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LITRONIC INC
Form 10-Q
August 14, 2001

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

FORM 10-Q

[LOGO OF LITRONIC]

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001,

OR

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

COMMISSION FILE NO. 000-26227

LITRONIC INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE
(STATE OR OTHER JURISDICTION
OF INCORPORATION OR ORGANIZATION)

33-0757190
(I.R.S EMPLOYER
IDENTIFICATION NO.)

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

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

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days. Yes No

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As of August 13, 2001, the registrant had 9,747,526 shares of common stock outstanding.

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LITRONIC INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LITRONIC INC. AND SUBSIDIARIES

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

(UNAUDITED)

DECEMBER 31,	JUNE 30
2000	2001
-----	-----

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ASSETS

Current assets:

Cash and cash equivalents	\$ 4,120	\$ 2,278
Accounts receivable (net of allowance for doubtful accounts of \$268 and \$140 as of December 31, 2000 and June 30, 2001, respectively)	4,137	3,298
Inventories	695	820
Prepaid expenses	542	666
Other current assets	325	454
	-----	-----
Total current assets	9,819	7,516
Property and equipment, net	823	483
Other assets	343	83
Goodwill and other intangibles, net	783	737
	-----	-----
	\$ 11,768	\$ 8,819
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

Current installments of long-term debt	\$ 1,986	\$ 1,168
Accounts payable	1,392	3,726
Accrued liabilities	1,366	1,183
Deferred revenue	217	215
	-----	-----
Total current liabilities	4,961	6,292
Long-term debt, less current installments	19	--
Deferred revenue	240	137
	-----	-----
Total liabilities	5,220	6,429

Stockholders' equity:

Preferred stock, \$.01 par value; Authorized 5,000,000 shares; no shares issued or outstanding	--	--
Common stock, \$.01 par value; Authorized 25,000,000 shares; issued and outstanding 9,743,573 at December 31, 2000 and 9,747,526 shares at June 30, 2001	97	97
Additional paid-in capital	52,834	52,837
Accumulated deficit	(46,383)	(50,544)
	-----	-----
Total stockholders' equity	6,548	2,390
	-----	-----
	\$ 11,768	\$ 8,819
	=====	=====

See accompanying notes to condensed consolidated financial statements.

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(UNAUDITED)

	THREE MONTHS ENDED		SIX MONTHS
	JUNE 30, 2000	JUNE 30, 2001	JUNE 30, 2000
Revenues:			
Product	\$ 8,418	\$ 5,895	\$ 12,770
License and service	632	454	1,002
Total revenues	9,050	6,349	13,772
Costs and expenses:			
Cost of sales--products	6,383	4,616	10,002
Cost of sales--license and service	228	117	396
Selling, general and administrative	2,803	1,681	5,183
Research and development	1,404	1,682	2,726
Amortization of goodwill and other intangibles	703	23	1,406
Operating loss	(2,471)	(1,770)	(5,941)
Total other expense (income), net	(53)	13	(66)
Loss before income taxes	(2,418)	(1,783)	(5,875)
Provision for income taxes	2	2	6
Net loss	\$ (2,420)	\$ (1,785)	\$ (5,881)
Net loss per share--basic and diluted	\$ (0.24)	\$ (0.18)	\$ (0.60)
Shares used in per share computations--basic and diluted	9,881	9,747	9,874

See accompanying notes to condensed consolidated financial statements.

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LITRONIC INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

(UNAUDITED)

SIX MONTHS ENDED	
JUNE 30, 2000	JUNE 30, 2001

Cash flows from operating activities:

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Net loss	\$ (5,881)	\$ (4,161)
Adjustments to reconcile net loss to net cash used in operating activities:		
Provision for losses on receivables	192	130
Depreciation and amortization	1,703	433
Changes in assets and liabilities:		
Accounts receivable	1,596	709
Inventories	(147)	(125)
Prepaid expenses	(264)	(124)
Other current assets	(49)	(129)
Other assets	(621)	260
Notes receivable	(3)	--
Accounts payable	1,833	2,334
Accrued liabilities	(262)	(183)
Deferred revenue	532	(105)
	-----	-----
Net cash used in operating activities	(1,371)	(961)
	-----	-----
Cash flows used in investing activities:		
Purchases of property and equipment	(766)	(47)
Restricted cash related to line of credit	612	--
	-----	-----
Net cash used in investing activities	(154)	(47)
	-----	-----
Cash flows from financing activities:		
Stock options exercised	20	3
Borrowings on revolving note payable	838	10,064
Proceeds from insurance financing	748	--
Repayment on insurance financing	(169)	(249)
Principal payments on revolving note payable and long-term notes payable to bank	(856)	(10,652)
	-----	-----
Net cash provided by (used in) financing activities	581	(834)
	-----	-----
Net decrease in cash	(944)	(1,842)
Cash and cash equivalents at beginning of period	6,441	4,120
	-----	-----
Cash and cash equivalents at end of period	\$ 5,497	\$ 2,278
	=====	=====
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 64	\$ 37
Income taxes	5	2
	=====	=====

See accompanying notes to condensed consolidated financial statements.

LITRONIC INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2000 AND 2001
 (UNAUDITED)
 (IN THOUSANDS, EXCEPT PER SHARE DATA)

(1) GENERAL INFORMATION:

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Condensed Consolidated Financial Statements

In the opinion of the Company, the accompanying unaudited condensed consolidated financial statements contain all adjustments (which are normal recurring accruals) necessary to present fairly the financial position as of June 30, 2001; the results of operations for the three and six months ended June 30, 2000 and 2001; and the statements of cash flows for the six months ended June 30, 2000 and 2001. Interim results for the six months ended June 30, 2001 are not necessarily indicative of the results that may be expected for the year ending December 31, 2001. The interim financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2000, included in the Company's Form 10-K/A, filed in April 2001.

Goodwill and Other Intangibles

The Company amortizes intangible assets relating to businesses acquired and costs in excess of the fair value of net assets of businesses acquired ("goodwill and other intangibles") using the straight-line method over the estimated useful lives of the intangible assets and business acquired. Amortization of goodwill and other intangibles was \$1,406 and \$46 for the six months ended June 30, 2000 and June 30, 2001, respectively.

New Accounting Standards

In July 2001, the Financial Accounting Standards Board issued Statement 141, "Business Combinations", and Statement 142, "Goodwill and Other Intangible Assets." Statement 141 requires that all business combinations be accounted for under a single method -- the purchase method. Use of the pooling-of-interests method is no longer permitted. Statement 141 requires that the purchase method be used for business combinations initiated after June 30, 2001. Statement 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. Under Statement 142, the amortization of goodwill ceases upon adoption of the Statement, which is effective for fiscal years beginning after December 15, 2001, which for calendar year-end companies, will be January 1, 2002. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not been previously issued. In all cases, the provisions of Statement 142 shall be initially applied at the beginning of a fiscal year.

The Company has historically amortized its goodwill and other intangible assets over their estimated useful lives. Beginning with the adoption of Statement 142, the Company will cease amortizing goodwill. The Company anticipates adopting Statement 142 as of the beginning of fiscal year 2002 (i.e. January 1, 2002).

The Company recorded an impairment charge of \$31,415 in the fourth quarter of 2000, related to unamortized goodwill and other intangible assets acquired in the purchase of Pulsar Data Systems, Inc. ("Pulsar"). Included in the impairment charge was \$10,737 related to goodwill. The goodwill included in the impairment charge represented all the Company's remaining unamortized goodwill, at December 31, 2000 there was no unamortized goodwill included on the Company's books. No expense related to the amortization of goodwill has been included in either the quarter ended March 31, 2001, or the three and six-month periods ended June 30, 2001. The Company will continue to amortize the other intangible assets over the remaining useful lives subsequent to the adoption of Statement 142.

