each of our product lines. We anticipate that profit margins will vary among our product lines and that product mix fluctuations could have an adverse effect on our overall profit margins.

Acquisitions. Some of our competitors have acquired several security companies with complementary technologies, and we anticipate that such acquisitions will continue in the future. These acquisitions may permit such competitors to accelerate the development and commercialization of broader product lines and more comprehensive solutions than we currently offer. In the past, we have relied upon a combination of internal product development and partnerships with other security vendors to provide competitive solutions to customers. Certain of the recent and future acquisitions by our competitors may have the effect of limiting our access to commercially significant technologies. Further, the business combinations and acquisitions in the security industry are creating companies with larger market shares, customer bases, sales forces, product offerings and technology and marketing expertise. There can be no assurance that we will be able to compete successfully in such an environment.

We have made acquisitions in the past, and we may, in the future, 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. Acquisitions involve numerous risks, including: difficulties in assimilation of operations, technologies, and products of the acquired companies; risks of entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions; the potential loss of key employees of the acquired company; and the diversion of our attention from normal daily operation of our business. There can be no assurance that any other acquisition or investment will be consummated or that such acquisition or investment will be realized.

Product Transitions. Once current security products have been in the market place for a period of time and begin to be replaced by higher performance products (whether of our design or a competitor s design), we expect the net sales of such products to decrease. In order to achieve revenue growth in the future, we will be required to design, develop and successfully commercialize higher performance products in a timely manner. There can be no assurance that we will be able to introduce new products and gain market acceptance quickly enough to avoid adverse revenue transition patterns during current or future product transitions. Nor can there be any assurance that we will be able to respond effectively to technological changes or new product announcements by competitors, which could render portions of our inventory obsolete.

Manufacturing and Suppliers. Our operational strategy relies on outsourcing of product assembly and certain other operations. There can be no assurance that we will effectively manage our third-party contractors or that these contractors will meet our future requirements for timely delivery of products of sufficient quality and quantity. Further, we intend to introduce a number of new products and product enhancements in the remainder of 2003 and 2004 that will require that we rapidly achieve volume production of those new products by coordinating our efforts with those of our suppliers and contractors. The inability of the third-party contractors to provide us with adequate supplies of high-quality products could cause a delay in our ability to fulfill orders and could have an adverse effect on our business, operating results and financial condition.

All of the materials used in our products are purchased under contracts or purchase orders with third parties. While we believe that many of the materials used in the production of our products are generally readily available from a variety of sources, certain components such as microprocessors and mother boards are available from one or a limited number of suppliers. The lead times for delivery of components vary significantly and can exceed twelve weeks for certain components. If we should fail to forecast our requirements accurately for components, we may experience excess inventory or shortages of certain components that could have an adverse effect on our business and operating results. Further, any interruption in the supply of any of these components, or the inability to procure these components from alternative sources at acceptable prices within a reasonable time, could have an adverse effect on our business and operating results.

Intellectual Property and Licenses. There are many patents held by companies, which relate to the design and manufacture of network security systems. Holders of those could assert potential claims of infringement. We could incur substantial costs in defending our company and our customers against any such claim regardless of the merits of such claims. In the event of a successful claim of infringement, we may be required to obtain one or more licenses from third parties. There can be no assurance that we could obtain the necessary licenses on reasonable terms.

Dependence on Check Point Technologies. A percentage of our sales are represented by our PDS family of security appliances, which are integrated with Check Point Software Technologies market-leading virtual private network and firewall security software. We expect the percentage of sales represented by these products to decrease in the future. Although we are a certified appliance partner of Check Point and our PDS products have received certification from Check Point, we have no long-term agreement or exclusive relationship with Check Point. As a result, the loss or significant change in our relationship with Check Point, the failure of future PDS products to receive Check Point certification, the business failure of Check Point or its acquisition by or of one of our competitors, and the loss of market share of Check Point or market acceptance of its products could each have a material adverse effect on our business, financial condition and results of operations.

Third-Party Products. We believe that it is beneficial to work with third parties with complementary technologies to broaden the appeal of our security products. These alliances allow us to provide integrated solutions to our customers by combining our developed technology with third-party products. As we also compete with these technology partners in certain segments of the market, there can be no assurance that we will have access to all of the third-party products that may be desirable or necessary in order to offer fully integrated solutions to our customers.

International Operations. Our international operations may be affected by changes in demand resulting from fluctuations in currency exchange rates and local purchasing practices, including seasonal fluctuations in demand, as well as by risks such as increases in duty rates, difficulties in distribution, regulatory approvals and other constraints upon international trade. Our sales to foreign customers are subject to export regulations. In particular, certain sales of our data security products require clearance and export licenses from the U.S. Department of Commerce under these regulations. Any inability to obtain such clearances or any required foreign regulatory approvals on a timely basis could have a material adverse effect on our operating results.

