

INTRUSION INC
Form 10-Q
November 14, 2017

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

For the transition period from _____ to _____

Commission File Number 0-20191

INTRUSION INC.

(Exact name of registrant as specified in its charter)

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

1101 East Arapaho Road, Suite 200, Richardson, Texas 75081

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(Address of principal executive offices)

(Zip Code)

(972) 234-6400

(Registrant's telephone number, including area code)

Not Applicable

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

* * * * *

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

Yes No

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

Yes No

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

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes No

The number of shares outstanding of the Registrant's Common Stock, \$0.01 par value, on November 1, 2017 was 12,797,836.

1

INTRUSION INC.

INDEX

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements	3
Unaudited Condensed Consolidated Balance Sheets as of September 30, 2017 and December 31, 2016	3
Unaudited Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2017 and 2016	4
Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and 2016	5
Notes to Unaudited Condensed Consolidated Financial Statements	6
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	9
Item 4. Controls and Procedures	12

PART II – OTHER INFORMATION

Item 1. Legal Proceedings	13
Item 1A. Risk Factors	13
Item 6. Exhibits	15
Signature Page	16

PART I – FINANCIAL INFORMATION**Item 1. FINANCIAL STATEMENTS****INTRUSION INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except par value amounts)

	September 30, 2017	December 31, 2016
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 263	\$ 64
Accounts receivable	879	745
Inventories	30	45
Prepaid expenses	37	75
Total current assets	1,209	929
Property and equipment, net	162	308
Other assets	38	40
TOTAL ASSETS	\$ 1,409	\$ 1,277
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 1,060	\$ 896
Dividends payable	411	303
Obligations under capital lease, current portion	70	139
Deferred revenue	658	395
Total current liabilities	2,199	1,733
Loan payable to officer	2,865	2,885
Obligations under capital lease, noncurrent portion	22	61
Commitments and contingencies		
Stockholders' deficit:		

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Preferred stock, \$0.01 par value: Authorized shares – 5,000		
Series 1 shares issued and outstanding — 200 Liquidation preference of \$1,150 in 2017 and \$1,113 in 2016	707	707
Series 2 shares issued and outstanding — 460 Liquidation preference of \$1,313 in 2017 and \$1,270 in 2016	724	724
Series 3 shares issued and outstanding — 289 Liquidation preference of \$720 in 2017 and \$697 in 2016	412	412
Common stock, \$0.01 par value:		
Authorized shares — 80,000		
Issued shares — 12,808 in 2017 and 12,758 in 2016 Outstanding shares — 12,798 in 2017 and 12,748 in 2016	128	128
Common stock held in treasury, at cost – 10 shares	(362)	(362)
Additional paid-in capital	56,541	56,595
Accumulated deficit	(61,720)	(61,499)
Accumulated other comprehensive loss	(107)	(107)
Total stockholders' deficit	(3,677)	(3,402)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	\$ 1,409	\$ 1,277

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Revenue	\$ 1,678	\$ 1,595	\$ 4,780	\$ 4,693
Cost of revenue	736	610	1,951	1,677
Gross profit	942	985	2,829	3,016
Operating expenses:				
Sales and marketing	394	429	1,169	1,276
Research and development	617	508	1,797	1,908
General and administrative	242	292	855	941
Operating loss	(311)	(244)	(992)	(1,109)
Other Income	928	—	928	—
Interest expense, net	(49)	(36)	(157)	(102)
Net Income (loss)	\$ 568	\$ (280)	\$ (221)	\$ (1,211)
Preferred stock dividends accrued	(35)	(35)	(104)	(104)
Net income (loss) attributable to common stockholders	\$ 533	\$ (315)	\$ (325)	\$ (1,315)
Net income (loss) per share attributable to common stockholders:				
Basic	\$ 0.04	\$ (0.02)	\$ (0.03)	\$ (0.10)
Diluted	\$ 0.04	\$ (0.02)	\$ (0.03)	\$ (0.10)
Weighted average common shares outstanding:				
Basic	12,798	12,748	12,781	12,733
Diluted	14,076	12,748	12,781	12,733

