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ALANCO TECHNOLOGIES INC  
Form 10QSB  
November 15, 2004

ALANCO TECHNOLOGIES, INC.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-QSB

X QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-9347

ALANCO TECHNOLOGIES, INC.  
(Exact name of small business issuer as specified in its charter)

Arizona  
(State or other jurisdiction of incorporation or organization)

86-0220694  
(I.R.S. Employer Identification No.)

15575 N. 83rd Way, Suite 3, Scottsdale, Arizona 85260  
(Address of principal executive offices) (Zip Code)

(480) 607-1010  
(Issuer's telephone number)

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

As of November 5, 2004 there were 25,437,200 shares, net of treasury shares, of common stock outstanding.

Transitional Small Business Disclosure Format (Check one): Yes  No

Forward-Looking Statements: Some of the statements in this Form 10-QSB Quarterly Report, as well as statements by the Company in periodic press releases, oral statements made by the Company's officials to analysts and shareholders in the course of presentations about the Company, constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words or phrases denoting the anticipated results of future events such as "anticipate," "believe," "estimate," "will likely," "are expected to," "will continue," "project," "trends" and similar expressions that denote uncertainty are intended to identify such forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Such factors include, among other things, (i) general economic and business conditions; (ii) changes in industries in which the Company does business; (iii) the loss of market share and increased competition in certain markets; (iv) governmental regulation including environmental laws; and (v) other factors over which the company has

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little or no control.

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## ALANCO TECHNOLOGIES, INC.

### CONDENSED CONSOLIDATED BALANCE SHEETS AS OF SEPTEMBER 30, 2004 AND JUNE 30, 2004 (Unaudited)

	Sep 30, 2004	June 30, 2004
	-----	-----
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 2,166,400	\$ 1,975,600
Accounts receivable, net	839,400	657,200
Inventories, net	2,337,300	2,282,300
Cost and est earnings in excess of billings on uncompleted contracts	21,600	--
Prepaid expenses and other current assets	162,200	110,600
	-----	-----
Total current assets	5,526,900	5,025,700
	-----	-----
PROPERTY, PLANT AND EQUIPMENT, NET	253,700	247,500
	-----	-----
<b>OTHER ASSETS</b>		
Goodwill and other intangible assets, net	5,994,900	6,048,000
Long-term notes receivable, net	38,000	68,000
Net assets held for sale	142,000	156,100
Other assets	35,400	40,600
	-----	-----
Total other assets	6,210,300	6,312,700
	-----	-----
<b>TOTAL ASSETS</b>	<b>\$ 11,990,900</b>	<b>\$ 11,585,900</b>
	=====	=====
<b>LIABILITIES AND EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued expenses	\$ 1,456,200	\$ 1,246,500
Credit line and capital leases, current	502,200	5,200
Billings in excess of cost and est earnings on uncompleted projects	--	27,200
Deferred revenue, current	--	25,800
	-----	-----
Total Current Liabilities	1,958,400	1,304,700
	-----	-----
<b>LONG TERM LIABILITIES</b>		
Notes payable and capital leases, long term	314,100	814,100
	-----	-----
<b>TOTAL LIABILITIES</b>	<b>2,272,500</b>	<b>2,118,800</b>
	-----	-----
Preferred Stock - Series B, 63,000 and 58,600 shares issued and outstanding, respectively	617,800	602,800
	-----	-----
<b>SHAREHOLDERS' EQUITY</b>		
Preferred Stock - Series A Convertible, 2,624,600 and 2,476,800 shares issued and outstanding, respectively	3,177,900	2,956,100

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Common Stock - 25,389,700 and 23,232,800		
shares outstanding, net of Treasury Stock	70,119,500	68,959,600
Accumulated deficit	(64,196,800)	(63,051,400)
	-----	-----
Total shareholders' equity	9,100,600	8,864,300
	-----	-----
 TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	 \$ 11,990,900	 \$ 11,585,900
	=====	=====

See accompanying notes to the consolidated financial statements

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### ALANCO TECHNOLOGIES, INC.

#### CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, (Unaudited)

	2004	2003
	-----	-----
NET REVENUES	\$ 1,737,200	\$ 1,037,400
Cost of goods sold	1,115,800	644,700
	-----	-----
GROSS PROFIT	621,400	392,700
Selling, general and administrative expense	1,518,700	1,119,900
	-----	-----
OPERATING LOSS	(897,300)	(727,200)
OTHER INCOME & EXPENSES		
Interest income (expense), net	(16,300)	(82,700)
Other income (expense), net	5,000	3,200
	-----	-----
LOSS FROM OPERATIONS	(908,600)	(806,700)
Preferred stock dividends - in kind	(236,800)	(13,500)
	-----	-----
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (1,145,400)	\$ (820,200)
	=====	=====
NET LOSS PER SHARE - BASIC AND DILUTED -		
Net loss attributable to common shareholders	\$ (0.05)	\$ (0.05)
	=====	=====
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	24,312,600	15,176,200
	=====	=====

See accompanying notes to the consolidated financial statements

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ALANCO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN CERTAIN SHAREHOLDERS' EQUITY AND STOCK ACCOUNTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004 (Unaudited)

	Common Stock		Preferred Stock - Ser A		Preferred S
	Shares	Dollars	Shares	Dollars	Shares
Balances at 6/30/04	23,732,800	\$ 69,334,700	2,476,800	\$ 2,956,100	61,500
Preferred dividends in kind	--	--	147,800	221,800	1,500
Shares issued for services	57,500	59,900	--	--	--
Options and Warrants exercised	2,099,400	1,100,100	--	--	--
Balances at 09/30/04	25,889,700	\$ 70,494,700	2,624,600	\$ 3,177,900	63,000

See accompanying notes to the consolidated financial statements

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ALANCO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
FOR THE THREE MONTHS ENDED SEPTEMBER 30,

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Loss from operations	\$ (908,700)	\$ (806,700)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	82,800	87,000
Stock and warrants issued for services	59,900	74,400
(Income) loss from assets held for sale	(5,000)	(2,200)
Gain on disposal of asset	--	(1,000)
Changes in:		
Accounts receivable, net	(182,200)	68,200
Inventories, net	(55,000)	(66,200)
Costs in excess of billings and estimated earnings on uncompleted contracts	(21,600)	--
Prepaid expenses and other current assets	(51,600)	(35,800)
Accounts payable and accrued expenses	209,700	(214,400)
Deferred revenue	(27,200)	
Billings and estimated earnings in excess of costs on uncompleted contracts	(25,800)	--
Other assets	5,200	2,200
Net cash used in operating activities	(919,500)	(894,500)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net cash from assets held for sale	19,100	15,700

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Collection of notes receivable	30,000	36,800
Purchase of property, plant and equipment	(34,000)	(5,900)
Proceeds from the sale of property, plant and equipment	--	3,500
Patent renewal	(1,900)	--
	-----	-----
Net cash provided by investing activities	13,200	50,100
	-----	-----

See accompanying notes to the consolidated financial statements

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ALANCO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
FOR THE THREE MONTHS ENDED SEPTEMBER 30, (Continued)

	2004	2003
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Advances on borrowings	--	788,500
Repayment on borrowings	(3,000)	(869,600)
Subscriptions receivable	--	899,200
Proceeds from sale of Preferred Stock	--	105,700
Proceeds from sale of Common Stock	1,100,100	
	-----	-----
Net cash provided by financing activities	1,097,100	923,800
	-----	-----
NET INCREASE IN CASH	190,800	79,400
CASH AND CASH EQUIVALENTS, beginning of period	1,975,600	97,700
	-----	-----
CASH AND CASH EQUIVALENTS, end of period	\$ 2,166,400	\$ 177,100
	=====	=====

SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION

Net cash paid during the period for interest	\$ 16,700	\$ 32,800
	=====	=====
Non-Cash Activities:		
Value of stock issued for cancellation of put option	\$ --	\$ 49,900
	=====	=====
Value of stocks and warrants issued for services	\$ 59,900	\$ 3,600
	=====	=====
Series B preferred stock dividend in kind	\$ 15,000	\$ 13,500
	=====	=====
Series A preferred stock dividend in kind	\$ 221,800	\$ --
	=====	=====
Value of treasury stock redeemed in preferred stock and warrant issuance	\$ --	\$ 198,300

=====

See accompanying notes to the consolidated financial statements

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ALANCO TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED SEPTEMBER 30, 2004

Note A - Basis of Presentation

Alanco Technologies, Inc., an Arizona corporation ("Alanco" or "Company"), operates in two business segments: Computer Data Storage Segment and RFID Technology Segment.