Impact of Government Customers. $0.3 million or 19.1% and $0.6 million or 13.2% of revenue in the quarter and nine months ended September 30, 2003, respectively, was derived from sales to the U.S. government, either directly by Intrusion or through system integrators and other resellers compared to $0.7 million or 27.7% and $1.1 million or 17.9% of revenue for the same periods in 2002. $0.2 million or 3.7% of revenue in the nine-month period ended September 30, 2003 was derived from sales to all U.K. government entities compared to $0.0 million or 0.0% of revenue for the same period ended September 30, 2002. We expect sales to the U.S. and foreign governments to represent a significant portion of our revenue in future periods. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruptions due to appropriation and spending patterns and the government s reservation of the right to cancel contracts and purchase orders for its convenience.

Effects of Military Actions. The United States military actions or other events occurring in response or in connection to them, including future terrorist attacks against United States targets, actual conflicts involving the

United States or its allies, or military or trade disruptions could impact our operations, including by:

- reducing government or corporate spending on network security products;
- increasing the cost and difficulty in obtaining materials or shipping products; and
- affecting our ability to conduct business internationally.

Should such events occur, our business, operating results and financial condition could be materially and adversely affected. The war in Iraq significantly reduced government spending in our market space and negatively impacted our first, second and third quarter earnings, as evidenced by the significant reduction in sales to U.S. government entities.

Restructuring and Cost Reductions. We implemented a restructuring plan in April 2002 and are adopting additional cost-cutting initiatives. The objective of these plans is to reduce our cost structure to a sustainable level that is consistent with the current macroeconomic environment and our cash flow projections. We have also implemented other strategic initiatives designed to strengthen our operations. These plans involved, among other things, reductions in our workforce and facilities, aligning our organization around our business objectives, realignment of our sales force and changes in our sales management. The workforce reductions, which continued into 2003, 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 the restructuring and other changes. Failure to achieve the desired results of our initiatives could seriously harm our business, results of operations and financial condition.

Potential Nasdaq Delisting. The Nasdaq Stock Market maintains certain minimum requirements to maintain the listing for our common stock. These requirements include a minimum bid price for our common stock of $1.00. We received a notice of noncompliance from Nasdaq on August 12, 2002. In order to take advantage of additional grace periods for compliance, we transferred the listing of our common stock from the Nasdaq National Market to the Nasdaq SmallCap Market, effective December 4, 2002. Pursuant to Nasdaq rules, in order to regain compliance for listing on the Nasdaq Stock Market, the minimum bid price of our common stock had to be at least $1.00 for at least 10 consecutive trading days on or prior to November 5, 2003.

Although our closing bid price was equal to or greater than $1.00 for 10 consecutive trading days prior to November 5, 2003, Nasdaq exercised its discretion to require additional days to evidence our long-term compliance with the minimum bid price requirement and contends that we failed to meet all of the requirements for continued listing on the Nasdaq Stock Market. As a result, Nasdaq sent us a notification of delisting on November 6, 2003. In accordance with Nasdaq rules, we have requested a hearing before a Nasdaq Listing Qualifications Panel in order to appeal the grounds for delisting and to present a plan for long-term compliance with Nasdaq s continued listing requirements. We are awaiting further notice from Nasdaq as to the date of our hearing. However, until the issuance of a written determination by the Listing Qualifications Panel regarding our appeal, our stock will continue to trade on the Nasdaq SmallCap Market.

Nasdaq has broad authority to determine compliance and continued listing on the Nasdaq Stock Market. Therefore, we cannot assure you that we will be successful in our appeal, nor can we be certain how long the entire process will take. Furthermore, even if the Listing Qualifications Panel accepts our appeal or our compliance plan, we cannot assure you that we will be successful in executing our plan or that we will remain in compliance with all of Nasdaq s continued listing standards in the future.

If we are unsuccessful in our attempt to obtain reinstatement from Nasdaq, if we fail to execute on our proposed compliance plan or if we fail to comply with other Nasdaq continued listing requirements, our common stock likely would trade in a less efficient market, such as the OTC Bulletin Board or in the pink sheets maintained by the National Quotation Bureau, Inc. Because these alternatives generally are considered to be less efficient markets, our stock price, the liquidity of our common stock and our general business reputation may be adversely impacted.