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Nine Months Ended	
	September	September
	30,	30,
	2017	2016
Operating Activities:		
Net loss	\$(221)	\$(1,211)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	159	218
Stock-based compensation	16	82
Penalties and waived penalties on dividends	24	13
Gain on sale of investment	(56)	—
Changes in operating assets and liabilities:		
Accounts receivable	(134)	(8)
Inventories	15	(7)
Prepaid expenses and other assets	40	30
Accounts payable and accrued expenses	168	41
Deferred revenue	263	236
Net cash provided by (used in) operating activities	274	(606)
Investing Activities:		
Purchases of property and equipment	(13)	(41)
Proceeds from sale of investment	56	—
Net cash provided by (used by) investing activities	43	(41)
Financing Activities:		
Proceeds from line of credit	—	364
Payments on line of credit	—	(364)
Proceeds from stock options exercised	11	99
Borrowings on loans from officer	1,580	805
Payments on loans from officer	(1,600)	—
Principal payments on capital leases	(109)	(149)
Net cash provided by (used by) financing activities	(118)	755
Net increase in cash and cash equivalents	199	108
Cash and cash equivalents at beginning of period	64	102
Cash and cash equivalents at end of period	\$263	\$ 210

SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ACTIVITIES:

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Preferred stock dividends accrued	<i>\$104</i>	<i>\$ 104</i>
Purchase of leased equipment under capital lease	<i>\$—</i>	<i>\$ 6</i>

See accompanying notes.

INTRUSION INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

We develop, market and support a family of entity identification, high speed data mining, cybercrime and advanced persistent threat detection products. Our product families include:

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

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

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

Our end-user customers include:

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

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

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

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form *10-Q* and Item *10-01* of Regulation S-X. Accordingly, they do *not* include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The *December 31, 2016* 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 ended *September 30, 2017*, are *not* necessarily indicative of the results that *may* be achieved for the full fiscal year or for any future period. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form *10-K* for the year ended *December 31, 2016*, filed with the U.S. Securities and Exchange Commission (the “SEC”) on *March 29, 2017*.

The Company calculates the fair value of its assets and liabilities which qualify as financial instruments and includes this additional information in the notes to consolidated financial statements when the fair value is different from the carrying value of these financial instruments. The estimated fair value of accounts receivable, accounts payable and accrued expenses, and dividends payable approximate their carrying amounts due to the relatively short maturity of these instruments. Loans payable to officer are with a related party and as a result do *not* bear market rates of interest (see Note *4*). Management believes based on its current financial position that it could *not* obtain comparable amounts of *third* party financing, and as such cannot estimate the fair value of the loans payable to officer. *None* of these instruments are held for trading purposes.

In *May 2014*, the FASB issued Accounting Standards Update *No. 2014-09*, Revenue from Contracts with Customers (ASU 2014-09), which supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a *five* step process to achieve this core principle and, in doing so, more judgment and estimates *may* be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for us beginning *2018*. We will be using the following transition method: a modified retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We do *not* believe the adoption of this guidance will have a material impact on our financial statements.

3. Inventories (In thousands)

	September 30, 2017	December 31, 2016
Inventories consist of:		
Finished products	30	45
Net inventory	\$ 30	45

4. Loan Payable to Officer

On *February 9, 2017*, the Company entered into an unsecured revolving promissory note to borrow up to *\$3,400,000* from G. Ward Paxton, the Company's Chief Executive Officer (the "CEO Note"). Under the terms of the note, the Company *may* borrow, repay, and re-borrow on the loan as needed up to an outstanding principal balance due of *\$3,400,000* at any given time through *March 2018*.

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

Amounts borrowed from this officer accrue interest at a floating rate per annum equal to Silicon Valley Bank's ("SVB") prime rate plus *1%* (*5.25%* at *September 30, 2017*). All outstanding borrowings and accrued but unpaid interest is due on *March 31, 2019*. As of *September 30, 2017*, the borrowings outstanding totaled *\$2,865,000* and accrued interest

totaled \$308,000.

6. Accounting for Stock-Based Compensation

During the *three* month periods ended *September 30, 2017* and *2016*, the Company did *not* grant any stock options to employees or directors. The Company recognized \$6,000 and \$20,000, respectively, of stock-based compensation expense for the *three* month periods ended *September 30, 2017* and *2016*. During the *nine* month periods ended *September 30, 2017* and *2016*, the Company granted 24,000 and 24,000, respectively, of stock options to employees and directors. The Company recognized \$16,000 and \$82,000, respectively, of stock-based compensation expense for the *nine* month periods ended *September 30, 2017* and *2016*.

During the *three* month periods ended *September 30, 2017* and *2016*, *no* options were exercised under the 2005 Plan. During the *nine* month periods ended *September 30, 2017* and *2016*, 50,000 and 136,000 options were exercised under the 2005 Plan, respectively.