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(2) INVENTORIES

A summary of inventories follows:

	DECEMBER 31, 2000 -----	JUNE 30, 2001 -----
Raw materials	\$258	\$336
Work-in-process	86	52
Finished goods	351	432
	----	----
	\$695	\$820
	=====	=====

(3) LONG TERM DEBT

A summary of long-term debt follows:

	DECEMBER 31, 2000 -----
Revolving note payable to bank with maximum availability of \$5,000, bearing interest at prime plus .625% (10.125% at December 31, 2000 and 7.375% at June 30, 2001) interest payable monthly through maturity on May 10, 2002; secured by substantially all assets of the Company	1,509
Note payable for insurance financing due in nine monthly payments beginning July 9, 2000 at an annual percentage rate of 7.15%	12
Note payable for insurance financing due in eighteen monthly payments beginning July 9, 2000 at an annual percentage rate of 8.18%	484

	2,005
Less current installments	1,986

	\$ 19
	=====

In June 1999 the Company entered into a three-year lending agreement with Guaranty Business Credit Corporation ("GBCC") permitting borrowings under a \$20,000 secured revolving line of credit facility that commenced on June 14, 1999. The agreement provided for an annual interest rate of prime plus .625%; and a pledge of substantially all of the Company's personal and real property as collateral. On April 18, 2001 the Company and GBCC amended the revolving line of credit facility. Although the amended credit facility was for borrowings up to \$5,000, under the terms of the agreement the amount of borrowing available to the Company is subject to a maximum borrowing limitation based on eligible collateral. Under the terms of the amended agreement eligible collateral includes 35% of eligible accounts receivable. As a result, the amount that was actually available to the Company at any particular time may have been significantly less than the full \$5,000 credit facility due to the maximum

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borrowing limitation calculation. Borrowings related to this agreement are included in current installments of long-term debt in the condensed consolidated financial statements.

The agreement with GBCC included a number of covenants and restrictions that the Company was required to adhere to. These covenants and restrictions included maintenance of minimum levels of working capital, tangible net worth, and profitability. In addition, the agreement did not allow the Company to pay dividends or enter into merger agreements. The Company was not in compliance with the adjusted covenants at June 30, 2001, however, the Company has obtained a waiver of those covenant violations as of June 30, 2001.

(4) CONCENTRATION OF RISK AND SIGNIFICANT CUSTOMERS

Financial instruments that potentially subject the Company to concentration of credit risk are trade receivables. Credit risk on trade receivables is limited as a result of the Company's customer base and their dispersion across different industries and geographic regions. As of December 31, 2000 and June 30, 2001, accounts receivable included \$3,732 and \$2,594 respectively, due from the U.S. Government and related agencies. Sales to federal government agencies represented 67% and 64% of the Company's revenues for the six months ended June 30, 2000 and 2001, respectively.

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The Company had sales to one customer that was an agency of the U.S. Government and represented 28% of the total revenues for the six months ended June 30, 2000. The Company had sales to two customers, which were agencies of the U.S. Government, which represented 17% and 13%, respectively, of total revenues for the six months ended June 30, 2001. No other customers accounted for more than 10% of total revenues during the six months ended June 30, 2000 and June 30, 2001. Trade accounts receivable totaled \$1,191 and \$1,306 from these major customers as of December 31, 2000 and June 30, 2001 respectively.

At June 30, 2001, the Company's investment portfolio consisted of \$1,976 in cash equivalents. The Company does not believe that it has a concentration of investment risk due to the diversification of the investment portfolio. All amounts are invested in a money market account with a major financial services firm.

(5) 1999 STOCK OPTION PLAN

During the quarter ended June 30, 2001, the Company granted options to purchase 22,500 shares at an exercise price of \$2.46 per share, the then current fair market value, under the Company's 1999 Stock Option Plan (the "1999 Plan"), which was established in April 1999.

(6) LOSS PER SHARE

The computation of diluted net loss per share for the three months ended June 30, 2000 and 2001 and the six months ended June 30, 2000 and 2001 excluded the dilutive effect of 751,195, and 915,142, respectively, of incremental common shares attributable to the exercise of outstanding common stock options and warrants as a result of the antidilutive effect.

(7) CONTINGENT LIABILITIES

As the Company provides engineering and other services to various government agencies, it is subject to retrospective audits, which may result in adjustments to amounts recognized as revenues, and the Company may be subject to

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investigation by governmental entities. Failure to comply with the terms of any governmental contracts could result in civil and criminal fines and penalties, as well as suspension from future government contracts. The Company is not aware of any adjustments, fines or penalties, which could have a material adverse effect on its financial position or results of operations.

The Company has cost reimbursable type contracts with the Federal Government. Consequently, the Company is reimbursed based upon its direct expenses attributable to the contract, plus a percentage based upon overhead, material handling, and general and administrative expenses. The overhead, material handling, and general and administrative rates are estimates. Accordingly, if the actual rates as determined by the Defense Contract Audit Agency were below the Company's estimates, a refund for the difference would be due to the Federal Government. It is management's opinion that no material liability will result from any contract audits.

On January 16, 1998, G2 Resources Inc. (G2) filed a complaint against Pulsar in the Circuit Court, Fifteenth Judicial Circuit, Palm Beach County, Florida. G2 claimed that Pulsar breached a contract under which G2 agreed to provide services related to the monitoring of government contracts available for bid and the preparation and submission of bids on behalf of Pulsar. The contract provided that Pulsar pay G2 \$500 in 30 monthly installments of \$16 and an additional fee of 2% of the gross dollar amount generated by awards. In its complaint, G2 alleged that Pulsar failed to make payments under the contract and claimed damages in excess of \$525 plus interest, costs and attorneys fees. In the course of discovery G2 asserted that its losses/costs arising out of its claim amounted to approximately \$10,300. Pulsar asserted that G2 failed to perform the services required under the contract and Pulsar filed a claim for compensatory damages, interest and attorneys fees against G2. Classical Financial Services, LLC intervened in the case. Classical claimed that G2 assigned its accounts receivable to Classical under a financing program and that Pulsar breached its obligations to Classical by failing to make payments under the contract with G2. Pulsar asserted defenses to Classical's claim. On April 20, 2001, a court hearing was held and G2's complaint against Pulsar was dismissed without prejudice on the basis of no prosecution activity for more than 12 months. On May 22, 2001, G2 filed a new complaint against Pulsar. The Company believes that the claims made by G2 against Pulsar are without merit and intends to vigorously defend against these claims.

The Company is involved from time to time in various other litigations that arise in the ordinary course of business. We are not currently involved in any litigation that we believe will have a material impact on our results of operations, financial condition or liquidity.

(8) BUSINESS SEGMENTS AND PRODUCT LINES

In 1998 and prior to the acquisition of Pulsar in June 1999, the Company operated in one business segment. Subsequent to the acquisition of Pulsar, the Company operates in two industry segments, the information security segment and the network solutions segment. Following are the revenues, cost of sales, and identifiable assets of these segments as of and for the three and six months ended June 30, 2000 and 2001.

THREE MONTHS ENDED		SIX MONTHS ENDED	
-----	-----	-----	-----
JUNE 30,	JUNE 30,	JUNE 30,	JUNE 30,

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	2000	2001	2000	2001
	-----	-----	-----	-----
Revenue				
Information Security Products and Services	\$ 2,139	\$ 1,945	\$ 3,559	\$ 3,895
Network Solutions Market	6,911	4,404	10,213	6,932
	=====	=====	=====	=====
Cost of sales				
Information Security Products and Services	709	757	1,242	1,679
Network Solutions Market	5,902	3,976	9,156	6,253
	=====	=====	=====	=====

	DECEMBER 31,	JUNE 30,		
	2000	2001		
	-----	-----		
Identifiable assets				
Information Security Products and Services	\$ 1,373	\$ 1,405		
Network Solutions Market	4,370	3,114		
	=====	=====		

As the Chief Operating Decision Maker does not review operating expenses by segment beyond cost of sales or assets, except as identified, additional segment information is not available.

During the three and six months ended June 30, 2000, the Company had four distinct product lines: network deployment products, data security products, license and service, and electric security systems. During the three and six months ended June 30, 2001, the Company had three distinct product lines: network deployment products, data security products and license and service. Following is a summary of total revenues by product line.