General. Sales of our products fluctuate, from time to time, based on numerous factors, including customers capital spending levels and general economic conditions. While certain industry analysts believe that there is a significant market for network security products, there can be no assurance as to the rate or extent of the growth of such market or the potential adoption of alternative technologies. Currently, capital spending for information technology products, including security products is being adversely affected by uncertain economic conditions and world events such as current military conflicts in Iraq and elsewhere. Future declines in network security product sales as a result of general economic conditions, adoption of alternative technologies or any other reason could have a material adverse effect on our business, operating results and financial condition.

Due to the factors noted above and in Management s Discussion and Analysis of Financial Condition and Results of Operations , our future earnings and common stock price may be subject to significant volatility, particularly on a quarterly basis. Past financial performance should not be considered a reliable indicator of future performance and investors should not use historical trends to anticipate results or trends in future periods. Any shortfall in revenue and earnings from the levels anticipated by securities analysts could have an immediate and significant effect on the trading price of our common stock in any given period. Also, we participate in a highly dynamic industry, which often results in volatility of our common stock price.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Exchange. Revenue originating outside the U.S. in the quarters ended September 30, 2003, 2002 and 2001 was 23.2%, 30.8% and 50.8% of total revenues, respectively. Revenue originating outside the U.S. in the nine months ended September 30, 2003, 2002 and 2001 was 35.8%, 35.0% and 35.0% of total revenues, respectively. International sales are made mostly from our foreign sales subsidiaries in the local countries and are typically denominated in U.S. dollars. These subsidiaries incur most of their expenses in the local currency.

Our international business is subject to risks typical of an international business, including, but not limited to: differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions and foreign exchange rate volatility. Accordingly, our future results could be materially adversely affected by changes in these or other

factors. The effect of foreign exchange rate fluctuations on us in 2003, 2002 and 2001 was not material.

Foreign Currency Translation On January 1, 2003, the Company elected to change the functional currency of its foreign operations to the United States dollar. This change in functional currency is supported by the fact that all foreign operations are funded monthly in United States dollars and the majority of a revenue contracts are denominated in United States dollars. Under United States dollar functional currency, the financial statements of foreign locations are remeasured from the recording currency to the United States dollar. The resulting remeasurement adjustment is recorded as foreign exchange gain or loss in the statement of operations. There is no translation adjustment to the separate component of stockholders equity or adjustment to comprehensive income. The effect of the change in functional currency had no material impact on results of operations. The accumulation of prior years translation adjustments remains on the balance sheet as a separate component of stockholders equity until part, or all, of the respective entities are disposed. During 2002, the financial statements were prepared using the local currency as the functional currency. All balance sheet accounts of foreign subsidiaries were translated at the current exchange rate as of the end of the accounting period. The resulting translation adjustment was recorded as a separate component of stockholders equity. Income statement items are translated at average currency exchange rates.

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

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

Investments in fixed rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have seen a decline in market value due to changes in interest rates. Our investment securities are held for purposes other than trading. The weighted-average of the stated coupon interest rate on investment securities at September 30, 2003 was 5.9%. Due to the amortization of premiums and discounts paid, the actual rate of return will vary from the weighted-average of the stated coupon interest rate. The fair value of investments held at September 30, 2003 approximated amortized cost.

Item 4. CONTROLS AND PROCEDURES

We have carried out an evaluation, under the supervision and the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of September 30, 2003 pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief

Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed is recorded, processed, summarized and reported in a timely manner.

We have carried out an evaluation, under the supervision and participation of our management, including our Chief Executive Officer and Chief Financial Officer, of any changes in our internal controls over financial reporting that occurred during the quarterly period ended September 30, 2003, and our Chief Executive Officer and Chief Financial Officer have concluded that there was no change during the quarterly period ended September 30, 2003 that has a materially affected or is reasonably expected 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.

On March 22, 2002, Morgan Newton Company, L.P. (Morgan Newton) filed suit against us in Dallas County District Court, Case No. DV02-02339-C, alleging claims for breach of contract, promissory estoppel, and fraud. The claims arise out of an alleged oral representation to Morgan Newton concerning a request for quotation for the purchase of a large amount of Morgan Newton s products. During the quarter ended September 30, 2003, Morgan Newton and Intrusion settled this matter, which resulted in a payment that is due to Morgan Newton during the fourth quarter of 2003. The amount due of $450,000 was recorded as litigation settlement during the quarter ended September 30, 2003 and is included in accrued expenses at September 30, 2003.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

During the quarter ended September 30, 2003, there were no reports filed on Form 8-K.

The following Exhibits are attached:

31.1 Certification of Chief Executive Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer Pursuant To 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 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002

SIGNATURES

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, 2003

/s/ Michael L. Paxton

Michael L. Paxton

Vice President, Chief Financial Officer,
Treasurer & Secretary
(Principal Financial & Accounting Officer)