Valuation Assumptions

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

	For Three	For Three	For Nine	For Nine	
	Months	Months	Months	Months	
	Ended	Ended	Ended	Ended	
	September	September	September	September	
	30, 2017	30, 2016	30, 2017	30, 2016	
Weighted average grant date fair value	-	-	\$ 0.26	\$ 0.29	
Weighted average assumptions used:					
Expected dividend yield	-	-	0.0	% 0.0	%
Risk-free interest rate	-	-	1.77	% 1.38	%
Expected volatility	-	-	75.0	% 96.0	%
Expected life (in years)	-	-	5.0	5.0	

Expected volatility is based on historical volatility and in part on implied volatility. The expected term considers the contractual term of the option as well as historical exercise and forfeiture behavior. The risk-free interest rate is based on the rates in effect on the grant date for U.S. Treasury instruments with maturities matching the relevant expected term of the award. Options granted to non-employees are valued using the fair market value on each measurement date of the option.

7. Net Loss Per Share

Basic net loss per share is computed by dividing net loss attributable to common stockholders for the period by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing the net loss attributable to common stockholders by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period. Our common stock equivalents include all common stock issuable upon conversion of preferred stock and the exercise of outstanding options and warrants. The aggregate number of common stock equivalents excluded from the diluted loss per share calculation for the *three* month periods ended *September 30, 2017* and *2016* are *1,014,500* and *3,532,943* as they are antidilutive. The aggregate number of common stock equivalents excluded from the diluted loss per share calculation for the *nine* month periods ended *September 30, 2017* and *2016* are *1,675,619* and *3,545,745* as they are antidilutive.

8. Concentrations

Our operations are concentrated in *one* area—security software/entity identification. Sales to the U.S. Government through direct and indirect channels totaled *90.6%* of total revenues for the *third* quarter of *2017* compared to *78.4%* of total revenues for the *third* quarter of *2016*. During the *third* quarter of *2017*, approximately *90.6%* of total revenues were attributable to *six* government customers compared to approximately *78.4%* of total revenues attributable to *five* government customers in the *third* quarter of *2016*. Sales to commercial customers totaled *9.4%* of total revenue for the *third* quarter of *2017* compared to *21.6%* of total revenue for the *third* quarter of *2016*. During the *third* quarter of *2017*, approximately *6.2%* of total revenue was attributable to *one* commercial customer compared to approximately *18.9%* to *one* commercial customer in the *third* quarter of *2016*. Our similar product and service offerings are *not* viewed as individual segments, as our management analyzes the business as a whole and expenses are *not* allocated to each product offering.

9. Commitments and Contingencies

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

10. Dividends Payable

During the quarter ended September 30, 2017, we accrued \$14,000 in dividends payable to the holders of our 5% Preferred Stock, \$15,000 in dividends payable to the holders of our Series 2 5% Preferred Stock and \$8,000 in dividends payable to the holders of our Series 3 5% Preferred Stock. As of September 30, 2017, we have \$411,000 in accrued and unpaid dividends.

Delaware law provides that we *may* only pay dividends out of our capital surplus or, if *no* surplus is available, out of our net profits for the fiscal year the dividend is declared and/or the preceding fiscal year. These dividends continue to accrue on all our outstanding shares of preferred stock, regardless of whether we are legally able to pay them. If we are unable to pay dividends on our preferred stock, we will be required to accrue an additional late fee penalty of 18% per annum on the unpaid dividends for the Series 2 Preferred Stock and Series 3 Preferred Stock. Our CEO, CFO and *one* outside board member who are holders of our Series 2 and Series 3 Preferred Stock have waived any possible late fee penalties. In addition to this late penalty, the holders of our Series 2 Preferred Stock and Series 3 Preferred Stock could elect to present us with written notice of our failure to pay dividends as scheduled, in which case we would have 45 days to cure such a breach. In the event that we failed to cure the breach, the holders of these shares of preferred stock would then have the right to require us to redeem their shares of preferred stock for a cash amount calculated in accordance with their respective certificates of designation. If we were required to redeem all shares of Series 2 Preferred Stock and Series 3 Preferred Stock as of November 1, 2017, the aggregate redemption price we would owe would be \$2.2 million.