	THREE MONTHS ENDED		SIX MONTHS
	JUNE 30,	JUNE 30,	JUNE 30,
	2000	2001	2000
	-----	-----	-----
Network deployment products	\$ 6,759	\$ 4,404	\$10,000
Data security products	1,659	1,491	2,770
License and service	480	454	788
Electric security systems	152	--	214
	-----	-----	-----
Total net product, license and service revenues	\$ 9,050	\$ 6,349	\$13,772
	=====	=====	=====

In July 2000 the Company discontinued the electric security systems product line. The Company has not and does not anticipate incurring any significant expense as the result of this decision.

(9) BIZ INTERACTIVE ZONE MERGER

In February 2001, the Company signed a Term Sheet with BIZ Interactive Zone, Inc. ("BIZ"), relating to the Company's proposed merger whereby Litronic Merger Corp., a Delaware corporation and a wholly owned subsidiary of the Company, will merge with and into BIZ. BIZ will become a wholly owned subsidiary

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of the Company. On February 12, 2001, the Company issued a press release regarding the proposed merger with BIZ. On July 3, 2001, the Company and BIZ signed a definitive Agreement and Plan of Reorganization. Concurrent with the signing of the definitive Agreement and Plan of Reorganization the majority shareholders of both the Company and BIZ signed a voting agreement agreeing to vote their shares in favor of the merger. The total number of shares of common stock to be issued to the BIZ shareholders (other than the Company's CEO) in the merger is 10,209,954. The Company's CEO will receive 665,124 shares of common stock in the merger. The Company expects the merger to be completed in the third quarter of 2001.

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

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements based on our current expectations, estimates and projections about our industry, management's beliefs and certain assumptions we have made. Words such as "anticipates," "expects," "intend," "plans," "believes," "may," "will," or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections, forecasts or other predictions regarding future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements may include, but are not limited to, statements concerning projected revenues, expenses and income or loss, the need for additional capital, acceptance of our products, growth of the Internet, our ability

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to identify and consummate acquisitions and integrate these operations successfully, our ability to integrate previously acquired businesses successfully, the status of evolving technologies and their growth potential, our production capacity, and the outcome of pending and threatened litigation. These statements are not guarantees or assurances of future performance and are subject to various risks, uncertainties, and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements. The section labeled "Business Environment and Risk Factors" set forth in this Form 10-Q and similar sections in our other Securities and Exchange Commission ("SEC") filings discuss some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this report and in our other SEC filings, before deciding to buy or sell our Common Stock. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

The information contained in this report is not a complete description of our business or the risks associated with an investment in our Common Stock. You should carefully review and consider the various disclosures made by us in this report and in our materials filed with the SEC that discuss our business in greater detail and that also disclose various risks, uncertainties and other factors that may affect our business, results of operations or financial condition.

GENERAL

We provide professional Internet data security services and develop and market software and microprocessor-based products needed to secure electronic commerce and communications over the Internet and other communications networks based on Internet protocols. Our primary technology offerings use public key

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infrastructure ("PKI"), which is the standard technology for securing Internet-based commerce and communications. In addition, Pulsar, a wholly owned subsidiary, is an established computer and networking product reseller that focuses on resales to government agencies, large corporate accounts and state and local governments. We acquired Pulsar in June 1999 in exchange for 2,169,938 shares of our common stock.

In February 2001, we signed a Term Sheet with BIZ Interactive Zone, Inc. ("BIZ"), relating to our proposed merger whereby Litronic Merger Corp., a Delaware corporation and a wholly owned subsidiary of the Company, will merge with and into BIZ. BIZ will become our wholly owned subsidiary. On February 12, 2001, we issued a press release regarding our proposed merger with BIZ. On July 3, 2001, we and BIZ signed a definitive Agreement and Plan of Reorganization. Concurrent with the signing of the definitive Agreement and Plan of Reorganization the holders of a majority of our shares and of BIZ signed a voting agreement agreeing to vote their shares in favor of the merger. We expect the merger to be completed in the third quarter of 2001.

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RESULTS OF OPERATIONS

The following table sets forth the percentage of net revenues represented by selected items from the unaudited Condensed Consolidated Statements of Operations. This table should be read in conjunction with the Condensed Consolidated Financial Statements included elsewhere herein.

	PERCENTAGE OF TOTAL REVENUES		PERCENTAGE OF TOTAL REVENUES	
	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30, 2000	JUNE 30, 2001	JUNE 30, 2000	JUNE 2001
Revenues:				
Product	93.0%	92.8%	92.7%	92.7%
License and service	7.0	7.2	7.3	7.3
Total revenues	100.0	100.0	100.0	100.0
Costs and expenses:				
Cost of sales--products	70.5	72.7	72.6	71.9
Cost of sales--license and service	2.5	1.8	2.9	2.9
Selling, general and administrative	31.0	26.5	37.6	31.1
Research and development	15.5	26.5	19.8	32.1
Amortization of goodwill and other intangibles	7.8	0.4	10.2	0.0
Operating loss	(27.3)	(27.9)	(43.1)	(38.1)
Total other expense (income), net	(0.6)	0.2	(0.5)	0.0
Loss before income taxes	(26.7)	(28.1)	(42.7)	(38.1)
Provision for income taxes	0.0	0.0	0.0	0.0
Net loss	(26.7)%	(28.1)%	(42.7)%	(38.1)%

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RESULTS OF OPERATIONS -- COMPARISON OF THE THREE MONTHS ENDED JUNE 30, 2000 AND 2001

TOTAL REVENUE. Total revenues decreased 30% from \$9.1 million during the three months ended June 30, 2000 to \$6.3 million during the three months ended June 30, 2001. The decrease was primarily attributable to a decrease in product revenues of \$2.4 million related to network deployment products and a decrease of \$178,000 in revenues related to license and service and primarily attributable to the discontinuation of the electric security systems product line.

During the three months ended June 30, 2000, we derived 29% and 10% of our revenue from sales to U.S. Immigration & Naturalization Service and the U.S. Patent & Trademark Office, respectively. During the three months ended June 30, 2001, we derived 23% and 14%, respectively, of our revenue from sales to the U.S. Immigration and Naturalization Service and the National Institute of Health. Sales to Federal government agencies accounted for approximately 67% and 69% of our sales during the three months ended June 30, 2000 and 2001, respectively.

PRODUCT REVENUE. Product revenue decreased 30% from \$8.4 million during the three months ended June 30, 2000 to \$5.9 million during the three months ended June 30, 2001. The decrease was primarily attributable to a \$2.4 million decrease in revenues related to network deployment products along with a \$168,000 decrease in revenues related to data security products.

LICENSE AND SERVICE REVENUE. License and service revenue decreased 28% from \$632,000 during the three months ended June 30, 2000 to \$454,000 during the three months ended June 30, 2001. The decrease was primarily attributable to a \$152,000 decrease in revenues related to electric security systems and a \$26,000 decrease in revenues related to license and services. The electric security systems product line was discontinued in July 2000.

PRODUCT GROSS MARGIN. Product gross margins decreased as a percentage of net product revenue from 24% during the three months ended June 30, 2000 to 22% during the three months ended June 30, 2001. The decrease was primarily attributable to a decrease in gross margins related to network deployment products. Margins on network deployment products decreased from 15% during the three months ended June 30, 2000 to 10% during the three months ended June 30, 2001.

LICENSE AND SERVICE GROSS MARGIN. License and service gross margin increased as a percentage of license and service revenue from 64% during the three months ended June 30, 2000 to 74% during the three months ended June 30, 2001. This increase was primarily attributable to the discontinued electric security systems product line. Gross margins related to the electric security systems product line were significantly less than those related to other types of licenses and services that we provide.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses decreased 40% from \$2.8 million during the three months ended June 30, 2000 to \$1.7 million during the three months ended June 30, 2001. The decrease was primarily attributable to a reduction in selling, general and administrative ("S,G&A") related payroll expenses at Pulsar. The average S,G&A headcount at Pulsar decreased by 18 or 47% during the three months ended June

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30, 2001 as compared to the three months ended June 30, 2000. As a percentage of revenue, selling, general and administrative expenses decreased from 31% during the three months ended June 30, 2000 to 27% during the three months ended June 30, 2001. The percentage decrease was also primarily attributable to reduced S,G&A related payroll expenses at Pulsar.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses increased 20% from \$1.4 million during the three months ended June 30, 2000 to \$1.7 million during the three months ended June 30, 2001. The increase was primarily attributable to increased staffing related to product development, including development efforts related to the Forte microprocessor, Maestro, ProFile Manager, NetSign and token reader/writers. As a percentage of revenue, research and development expenses increased from 16% during the three months ended June 30, 2000 to 27% during the three months ended June 30, 2001. The percentage increase was primarily attributable to an increase in research and development spending combined with a decrease in total revenue.

AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES. In June 1999, we acquired Pulsar. All of the outstanding shares of Pulsar were exchanged for 2,169,938 shares of our common stock. The acquisition was accounted for using the purchase method of accounting. In the fourth quarter of 2000 we determined the integration of Pulsar would not be completed as planned and the anticipated operating synergies would not be realized, therefore, we are currently exploring various alternatives for the Pulsar operations. As a result, in accordance with Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of", we analyzed the recoverability of the goodwill and other intangibles relating to the acquisition of Pulsar. In order to evaluate the recoverability of the remaining goodwill and other intangible assets, we engaged the services of an independent valuation firm to perform a valuation. During the fourth quarter of 2000, based on the results of the independent valuation, we recorded an impairment charge of \$31.4 million related to unamortized intangible assets acquired in the purchase of Pulsar. Based on the independent valuation, management believes that after the impairment charge of \$31.4 million, no further impairment exists. The remaining unamortized intangible assets acquired in the purchase of Pulsar will be amortized over the remainder of their 10-year life.

The amortization of goodwill and other intangibles decreased 97% from \$703,000 during the three months ended June 30, 2000 to \$23,000 during the three months ended June 30, 2001. The decrease is primarily attributable to the reduction of goodwill and other intangibles that occurred as the result of the impairment charge that we recorded in the fourth quarter of 2000.

OTHER EXPENSE (INCOME), NET. Net other income changed \$66,000 from \$53,000 net interest income during the three months ended June 30, 2000 to \$13,000 net interest expense during the three months ended June 30, 2001. The change was primarily attributable to a reduction in interest income of \$85,000 and decrease in interest expense of \$19,000. The reduction in interest income was primarily the result of lower cash balances and the decrease in interest expense was the result of decreased borrowings.

INCOME TAXES. Tax expense of \$2,000 was recognized during the three months ended June 30, 2000 and 2001 and was related to minimum franchise taxes for the state of California. We did not recognize any tax benefit from operating losses in the three months ended June 30, 2000 or 2001.

RESULTS OF OPERATIONS -- COMPARISON OF THE SIX MONTHS ENDED JUNE 30, 2000 AND 2001

TOTAL REVENUE. Total revenues decreased 21% from \$13.8 million during the six months ended June 30, 2000 to \$10.8 million during the six months ended June

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30, 2001. The decrease was primarily attributable to a decrease in product revenue of \$3.1 million related to network deployment products offset by an increase in data security products of \$337,000 and a decrease of \$214,000 in revenues related to the discontinuation of the electric security systems product line.

During the six months ended June 30, 2000, we derived 28% of our revenue from sales to U.S. Immigration and Naturalization Service. During the six months ended June 30, 2001, we derived 17% and 13% of our revenue from sales to the U.S. Immigrations and the National institute of Health. Sales to Federal government agencies accounted for approximately 67% and 64% of our sales during the six months ended June 30, 2000 and 2001, respectively.

PRODUCT REVENUE. Product revenue decreased 21% from \$12.8 million during the six months ended June 30, 2000 to \$10.0 million during the six months ended June 30, 2001. The decrease was primarily attributable to a \$3.1 million decrease in revenues related to network deployment products combined with a \$337,000 increase in revenues related to data security products.

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LICENSE AND SERVICE REVENUE. License and service revenue decreased 21% from \$1.0 million during the six months ended June 30, 2000 to \$788,000 during the six months ended June 30, 2001. The decrease was primarily attributable to a \$214,000 decrease in revenues related to electric security systems. The electric security systems product line was discontinued in July 2000.

PRODUCT GROSS MARGIN. Product gross margins increased as a percentage of net product revenue from 22% during the six months ended June 30, 2000 to 23% during the six months ended June 30, 2001. The increase is primarily attributable to a change in the mix of data security products as compared to network deployment products. Data security products have a higher gross margin associated with them, whereas network deployment products have a higher cost of sales as a percentage of sales associated with them.

LICENSE AND SERVICE GROSS MARGIN. License and service gross margin increased as a percentage of license and service revenue from 60% during the six months ended June 30, 2000 to 68% during the six months ended June 30, 2001. This increase was primarily attributable to the discontinued electric security systems product line. Gross margins related to the electric security systems product line were significantly less than those related to other types of licenses and services that we provide.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses decreased 33% from \$5.2 million during the six months ended June 30, 2000 to \$3.5 million during the six months ended June 30, 2001. The decrease was primarily attributable to a reduction S,G&A related payroll expenses at Pulsar. The average S,G&A headcount at Pulsar decreased by 18 or 47% during the six months ended June 30, 2001 as compared to the six months ended June 30, 2000. As a percentage of revenue, selling, general and administrative expenses decreased from 38% during the six months ended June 30, 2000 to 32% during the six months ended June 30, 2001. The percentage decrease was also primarily attributable to reduced S,G&A related payroll expenses at Pulsar.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses increased 29% from \$2.7 million during the six months ended June 30, 2000 to \$3.5 million during the six months ended June 30, 2001. The increase was primarily attributable to increased staffing related to product development, including development efforts related to the Forte microprocessor, Maestro, ProFile Manager, NetSign and token reader/writers. As a percentage of revenue, research and development expenses increased from 20% during the six months ended

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June 30, 2000 to 33% during the six months ended June 30, 2001. The percentage increase was primarily attributable to an increase in research and development spending combined with a decrease in total revenues.

AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES. In June 1999, we acquired Pulsar. All of the outstanding shares of Pulsar were exchanged for 2,169,938 shares of our common stock. The acquisition was accounted for using the purchase method of accounting. In the fourth quarter of 2000 we determined the integration of Pulsar would not be completed as planned and the anticipated operating synergies would not be realized, therefore, we are currently exploring various alternatives for the Pulsar operations. As a result, in accordance with Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of", we analyzed the recoverability of the goodwill and other intangibles relating to the acquisition of Pulsar. In order to evaluate the recoverability of the remaining goodwill and other intangible assets, we engaged the services of an independent valuation firm to perform a valuation. During the fourth quarter of 2000, based on the results of the independent valuation, we recorded an impairment charge of \$31.4 million related to unamortized intangible assets acquired in the purchase of Pulsar. Based on the independent valuation, management believes that after the impairment charge of \$31.4 million, no further impairment exists. The remaining unamortized intangible assets acquired in the purchase of Pulsar will be amortized over the remainder of their 10-year life.

The amortization of goodwill and other intangibles decreased 97% from \$1.4 million during the six months ended June 30, 2000 to \$46,000 during the six months ended June 30, 2001. The decrease is primarily attributable to the reduction of goodwill and other intangibles that occurred as the result of the impairment charge that we recorded in the fourth quarter of 2000.

OTHER EXPENSE (INCOME), NET. Net other income changed \$95,000 from \$66,000 net interest income during the six months ended June 30, 2000 to \$29,000 net interest expense during the six months ended June 30, 2001. The change was primarily attributable to a reduction interest income of \$106,000 and a decrease in interest expense of \$11,000. The reduction in interest income was primarily the result of lower cash balances and the decrease in interest expense was the result of decreased borrowings.

INCOME TAXES. Tax expense of \$6,000 was recognized during the six months ended June 30, 2000 and was related to minimum franchise taxes for the state of California. We did not recognize any tax benefit from operating losses in the six months ended June 30, 2000. Tax expense of \$2,000 was recognized during the six months ended June 30, 2001 and was related to minimum franchise taxes for the state of California. We did not recognize any tax benefit from operating losses in the six months ended June 30, 2001.