11. Other Income

On July 7, 2017, the Company entered into a sale of certain IP addresses that were *not* currently being used in the Company's business operations and were *not* required for the Company's future business plans. The net proceeds from the sale of these intellectual property assets were in the amount of \$872,000 which the Company received on August 9, 2017. In addition, \$56,000 was received on August 3, 2017 from the sale of an investment. The receipt of these transactions had an immediate positive impact on the Company's liquidity position.

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

Forward Looking Statements

This Quarterly Report on Form 10-Q, including, without limitation, the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such forward-looking statements are generally accompanied by words such as "estimate," "expect," "believe," "should," "would," "could," "anticipate," "may" or other words that convey uncertainty of future events or outcomes. These statements relate to future events or to our future financial performance, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Factors that may cause actual results to differ materially from current expectations, which we describe in more detail elsewhere in this Quarterly Report on Form 10-Q in Part II Item 1A "Risk Factors", and in our 2016 Annual Report on Form 10-K in Item 1A "Risk Factors" include, but are not limited to:

insufficient cash to operate our business and inability to meet our liquidity requirements;

loss of revenues due to the failure of our newer products to achieve market acceptance;

our need to increase current revenue levels in order to achieve sustainable profitability;

concentration of our revenues from U.S. government entities or commercial customers and the possibility of loss of one of these customers and the unique risks associated with government customers;

our dependence on sales made through indirect channels;

our dependence on equity or debt financing provided primarily by our Chief Executive Officer under the CEO Note in order to meet our cash flow requirements;

the adverse effect that payment of accrued dividends on our preferred stock would have on our cash resources and the substantial dilution upon the conversion or redemption of our preferred stock;

the consequences of our inability to pay scheduled dividends on shares of our preferred stock;

the potentially detrimental impact that the conversion of preferred stock would have on the price of our common stock;

the ability of our preferred stockholders to hinder additional financing; and

the influence that our management and larger stockholders have over actions taken by the Company.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. 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. Any forward-looking statement you read in this Quarterly Report on Form 10-Q or our Annual Report on Form 10-K reflects our current views with respect to future events and is subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reason, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future. 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.

Results of Operations

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

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	September 30, 2017	September 30, 2016		September 30, 2017	September 30, 2016	
Total revenue	100.0%	100.0	%	100.0%	100.0	%
Total cost of revenue	43.9	38.2		40.8	35.7	
Gross profit	56.1	61.8		59.2	64.3	
Operating expenses:						
Sales and marketing	23.5	26.8		24.4	27.2	
Research and development	36.7	31.9		37.6	40.7	
General and administrative	14.4	18.4		17.9	20.0	
Operating loss	(18.5)	(15.3)	)	(20.7)	(23.6)	)
Other income	55.3	—		19.4	—	
Interest expense, net	(2.9)	(2.3)	)	(3.3)	(2.2)	)
Income (loss) before income tax provision	33.9	(17.6)	)	(4.6)	(25.8)	)
Income tax provision	—	—		—	—	
Net income (loss)	33.9 %	(17.6)%		(4.6)%	(25.8)%	
Preferred stock dividends accrued	(2.1)	(2.2)	)	(2.2)	(2.2)	)
Net income (loss) attributable to common stockholders	31.8 %	(19.8)%		(6.8)%	(28.0)%	

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	September 30, 2017	September 30, 2016		September 30, 2017	September 30, 2016	
Domestic revenues	100.0%	100.0	%	100.0%	100.0	%

Export revenues	—	—	—	—	—
Net revenues	100.0%	100.0	%	100.0%	100.0 %

Net Revenues. Net revenues for the quarter and nine months ended September 30, 2017 were \$1.7 million and \$4.8 million, respectively, compared to \$1.6 million and \$4.7 million for the same periods in 2016. Product revenues increased \$0.1 million for the quarter ended September 30, 2017, and increased \$0.1 million for the nine months ended September 30, 2017 compared to the same periods in 2016. TraceCop sales for the quarters ended September 30, 2017 and 2016 were \$1.7 million and \$1.6 million, respectively. Savant sales were \$29 thousand for the quarter ended September 30, 2017 and \$22 thousand for the quarter ended September 30, 2016.

Concentration of Revenues. Revenues from sales to various U.S. government entities totaled \$1.5 million, or 90.6% of revenues, for the quarter ended September 30, 2017 compared to \$1.3 million, or 78.4% of revenues, for the same period in 2016. Revenues from sales to various U.S. government entities totaled \$3.8 million, or 80.2% of revenues, for the nine months ended September 30, 2017 compared to \$3.3 million, or 70.0% of revenues, for the same period in 2016. Sales to commercial customers totaled 9.4% of total revenue for the third quarter of 2017 compared to 21.6% of total revenue for the third quarter of 2016. During the third quarter of 2017, approximately 6.2% of total revenue was attributable to one commercial customer compared to approximately 18.9% to one commercial customer in the third quarter of 2016. Although we expect our concentration of revenues to vary among customers in future periods depending upon the timing of certain sales, we anticipate that sales to government customers will continue to account for a significant portion of our revenues in future periods. Sales to the government present risks in addition to those involved in sales to commercial customers which could adversely affect our revenues, including, without limitation, potential disruption to appropriation and spending patterns and the government's reservation of the right to cancel contracts and purchase orders for its convenience. Although we do not anticipate that any of our revenues with government customers will be renegotiated, a large number of cancelled or renegotiated government orders could have a material adverse effect on our financial results. Currently, we are not aware of any proposed cancellation or renegotiation of any of our existing arrangements with government entities and, historically, government entities have not cancelled or renegotiated orders which had a material adverse effect on our business.

Gross Profit. Gross profit was \$0.9 million or 56.1% of net revenues for the quarter ended September 30, 2017, compared to \$1.0 million or 61.8% of net revenues for the quarter ended September 30, 2016. Gross profit was \$2.8 million or 59.2% of net revenues for the nine months ended September 30, 2017 compared to \$3.0 million or 64.3% of net revenues for the nine months ended September 30, 2016. Gross profit on product revenues for the quarter and nine months ended September 30, trended from 61.8% and 64.3%, respectively, in 2016 to 56.1% and 59.2%, respectively, in 2017 mainly due to a change in product mix and slightly higher labor cost associated with TraceCop sales. Gross profit as a percentage of net revenues is impacted by several factors, including shifts in product mix, changes in channels of distribution, revenue volume, pricing strategies, and fluctuations in revenues of integrated third-party products.

Sales and Marketing. Sales and marketing expenses remained constant at \$0.4 million for the three months ended September 30, 2017 and 2016. Sales and marketing expenses decreased to \$1.2 million for the nine months ended September 30, 2017 compared to \$1.3 million for the same period in 2016. Sales and marketing expenses may vary in the future. We believe that these costs will increase through the end of 2017, due to increases associated with increases in revenue.

Research and Development. Research and development expenses increased to \$0.6 million for the quarter ended September 30, 2017 compared to \$0.5 million for the same period in 2016. Research and development expenses decreased to \$1.8 million for the nine months ended September 30, 2017 compared to \$1.9 million for the same period in 2016. Research and development costs are expensed in the period incurred. Research and development expenses may vary in the future; however, we believe that these costs will remain relatively constant through the end of 2017, although expenses may be increased relative to increases in revenue.

General and Administrative. General and administrative expenses decreased to \$0.2 million for the quarters ended September 30, 2017 compared to \$0.3 million for the same period in 2016. General and administrative expenses remained constant at \$0.9 million for the nine months ended for September 30, 2017 and 2016. It is expected that general and administrative expenses will remain relatively constant throughout the remainder of 2017, although expenses may be increased relative to increases in revenue.

Other Income. On July 7, 2017, the Company entered into a sale of certain IP addresses that were not currently being used in the Company's business operations and were not required for the Company's future business plans. The net proceeds from the sale of these intellectual property assets were in the amount of \$872,000 which the Company received on August 9, 2017. In addition, \$56,000 was received on August 3, 2017 from the sale of an investment.

Interest. Net interest expense increased to \$49 thousand for the quarter ended September 30, 2017 compared to \$36 thousand for the same period in 2016. Net interest expense increased to \$157 thousand for the nine months ended September 30, 2017 compared to \$102 thousand for the same period in 2016. The increase in interest expense was primarily due to an increase in the shareholder loan amount from our CEO and an increase in the prime rate by 0.25%

in June. Net interest expense may vary in the future based on our level of borrowing, which will be affected by our cash flow, operating income and capital expenditures.

Liquidity and Capital Resources

Our principal source of liquidity at September 30, 2017, was approximately \$263 thousand of cash and cash equivalents. At September 30, 2017, we had a working capital deficiency of \$1.0 million compared to a \$1.0 million deficiency at September 30, 2016.