LIQUIDITY AND CAPITAL RESOURCES

In June 1999 we entered into a three-year lending agreement with Guaranty Business Credit Corporation ("GBCC") permitting borrowings under a \$20.0 million secured revolving line of credit facility that commenced on June 14, 1999. The agreement provided for an annual interest rate of prime plus .625%; and a pledge of substantially all of our personal and real property as collateral. Although the credit facility was for borrowings up to \$20.0 million, under the terms of the agreement the amount of borrowing available to us was subject to a maximum

borrowing limitation based on eligible collateral. Eligible collateral consisted of 85% of eligible accounts receivable plus the lesser of (a) 50% of the value of eligible on-hand inventory or (b) \$1.0 million. As a result, the amount that

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was actually available to us at any particular time may have been significantly less than the full \$20.0 million credit facility due to the maximum borrowing limitation calculation. The agreement with our lender included a number of covenants and restrictions that we were required to adhere to. These covenants and restrictions included maintenance of minimum levels of working capital, tangible net worth, and profitability. In addition, the agreement did not allow us to pay dividends. Our borrowings related to this agreement are included in current installments of long-term debt in the condensed consolidated financial statements.

On April 18, 2001 we and our lender amended the revolving line of credit facility. Under the terms of the amended agreement the maximum borrowings are \$5.0 million, eligible collateral excludes inventory, and the advance rate is 35%. In addition, certain of the financial covenants and requirements were adjusted. Changes in the amended agreement related to the definition of maximum borrowing, eligible collateral and the advance rate were effective on April 18, 2001, changes related to financial covenants and requirements were effective as of March 31, 2001. We were not in compliance with the adjusted covenants at June 30, 2001, however, we have obtained a waiver of those covenant violations as of June 30, 2001.

Cash used in operations decreased \$410,000 during the six months ended June 30, 2001 as compared to the six months ended June 30, 2000. The decrease in cash used in operations was primarily attributable to a decrease of \$388,000 in the net loss after adding back the provision for losses on receivables and depreciation and amortization expense.

Cash used in investing activities decreased \$107,000 during the six months ended June 30, 2001 as compared to the six months ended June 30, 2000. The decrease in cash used in investing activities was attributable to a decrease of \$719,000 in the amount of property and equipment purchased during the six months ended June 30, 2001 as compared to the six months ended June 30, 2000, however, during the six months ended June 30, 2000, the amount of property and equipment purchased was partially offset by \$612,000 of previously restricted cash related to our revolving credit line that was reclassified as unrestricted during the six months ended June 30, 2000.

Cash used in financing activities increased \$1.4 million during the six months ended June 30, 2001 as compared to the six months ended June 30, 2000. The increase was primarily attributable to a net increase in debt repayments combined with a reduction in proceeds from insurance financing during the six months ended June 30, 2001 as compared the six months ended June 30, 2000.

We believe that existing cash and cash equivalents and the current availability under our amended \$5.0 million revolving line of credit may not be sufficient to satisfy our contemplated cash requirements for the next twelve months. As noted above, our amended \$5.0 million revolving credit facility contains various covenants and restrictions. Since June 30, 2001, we have been out of compliance with certain covenants, including maintenance of minimum levels of working capital, tangible net worth, and profitability. The lender has not granted us a waiver of these continuing covenant violations. As a result of our non-compliance, under the terms of the agreement, the lender has the right to declare our outstanding borrowings immediately due and payable and have no further obligation to make advances under the terms of the lending agreement. As of the date of this filing the lender has not declared outstanding borrowings immediately due and payable and has continued to make advances in accordance with the amended agreement. Under the terms of the agreement, we must obtain the lender's consent for any merger or consolidation. The lender has indicated to us that it intends to discontinue making advances under the terms of the amended agreement effective with our merger with BIZ and will apply all subsequent collections to outstanding borrowings until such borrowings and related interest charges are paid in full. Once all borrowings and related interest have been

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paid the lender will release its security interest in our assets. We have no assurance that the lender will continue to make advances until the merger or that the lender will not declare all outstanding borrowings immediately due and payable prior to, or at the time of, the merger.

BIZ is a development stage enterprise and is devoting substantially all of its efforts towards conducting research and development, advertising and promotions, raising capital and building infrastructure. BIZ has and is expected to continue to utilize significant cash resources and will require additional outside funding in the future.

We are currently looking for a new lender to replace all, or a portion of, the borrowing availability of our current lending agreement. We are in discussions with several lenders that primarily focus on factoring accounts receivable. If we are successful in finding a new lender it will be necessary to arrange to pay off the outstanding borrowings under our current lending agreement so that our current lender will release its security interest in our assets. Although we hope to have a new lender in place at the time of, or prior to, the merger, we have no assurance that we will be able to find a new lender who will offer us borrowing availability and terms that are acceptable to us.

In addition to finding a new lender, to satisfy our contemplated cash requirements for the next twelve months it will also be necessary to obtain additional capital from one or more of the following sources:

- o Company merger - On July 3, 2001, we signed a definitive Agreement and Plan of Reorganization with BIZ relating to our proposed merger. We anticipate that the merger will be completed in August 2001. We will be the surviving entity after the proposed merger is complete and will be renamed SSP Solutions, Inc. We anticipate that the combined entity will be in a more favorable position to access capital markets. If the merger is not completed in a timely manner or not at all, we may seek additional capital on terms less favorable than if the merger were completed in a timely manner.

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- o Additional equity capital -- We may seek additional equity capital. Equity capital, if available, may be issued at a discount to market resulting in dilution to current stockholders. In addition, providers of new equity capital may require additional concessions in order for them to provide needed capital to the Company.
- o Additional commitment - In a letter to us dated April 17, 2001, our chief executive officer and majority shareholder committed, if necessary, to providing the personal financial resources required to enable us to meet all of our financial obligations as they become due through January 1, 2002.

On May 9, 2001, we announced the implementation of a cost reduction program with the objective of lowering annualized expenses by \$2.5 to \$3.0 million. The cost reduction program was implemented in response to the general economic slowdown so that our cost structure would be better aligned with overall market conditions. The cost reductions include an approximate 20% decrease in workforce and the reduction of discretionary spending where appropriate. The cost reductions were not limited to one particular area but were spread throughout the company. The cost reductions related to workforce had an immediate impact while the reductions in discretionary spending will be realized at the time such expenses are not incurred.

We had previously indicated our plan to begin shipping our new

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CypherServers in mid-2001. Our operating forecast assumed the CypherServer product launch would go as planned and that anticipated sales of the CypherServers would be realized. We have not realized the sales previously anticipated and have undertaken further market research to clarify customer requirements. We are currently designing a significant enhancement to the software that operates the CypherServer to more closely meet customer needs. We will re-launch the CypherServer family of products during the second half of 2001. Since we did not realize the anticipated sales from the initial launch of our CypherServer products it may be necessary for us to make additional expense reductions beyond those already made, although no additional reductions are currently planned.

Our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors including, but not limited, to:

- o the market acceptance of our products and services
- o the levels of promotion and advertising that will be required to launch new products and services and attain a competitive position in the market place
- o research and development plans
- o levels of inventory and accounts receivable
- o technological advances
- o competitors' responses to our products and services
- o relationships with partners, suppliers and customers
- o our projected capital expenditures
- o the proposed merger with BIZ and successful integration

In addition, we may require additional capital to accommodate planned growth, hiring, infrastructure and facility needs or to consummate acquisitions of other businesses, products or technologies.

BUSINESS ENVIRONMENT AND RISK FACTORS

THE ANTICIPATED BENEFITS OF OUR PROPOSED MERGER WITH BIZ MAY NOT BE REALIZED

In February 2001, we signed a Term Sheet with BIZ, relating to our proposed merger and on February 12, 2001, we issued a press release regarding the proposed merger. On July 3, 2001, we and BIZ signed a definitive Agreement and Plan of Reorganization. Concurrent with the signing of the definitive Agreement and Plan of Reorganization the majority shareholders of both companies signed a voting agreement agreeing to vote their shares in favor of the merger. We expect the merger to be completed in the third quarter of 2001. Even though we expect that our merger with BIZ will result in mutual benefits, those benefits may not be realized due to a number of factors:

- o If the merger is not completed in a timely manner or not at all, we may seek additional capital on terms less favorable than if the merger were completed in a timely manner.
- o The anticipated management and operational synergies of the proposed merger may not be realized.