Net cash provided by operations for the nine months ended September 30, 2017, was \$274 thousand due to the following sources of cash and non-cash items: \$263 thousand increase in deferred revenue, \$168 thousand increase in accounts payable and accrued expenses, \$40 thousand decrease in prepaid expenses and other assets, \$15 thousand decrease in Inventories, \$106 thousand in amortization expense of capital leases, \$53 thousand in depreciation expense, \$24 thousand in penalties and waived penalties on dividends, and \$16 thousand in stock-based compensation. This was partially offset by a net operating loss of \$221 thousand, \$56 thousand gain on sale of investment and a \$134 thousand increase in accounts receivable. Net cash used in operations for the nine months ended September 30, 2016, was \$606 thousand due to a net loss of \$1.2 million and the following use of cash: a \$8 thousand decrease in accounts receivable and a \$7 thousand decrease in Inventories. This was partially offset by the following sources of cash and non-cash items: \$236 thousand increase in deferred revenue, \$39 thousand increase in accounts payable and accrued expenses, a \$31 thousand decrease in prepaid expenses and other assets, \$71 thousand in depreciation expense, \$147 thousand in amortization expense of capital leases, \$82 thousand in stock-based compensation, and \$13 thousand in penalties and waived penalties on dividends. Future fluctuations in inventory balances, accounts receivable and accounts payable will be dependent upon several factors, including, but not limited to, quarterly sales volumes and timing of invoicing, and the accuracy of our forecasts of product demand and component requirements.

Net cash provided by investing activities for the nine months ended September 30, 2017, was \$43 thousand due to \$56 thousand in proceeds from sale of investment offset by \$13 thousand for net purchases of property and equipment, compared to \$41 thousand for net purchases of property and equipment for cash used in investing activities for the nine months ended September 30, 2016.

Net cash used by financing activities for the nine months ended September 30, 2017, was \$118 thousand due to \$1.6 million in payments to the loan by an officer, and \$109 thousand payment on the principal of capital leases. This was offset by: proceeds from a loan by an officer of \$1.58 million and \$11 thousand in proceeds from the exercise of stock options. Net cash provided by financing activities in 2016 was \$755 thousand primarily due to proceeds from a loan by an officer of \$805 thousand. Other provisions were proceeds from the line-of-credit of \$364 thousand and \$99 thousand from the exercise of stock options. This was directly offset by the following uses of cash: \$364 thousand in payments to the line-of-credit and \$149 thousand payment on principal on capital leases.

At September 30, 2017, the Company did not have any material commitments for capital expenditures.

During the nine months ended September 30, 2017, the Company funded its operations through the use of cash and cash equivalents sale of certain assets (see note 11) and advances under the CEO Note.

As of September 30, 2017, we had cash and cash equivalents of approximately \$263,000, up from approximately \$64,000 as of December 31, 2016. We generated net income of \$568,000 for the quarter ended September 30, 2017 compared to net loss of \$280,000 for the quarter ended September 30, 2016. We also received one-time revenue

during our third quarter in the amount \$872,000, recognized as other income, which increased our net income significantly. As of September 30, 2017, in addition to cash and cash equivalents of \$263,000, we had \$835,000 funding available from a promissory note to borrow up to \$3.7 million from G. Ward Paxton, the Company's Chief Executive Officer. We are obligated to make payments of accrued dividends on all our outstanding shares of preferred stock that will reduce our available cash resources. Based on projections of growth in revenue and net income in the coming quarters, and the borrowings available previously mentioned, we believe that we will have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. We expect to fund our operations through anticipated Company profits and borrowings from the Company's CEO, and possibly additional investments of private equity and debt, which, if we are able to obtain, will have the effect of diluting our existing common stockholders, perhaps significantly. 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. If our operations do not generate positive cash flow in the upcoming year, or if we are not able to obtain additional debt or equity financing on terms and conditions acceptable to us, if at all, we may be unable to implement our business plan, fund our liquidity needs or even continue our operations.

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

Item 4. CONTROLS AND PROCEDURES

We maintain "disclosure controls and procedures," as defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable assurance of achieving the desired control objectives, and we necessarily are required to apply our judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures.

Our management, including our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2017, and concluded that the disclosure controls and procedures were effective.