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- o The anticipated increase in sales resulting from the combined efforts and combined distribution channels may not be realized.
- o Potential adverse short-term effects on operating results, primarily as a result of increased costs resulting from the integration of the operation of the two companies may adversely affect our earnings.
- o Difficulties in creating and maintaining uniform standards, controls, procedures and policies may adversely affect the operations of the two companies.

If we are unable to successfully integrate the operations of BIZ after the merger, our business, financial condition and operating results may be adversely affected.

IF WE ARE NOT ABLE TO FIND A LENDER TO REPLACE OUR CURRENT LENDER, WHO HAS INDICATED IT WILL NO LONGER LEND TO US ONCE THE MERGER WITH BIZ HAS BEEN COMPLETED, OUR LIQUIDITY MAY BE SEVERELY IMPAIRED

Our current lender has indicated that it intends to discontinue making advances to us effective upon the closing of our merger with BIZ. We have not yet located a replacement lender, and cannot be assured that we will be able to find a lender that will offer us favorable terms. If we are unable to find a replacement lender in a timely manner or at all, we will have to seek other forms of capital, and likewise cannot be assured that capital will be available on terms favorable to us. In addition, if we are not able to find a replacement lender or other source of capital, it may be necessary for us to make significant reductions in our operations that could negatively impact our business.

OUR QUARTERLY OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY

Our quarterly operating results may fluctuate significantly as a result of a variety of factors, many of which are outside our control. These factors include:

- o the length of our customer commitments
- o patterns of information technology spending by customers
- o the timing, size, mix and customer acceptance of our product and service product offerings and those of our competitors
- o the timing and magnitude of required capital expenditures
- o the need to use outside contractors to complete some assignments

AN INCREASE IN OUR FUTURE CAPITAL REQUIREMENTS COULD ADVERSELY AFFECT OUR ABILITY TO FUND OUR OPERATIONS.

Future capital requirements may vary materially from those now planned. If our future capital requirements increase significantly, we may not be able to raise sufficient capital to fund our operations. The amount of capital that we will need in the future will depend on many factors including, but not limited to:

- o the market acceptance of our products and services
- o the levels of promotion and advertising that will be required to

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launch new products and services and attain a competitive position in the market place

- o research and development plans
- o levels of inventory and accounts receivable
- o technological advances
- o competitors' responses to our products and services
- o relationships with partners, suppliers and customers
- o our projected capital expenditures
- o the proposed merger with BIZ

If we do need to raise additional capital it may be on terms that are unfavorable to us and may result in dilution to current shareholders.

If we are unable to raise additional capital to fund our operations, it may be necessary for us to restructure our business operations or implement other cost-cutting measures. Such a plan to cut costs may improve our cash flow but it may also inhibit our growth, as we may not have the personnel and resources to implement our business strategies and expand our operations.

WE HAVE A HISTORY OF LOSSES AND MAY INCUR FUTURE LOSSES.

We may not become profitable or significantly increase our revenue. We incurred net losses of \$5.9 million for the six months ended June 30, 2000 and \$4.2 million for the six months ended June 30, 2001.

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HEADCOUNT REDUCTIONS IMPLEMENTED AS PART OF A COST REDUCTION STRATEGY MAY INHIBIT FUTURE GROWTH.

The headcount reductions we have made along with any additional headcount reductions we may make in the future could inhibit our future growth. Our ability to respond in a timely manner as future business opportunities arise depends on having highly skilled employees available. If our staffing levels are not adequate to respond as future business opportunities arise and if we are not able to hire additional employees due to the constraints of our overall cost reduction strategy our business could be adversely affected.

A DEFAULT UNDER OUR SECURED CREDIT ARRANGEMENTS COULD RESULT IN A FORECLOSURE OF OUR ASSETS BY OUR CREDITORS.

All of our assets are pledged as collateral to secure portions of our debt. This means that if we default on our secured debt obligations our indebtedness could become immediately due and payable and the lenders could foreclose on our assets. From time to time we have been in violation of financial covenants under our existing credit arrangements and have had to negotiate with our lenders for waivers or forbearance agreements for these violations. Although we have received waivers in the past, we may not be able to obtain waivers of future covenant violations. Since June 30, 2001, we have been out of compliance with certain covenants, including maintenance of minimum levels of working capital, tangible net worth, and profitability. The lender has not granted us a waiver of these covenant violations. As a result of our non-compliance, under the terms of the agreement, the lender has the right to declare our outstanding borrowings

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immediately due and payable and have no further obligation to make advances under the terms of the lending agreement. As of the date of this filing the lender has not declared outstanding borrowings immediately due and payable and has continued to make advances in accordance with the agreement. Under the terms of the agreement, we must obtain the lender's consent for any merger or consolidation. The lender has indicated to us that it intends to discontinue making advances under the terms of the amended agreement effective with our merger with BIZ Interactive Zone, Inc. and will apply all subsequent collections to outstanding borrowings until such borrowings and related interest charges are paid in full. Once all borrowings and related interest have been paid the lender will release its security interest in our assets. We have no assurance that the lender will continue to make advances until the merger or that the lender will not declare all outstanding borrowings immediately due and payable prior to, or at the time of, the merger.

THE TERMS OF OUR LOAN AGREEMENTS COULD LIMIT OUR ABILITY TO IMPLEMENT OUR BUSINESS STRATEGY.

The terms of our loan agreements with our credit providers could limit our ability to implement our strategy. In addition to substantially prohibiting us from incurring additional indebtedness, our loan agreements with these creditors limit or prohibit us from the following unless we first obtain their consent:

- o declaring or paying cash dividends
- o making capital distributions or other payments to stockholders;
- o merging or consolidating with another corporation
- o selling all or substantially all of our assets

WE DERIVE A SUBSTANTIAL PORTION OF OUR REVENUE FROM A SMALL NUMBER OF CUSTOMERS AND, THEREFORE, THE LOSS OF EVEN ONE OF THESE CUSTOMERS COULD SIGNIFICANTLY AND NEGATIVELY IMPACT OUR OPERATING RESULTS.

We depend on a limited number of customers for a substantial portion of our revenue and many of our contracts with our significant customers are short-term contracts. The nonrenewal of any significant contract upon expiration, or a substantial reduction in sales to any of our significant customers, would adversely affect our business unless we were able to replace the revenue we received from these customers. During the six months ended June 30, 2000, we derived 28% of our total revenues from one customer and during the six months ended June 30, 2001 we derived 17% and 13% of our total revenues from two customers.

DOING BUSINESS WITH THE U.S. GOVERNMENT ENTAILS MANY RISKS, WHICH COULD ADVERSELY AFFECT US.

Sales to U.S. government agencies accounted for 71% of our consolidated revenue during the six months ended June 30, 2001. Our sales to these agencies are subject to risks, including:

- o early termination of our contracts;
- o disallowance of costs upon audit; and
- o the necessity to participate in competitive bidding and proposal processes, which is costly, time consuming and may result in unprofitable contracts.

In addition, the government may be in a position to obtain greater rights with respect to our intellectual property than we would grant to other entities. Government agencies also have the power, based on financial difficulties or investigations of its contractors, to deem contractors unsuitable for new contract awards. Because we engage in the government contracting business, we have been and will be subject to audits and may be subject to investigation by governmental entities. Failure to comply with the terms of any of our governmental contracts could result in substantial civil and criminal fines and penalties, as well as our suspension from future government contracts for a significant period of time, any of which could adversely affect our business.

IF USE OF THE INTERNET AND OTHER COMMUNICATIONS NETWORKS BASED ON INTERNET PROTOCOLS DOES NOT CONTINUE TO GROW, DEMAND FOR OUR PRODUCTS MAY NOT INCREASE.

Increased demand for our products depends in large part on the continued growth of the Internet and Internet protocol-based networks and the widespread acceptance and use of these mediums for electronic commerce and communications. Because electronic commerce and communications over these networks are evolving, we cannot predict the size of the market and its sustainable growth rate. A number of factors may affect market size and growth rate, including:

- o the use of electronic commerce and communications may not increase, or may increase more slowly than we expect;
- o the Internet infrastructure and communications services to support electronic commerce may not be able to continue to support the demands placed on it by continued growth; and
- o the growth and reliability of electronic commerce and communications could be harmed by delays in development or adoption of new standards and protocols to handle increased levels of activity or by increased governmental regulation.

IF PKI TECHNOLOGY IS COMPROMISED, OUR BUSINESS WOULD BE ADVERSELY AFFECTED.

Many of our products are based on PKI technology. The security afforded by this technology depends on the integrity of a user's private key, which depends in part on the application of algorithms, or advanced mathematical factoring equations. The occurrence of any of the following could result in a decline in demand for our data security products:

- o any significant advance in techniques for attacking PKI systems, including the development of an easy factoring method or faster, more powerful computers
- o publicity of the successful decoding of cryptographic messages or the misappropriation of private keys
- o government regulation limiting the use, scope or strength of PKI

OUR INABILITY TO FIND ALTERNATIVE SUPPLIERS OF COMPONENTS MAY ADVERSELY AFFECT OUR BUSINESS.

Some of the components incorporated into our products are produced by other vendors. We currently purchase some of these components from a single supplier, thus presenting a risk that they may not be available on commercially reasonable terms in the future or at all. Our inability to develop alternative sources, if necessary, may require us to redesign certain products which could result in delays or reductions in product shipments that could adversely affect our

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business.

IF WE DO NOT RESPOND TO RAPID TECHNOLOGICAL CHANGES, OUR PRODUCTS AND SERVICE OFFERINGS COULD BECOME OBSOLETE.

If we are unable to modify existing products and develop new products that are responsive to changing technology and standards and meet customer needs in a timely and cost effective manner, our business could be adversely affected. The markets we serve are characterized by rapidly changing technology, emerging industry standards and frequent introduction of new products. The introduction of products embodying new technologies and the emergence of new industry standards may render our products obsolete or less marketable. The process of developing our products and services is extremely complex and requires significant continuing development efforts.

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IF WE FAIL TO ESTABLISH AND MAINTAIN STRATEGIC RELATIONSHIPS, OUR ABILITY TO DEVELOP AND MARKET OUR PRODUCTS WOULD BE ADVERSELY AFFECTED.

The loss of any of our existing strategic relationships, or the inability to create new strategic relationships in the future, could adversely affect our ability to develop and market our products. We depend upon our partners to develop and market products and to fund and perform their obligations as contemplated by our agreements with them. We do not control the time and resources devoted by our partners to these activities. These relationships may not continue or may require us to spend significant financial, personnel and administrative resources from time to time. We may not have the resources available to satisfy our commitments, which may adversely affect our strategic relationships. Further, our products and services may compete with the products and services of our strategic partners. This competition may adversely affect our relationships with our strategic partners, which could adversely affect our business.

WE DEPEND ON KEY MANAGEMENT PERSONNEL.

Our success will depend largely on the continuing efforts of our executive officers and senior management. Our business may be adversely affected if the services of any of our key personnel become unavailable to us. There is a risk that these individuals will not continue to serve for any particular period of time. While we have obtained a key person life insurance policy on the life of our current chief executive officer, in the amount of \$3.0 million, this amount may not be sufficient to offset the loss of his services.

THERE IS SIGNIFICANT COMPETITION IN OUR INDUSTRY FOR HIGHLY SKILLED EMPLOYEES AND OUR FAILURE TO ATTRACT AND RETAIN TECHNICAL PERSONNEL WOULD ADVERSELY AFFECT OUR BUSINESS.

We may not be able to successfully attract or retain highly skilled employees. Our inability to hire or retain highly qualified individuals may impede our ability to develop, install, implement and service our software and hardware systems, customers and potential customers or efficiently conduct our operations, all of which may adversely affect our business. The data security and networking solution industries are characterized by a high level of employee mobility, and the market for highly qualified individuals in the computer-related fields is intense. This competition means there are fewer highly qualified employees available to hire and the costs of hiring and retaining these individuals are high. Even if we are able to hire these individuals, we may be unable to retain them. Furthermore, there is increasing

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pressure to provide technical employees with stock options and other equity interests, which may dilute earnings per share.

POTENTIAL PRODUCT DEFECTS COULD SUBJECT US TO CLAIMS FROM CUSTOMERS.

Products as complex as the ones we offer may contain undetected errors or result in failures when first introduced or when new versions are released. Despite our product testing efforts and testing by current and potential customers, it is possible that errors will be found in new products or enhancements after commencement of commercial shipments. The occurrence of product defects or errors could result in adverse publicity, delay in product introduction, diversion of resources to remedy defects, loss of or a delay in market acceptance or claims by customers against us, or could cause us to incur additional costs, any of which could adversely affect our business.

WE MAY BE EXPOSED TO POTENTIAL LIABILITY FOR ACTUAL OR PERCEIVED FAILURE TO PROVIDE REQUIRED PRODUCTS OR SERVICES.

Because our customers rely on our products for critical security applications, we may be exposed to potential liability claims for damage caused to an enterprise as a result of an actual or perceived failure of our products. An actual or perceived breach of enterprise network or data security systems of one of our customers, regardless of whether the breach is attributable to our products or solutions, could adversely affect our business reputation.

Furthermore, our failure or inability to meet a customer's expectations in the performance of our services, or to do so in the time frame required by the customer, regardless of our responsibility for the failure, could:

- o result in a claim for substantial damages against us by the customer;
- o discourage customers from engaging us for these services; and
- o damage our business reputation.

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In addition, as a professional services provider, a portion of our business involves employing people and placing them in the workplace of other businesses. Therefore, we are also exposed to liability for actions taken by our employees while on assignment.

WE FACE INTENSE COMPETITION FROM A NUMBER OF SOURCES.

The markets for our products and services are intensely competitive and, as a result, we face significant competition from a number of different sources. We may be unable to compete successfully as many of our competitors are more established, benefit from greater name recognition and have substantially greater financial, technical and marketing resources than we have. In addition, there are several smaller companies and start-up companies with which we compete from time to time. We also expect that competition will increase as a result of consolidation in the information security technology and product reseller industries.

THIRD PARTIES COULD OBTAIN ACCESS TO OUR PROPRIETARY INFORMATION OR INDEPENDENTLY DEVELOP SIMILAR TECHNOLOGIES BECAUSE OF THE LIMITED PROTECTION FOR OUR INTELLECTUAL PROPERTY.

Our business, financial condition and operating results could be adversely affected if we are unable to protect our intellectual property rights.

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Notwithstanding the precautions we take, third parties may copy or obtain and use our proprietary technologies, ideas, know-how and other proprietary information without authorization or independently develop technologies similar or superior to our technologies. In addition, the confidentiality and non-competition agreements between us and our employees, distributors, and clients may not provide meaningful protection of our proprietary technologies or other intellectual property in the event of unauthorized use or disclosure. Policing unauthorized use of our technologies and other intellectual property is difficult, particularly because the global nature of the Internet makes it difficult to control the ultimate destination or security of software or other data transmitted. Furthermore, the laws of other jurisdictions may afford little or no effective protection of our intellectual property rights.

WE MAY FACE CLAIMS OF INFRINGEMENT OF PROPRIETARY RIGHTS.

There is a risk that our products infringe the proprietary rights of third parties. In addition, whether or not our products infringe on proprietary rights of third parties, infringement or invalidity claims may be asserted or prosecuted against us and we could incur significant expense in defending them. If any claims or actions are asserted against us, we may be required to modify our products or seek licenses for these intellectual property rights. We may not be able to modify our products or obtain licenses on commercially reasonable terms, in a timely manner or at all. Our failure to do so could adversely affect our business.

OUR EFFORTS TO EXPAND INTERNATIONAL OPERATIONS ARE SUBJECT TO A NUMBER OF RISKS.