Our management, with the participation of our principal executive officer and principal financial officer, evaluated our “internal control over financial reporting” (as defined in Rule 13a-15(f) under the Exchange Act) as of December 31, 2016, and concluded that there have not been any changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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

Item 1A. RISK FACTORS

Factors That May Affect Future Results of Operations

We are providing the following information regarding changes that have occurred to previously disclosed risk factors from our Annual Report on Form 10-K for the year ended December 31, 2016. In addition to the other information set forth below and elsewhere in this report, you should consider the factors discussed under the heading "Risk Factors" in our Form 10-K for the year ended December 31, 2016 and the previous Quarterly Reports filed on Form 10-Q for the periods ended on March 31, 2017 and June 30, 2017. The risks described in our Quarterly Reports on Form 10-Q are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

We may not have sufficient cash to operate our business. Additional debt and equity offerings to fund future operations may not be available and, if available, may significantly dilute the value of our currently outstanding common stock.

As of September 30, 2017, we had cash and cash equivalents of approximately \$263,000, up from approximately \$64,000 as of December 31, 2016. We generated net income of \$568,000 for the quarter ended September 30, 2017 compared to net loss of \$280,000 for the quarter ended September 30, 2016. We also received one-time revenue during our third quarter in the amount \$872,000, recognized as other income, which increased our net income significantly. As of September 30, 2017, in addition to cash and cash equivalents of \$263,000, we had \$835,000 funding available from a promissory note to borrow up to \$3.7 million from G. Ward Paxton, the Company's Chief Executive Officer. We are obligated to make payments of accrued dividends on all our outstanding shares of preferred stock that will reduce our available cash resources. Based on projections of growth in revenue and net income in the

coming quarters, and the borrowings available previously mentioned, we believe that we will have sufficient cash resources to finance our operations and expected capital expenditures for the next twelve months. We expect to fund our operations through anticipated Company profits and borrowings from the Company's CEO, and possibly additional investments of private equity and debt, which, if we are able to obtain, will have the effect of diluting our existing common stockholders, perhaps significantly. 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. If our operations do not generate positive cash flow in the upcoming year, or if we are not able to obtain additional debt or equity financing on terms and conditions acceptable to us, if at all, we may be unable to implement our business plan, fund our liquidity needs or even continue our operations.

We had net income of \$568 thousand for the quarter ended September 30, 2017, and have an accumulated deficit of \$61.7 million as of September 30, 2017. To achieve annual profitability, we must generate increased revenue levels.

For the quarter ended September 30, 2017, we generated net income of \$568 thousand and had an accumulated deficit of approximately \$61.7 million, compared to a net loss of \$280 thousand for the quarter ended September 30, 2016 and an accumulated deficit of approximately \$61.2 million. We need to sustain greater revenue levels from the sales of our products if we are to achieve annual profitability. If we are unable to achieve these revenue levels, losses could happen for the near term and possibly longer, and we may not sustain profitability or generate positive cash flow from operations.

A large percentage of our revenues are received from U.S. government entities/resellers, and the loss of any one of these customers could reduce our revenues and materially harm our business and prospects.

A large percentage of our revenues result from sales to U.S. government entities/resellers. If we were to lose one or more of these key relationships, our revenues could decline and our business and prospects may be materially harmed. We expect that even if we are successful in developing relationships with non-governmental customers, our revenues will continue to be concentrated among government entities. For the quarter ended September 30, 2017, sales to U.S. government entities/resellers collectively accounted for 90.6% of our revenues, compared to 78.4% for the comparable period in 2016. The loss of any of these key relationships may send a negative message to other U.S. government entities or non-governmental customers concerning our product offering. We cannot assure you that U.S. government entities will be customers of ours in future periods or that we will be able to diversify our customer portfolio to adequately mitigate the risk of loss of any of these customers.

A large percentage of our revenues are from one product line with a limited number of customers, and the decrease of revenue from sales of this product line could materially harm our business and prospects.

A large percentage of our revenues result from sales of our security product line. Savant revenues were \$29 thousand for the quarter ended September 30, 2017 compared to \$22 thousand for the same period in 2016. TraceCop revenues were \$1.7 million for the quarter ended September 30, 2017, compared to \$1.6 million for the same quarter in 2016. No individual commercial customer in the third quarter of 2017 exceeded 10% of total revenues compared to one customer at 18.9% for the same period in 2016 that exceeded 10% of total revenues for that quarter. If sales of this key product line were to decrease, our revenues could decline and our business and prospects may be materially harmed.

We are highly dependent on sales made through indirect channels, the loss of which would materially adversely affect our operations.

We derived 92.1% of revenue in the third quarter of 2017 through indirect channels of mainly government resellers, compared to 79.8% of our revenues in the quarter ended September 30, 2016. We must continue to expand our sales through these indirect channels in order to increase our revenues. We cannot assure you that our products will gain market acceptance in these indirect sales channels or that sales through these indirect sales channels will increase our revenues. Further, many of our competitors are also trying to sell their products through these indirect sales channels, which could result in lower prices and reduced profit margins for sales of our products.

You will experience substantial dilution upon the conversion or redemption of the shares of preferred stock that we issued in our private placements or in the event we raise additional funds through the issuance of new shares of our common stock or securities convertible or exercisable into shares of common stock.

On November 1, 2017, we had 12,797,836 shares of common stock outstanding. Upon conversion of all outstanding shares of preferred stock, we will have 13,865,279 shares of common stock outstanding, approximately an 8.3% increase in the number of shares of our common stock outstanding.

In addition, management may issue additional shares of common stock or securities exercisable or convertible into shares of common stock in order to finance our continuing operations. Any future issuances of such securities would have additional dilutive effects on the existing holders of our Common Stock.

Further, the occurrence of certain events could entitle holders of our Series 2 Preferred Stock and Series 3 Preferred Stock to require us to redeem their shares for a certain number of shares of our common stock. Assuming (i) we have

paid all liquidated damages and other amounts to the holders, (ii) paid all outstanding dividends, (iii) a volume weighted average price of \$0.23, which was the ten-day volume weighted average closing price of our common stock on October 27, 2017, and (iv) our 12,797,836 shares of common stock outstanding on October 27, 2017, upon exercise of their redemption right by the holders of the Series 3 Preferred Stock and the Series 2 Preferred Stock, we would be obligated to issue approximately 1,215,000 shares of our common stock. This would represent an increase of approximately 9.5% in the number of shares of our common stock as of October 27, 2017.

The conversion of preferred stock we issued in the private placements may cause the price of our common stock to decline.

The holders of the shares of our 5% Preferred Stock may freely convert their shares of preferred stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of November 1, 2017, 800,000 shares of our 5% Preferred Stock had converted into 1,272,263 shares of common stock and 200,000 shares of our 5% preferred stock, convertible into 318,065 shares of common stock, remain outstanding.

The holders of the shares of Series 2 5% Preferred Stock may freely convert their shares of preferred stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of November 1, 2017, 605,200 shares of Series 2 Preferred Stock had converted into 605,200 shares of common stock and 460,000 shares of Series 2 5% preferred stock remain outstanding.

The holders of the shares of Series 3 5% Preferred Stock may freely convert their shares of Series 3 Preferred Stock and sell the underlying shares of common stock pursuant to Rule 144 of the Securities and Exchange Commission. As of November 1, 2017, 275,230 shares of Series 3 Preferred Stock had converted into 275,230 shares of common stock and 289,377 shares of Series 3 5% preferred stock remain outstanding.

For the four weeks ended on October 27, 2017, the average daily trading volume of our common stock on the OTCQB was 2,011 shares. Consequently, if holders of preferred stock elect to convert their remaining shares and sell a material amount of their underlying shares of common stock on the open market, the increase in selling activity could cause a decline in the market price of our common stock. Furthermore, these sales, or the potential for these sales, could encourage short sales, causing additional downward pressure on the market price of our common stock.

You will experience substantial dilution upon the exercise of stock options currently outstanding.

On November 1, 2017, we had 12,797,836 shares of common stock outstanding. Upon the exercising of current options exercisable at or below the exercise price of \$1.10, we will have approximately 14,905,000 shares of common stock outstanding, an 18.0% increase in the number of shares of our common stock outstanding.

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

As of November 1, 2017, our executive officers, directors and preferred stockholders beneficially own approximately 29% of our voting power. In addition, other related parties control approximately 30% of voting power. As a result, these stockholders will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us. These stockholders may use their influence to approve or take actions that may be adverse to the interests of holders of our Common Stock. Further, we contemplate the possible issuance of shares of our Common Stock or of securities exercisable or convertible into shares of our Common Stock in the future to our Chief Executive Officer and Chief Financial Officer. Any such issuance will increase the percentage of stock our Chief Executive Officer, Chief Financial Officer and our management group beneficially holds.

Item 6. Exhibits

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

- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.
- 32.1 Certification Pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document

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 14, 2017 /s/ G. Ward Paxton
G. Ward Paxton
Chairman, President & Chief Executive Officer
(Principal Executive Officer)

Date: November 14, 2017 /s/ Michael L. Paxton
Michael L. Paxton
Vice President, Chief Financial Officer,
Treasurer & Secretary
(Principal Financial & Accounting Officer)