We are currently seeking to increase our international sales. Our inability to maintain or to obtain federal or foreign regulatory approvals relating to the import or export of our products on a timely basis could adversely affect our ability to expand our international business. Additionally, our international operations could be subject to a number of risks, any of which could adversely affect our future international sales, including:

- o increased collection risks;
- o trade restrictions;
- o export duties and tariffs; and
- o uncertain political, regulatory and economic developments.

OUR ABILITY TO PRODUCE THE FORTE PKI CARD ON A TIMELY AND COST-EFFECTIVE BASIS DEPENDS ON THE AVAILABILITY OF A COMPUTER CHIP FROM A THIRD-PARTY SUPPLIER, WITH WHOM WE DO NOT EXPECT TO MAINTAIN A SUPPLY AGREEMENT.

Any inability to receive adequate supplies of Atmel Corporation's specially designed Forte microprocessor would adversely affect our ability to complete and sell the Forte PKI card. We do not anticipate maintaining a supply agreement with Atmel Corporation for the Forte microprocessor. If Atmel were unable to deliver the Forte microprocessor for a lengthy period of time or terminated its relationship with us, we would be unable to produce the Forte PKI card until we could design a replacement computer chip for the Forte microprocessor. We anticipate this would take substantial time and resources to complete.

SMALL NUMBER OF STOCKHOLDERS, INCLUDING OUR OFFICERS AND DIRECTORS, WILL HAVE THE ABILITY TO CONTROL STOCKHOLDER VOTES.

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Kris Shah and members of his family beneficially own, in the aggregate, approximately 55% of our outstanding common stock. These stockholders, if acting together, would have the ability to elect our directors and to determine the outcome of corporate actions requiring stockholder approval, irrespective of how other stockholders may vote. This concentration of ownership may also have the effect of delaying or preventing a change in control.

LAWSUITS MAY BE FILED AGAINST US THAT COULD ADVERSELY AFFECT OUR BUSINESS IF THEY ARE RESOLVED AGAINST US.

We are involved from time to time in litigation that arises in the ordinary course of business. We are not currently involved in any litigation that we believe will have a material impact on our results of operations, financial condition or liquidity. See "Part II - Other Information, Item 1 - Legal Proceedings."

OUR STOCK PRICE IS EXTREMELY VOLATILE.

The trading price of our common stock is highly volatile as a result of factors specific to us or applicable to our market and industry in general. These factors, include:

- o variations in our annual or quarterly financial results or those of our competitors
- o company issued earnings announcements that vary from consensus analyst estimates
- o changes by financial research analysts in their recommendations or estimates of our earnings
- o conditions in the economy in general or in the information technology service sector in particular
- o announcements of technological innovations or new products or services by us or our competitors
- o unfavorable publicity or changes in applicable laws and regulations, or their judicial or administrative interpretations, affecting us or the information technology service sectors

In addition, the stock market has recently been subject to extreme price and volume fluctuations. This volatility has significantly affected the market prices of securities issued by many companies for reasons unrelated to the operating performance of these companies. In the past, following periods of volatility in the market price of a company's securities, some companies have been sued by their stockholders. If we were sued, it could result in substantial costs and a diversion of management's attention and resources, which could adversely affect our business.

WE HAVE ANTI-TAKEOVER DEFENSES THAT COULD DELAY OR PREVENT AN ACQUISITION AND COULD ADVERSELY AFFECT THE PRICE OF OUR COMMON STOCK.

Our certificate of incorporation and bylaws contain provisions that may deter a takeover or a change in control or prevent an acquisition not approved by our board of directors, or that may adversely affect the price of our common stock.

THE NUMBER OF SHARES ELIGIBLE FOR FUTURE SALE AND THE EXISTENCE OF REGISTRATION RIGHTS COULD DEPRESS THE MARKET FOR OUR COMMON STOCK.

The possibility that a substantial number of additional shares of common

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stock may become tradable in the public market in the future may adversely affect prevailing market prices for our common stock and could impair our ability to raise capital through the sale of equity securities. The shares that are restricted from trading, pursuant to agreement with the underwriter in our initial public offering, became available for sale in June 2000 and over succeeding months. We cannot predict the effect, if any, that sales of these additional securities or the availability of these additional securities for sale will have on the market prices prevailing from time to time. In addition, the representatives of the underwriters in our initial public offering were also granted registration rights, which

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commenced in June 2000 provided for the registration under the Securities Act of the securities issuable upon exercise of the representatives' warrants. The exercise of these rights could result in substantial expense to us. Furthermore, if the representatives exercise their registration rights, they will be unable to make a market in our securities for up to nine days before the initial sales of the warrants until the discontinuation of sales. If the representatives cease making a market, the market and market prices for the securities may be adversely affected and the holders of these securities may be unable to sell them.

THE CURRENT CALIFORNIA ENERGY CRISIS COULD ADVERSELY AFFECT OUR BUSINESS

Our headquarters and principal operations are located in Orange County, California. California has recently found itself in a utility crisis caused, in part, by a lack of affordable power sources and the financial instability of several of its primary power suppliers. Orange County has undergone several periods of "rolling blackouts," a technique used by our power provider to conserve its resources. Although our operations have not been halted as a result of these conservation measures, potential suspensions of our operations due to power disruptions could result in materially higher costs and lost revenues, either of which would materially adversely impact our business, financial condition and results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We entered into an agreement with GBCC permitting us to borrow under a \$20.0 million secured revolving line of credit facility in June 1999. On April 18, 2001, the agreement was amended and now allows maximum borrowings of \$5.0 million. Changes in the amended agreement related to the definition of maximum borrowing, eligible collateral and the advance rate were effective on April 18, 2001, changes related to financial covenants and requirements were effective as of March 31, 2001. Under both the original agreement and the amended agreement, we are subject to an annual interest rate of the prime rate plus 0.625%. Future operating results could be adversely affected by increases in interest rates that occur while significant borrowings are outstanding. We had outstanding borrowings of \$921,000 related to this line of credit at June 30, 2001. A 10% change in the underlying prime rate would result in an approximately \$7,000 change in the annual amount of interest paid on such debt.

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PART II. OTHER INFORMATION

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ITEM 1. LEGAL PROCEEDINGS

We are involved from time to time in routine litigation that arises in the ordinary course of business. We are not currently involved in any litigation that we believe will have a material impact on our results of operations, financial condition or liquidity.

On January 16, 1998, G2 Resources Inc. (G2) filed a complaint against Pulsar in the Circuit Court, Fifteenth Judicial Circuit, Palm Beach County, Florida. G2 claimed that Pulsar breached a contract under which G2 agreed to provide services related to the monitoring of government contracts available for bid and the preparation and submission of bids on behalf of Pulsar. The contract provided that Pulsar pay G2 \$500,000 in 30 monthly installments of \$16,666 and an additional fee of 2% of the gross dollar amount generated by awards. In its complaint, G2 alleged that Pulsar failed to make payments under the contract and claimed damages in excess of \$525,000 plus interest, costs and attorneys fees. In the course of discovery G2 asserted that its losses/costs arising out of its claim amounted to approximately \$10.3 million. Pulsar asserted that G2 failed to perform the services required under the contract and Pulsar filed a claim for compensatory damages, interest and attorneys fees against G2. Classical Financial Services, LLC intervened in the case. Classical claims that G2 assigned its accounts receivable to Classical under a financing program and that Pulsar breached its obligations to Classical by failing to make payments under the contract with G2. Pulsar asserted defenses to Classical's claim. On April 20, 2001, a court hearing was held and G2's complaint against Pulsar was dismissed without prejudice on the basis of no prosecution activity for more than 12 months. On May 22, 2001, G2 filed a new complaint against Pulsar. We believe that the claims made by G2 against Pulsar are without merit and intend to vigorously defend against these claims.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

None.

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.

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Date: August 14, 2001

LITRONIC INC.

By /s/ KRIS SHAH

Kris Shah
Director, Chairman of the Board
and Chief Executive Officer

By /s/ ROY E. LUNA

Roy E. Luna
Chief Financial Officer and
Principal Accounting Officer