The unaudited condensed consolidated balance sheet as of September 30, 2004 and the related unaudited condensed consolidated statements of operations and cash flows for the three months ended September 30, 2004 presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and in accordance with the instructions to Form 10-QSB. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. In our opinion, the accompanying condensed consolidated financial statements include all adjustments necessary for a fair presentation of such condensed consolidated financial statements. Such necessary adjustments consist of normal recurring items and the elimination of all significant intercompany balances and transactions.

These interim condensed consolidated financial statements should be read in conjunction with the Company's June 30, 2004, Annual Report on Form 10-KSB. Interim results are not necessarily indicative of results for a full year. Certain reclassifications have been made to conform prior period financials to the presentation in the current reporting period. The reclassifications had no effect on net loss.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

All stock options issued to employees have an exercise price not less than the fair market value of the Company's Common Stock on the date of grant. In accordance with accounting for such options utilizing the intrinsic value method under APB 25, there is no related compensation expense recorded in the Company's financial statements for the three months ended September 30, 2004 and 2003. Had compensation cost for stock-based compensation been determined based on the fair value of the options at the grant dates consistent with the method of SFAS 123, the Company's net loss and loss per share would have been increased to the pro forma amounts presented below.

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## ALANCO TECHNOLOGIES, INC.

	3 months ended September 30, 2004	2003
	-----	-----
Net loss, as reported	\$ (1,145,400)	\$ (820,200)
Add: Stock-based Employee compensation expense included in reported income, net of related tax effects	--	--
Deduct: Total stock-based Employee compensation expense determined under fair value based methods for all awards, net of related tax effects	\$ (43,500)	\$ (245,700)
Pro forma net loss	\$ (1,188,900)	\$ (1,065,900)
Net loss per common share, basic and diluted		
As reported	\$ (0.05)	\$ (0.05)
Pro forma	\$ (0.05)	\$ (0.07)
Weighted average common shares	24,312,600	15,176,200

During the quarter ended September 30, 2004, the Company granted employee stock options to purchase 75,000 shares of the Company's Class A Common Stock at an average purchase price of \$1.20, market price on date granted. The fair value of option grants is estimated as of the date of grant, in accordance with SFAS 123, utilizing the Black-Scholes option-pricing model, with the assumptions substantively utilized in the year-end financial statements.

### Note B - Inventories

Inventories have been recorded at the lower of cost or market. The composition of inventories as of September 30 and June 30, 2004 are summarized as follows:

	September 30, 2004	June 30, 2004
	-----	-----
	(unaudited)	
Raw materials and purchased parts	\$ 2,095,100	\$ 1,894,700
Work-in-progress	239,900	198,300
Finished goods	245,300	279,300
	-----	-----
	2,580,300	2,372,300
Less reserves for obsolescence	(243,000)	(90,000)
	-----	-----
	\$ 2,337,300	\$ 2,282,300
	=====	=====



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Note C - Contracts In Process

Costs incurred, estimated earnings and billings in the RFID Technology segment, related to contracts for the installation of TSI PRISM system in process at September 30, 2004 and June 30, 2004 consist of the following.

	September 30, 2004	June 30, 2004
	-----	-----
Costs incurred on uncompleted contracts	\$ 334,000	\$ 117,300
Estimated gross profit earned to date	193,900	58,200
	-----	-----
Revenue earned to date	527,900	175,500
Less Billing to date	(506,300)	(201,300)
	-----	-----
Costs and estimated earnings in excess of Billing (billing in excess of costs and earnings)	\$ 21,600	\$ (25,800)
	=====	=====

Note D - Deferred Revenue

Deferred Revenues at September 30, 2004 and June 30, 2004 consist of the following:

	September 30, 2004	June 30, 2004
	-----	-----
Extended warranty revenue	\$ --	27,200
Less - current portion	--	(27,200)
	-----	-----
Deferred revenue - long term	\$ --	\$ --
	=====	=====

Note E - Loss Per Share

Basic loss per share of common stock was computed by dividing net loss by the weighted average number of shares of common stock outstanding.

Diluted earnings per share are computed based on the weighted average number of shares of common stock and dilutive securities outstanding during the period. Dilutive securities are options and warrants that are freely exercisable into common stock at less than the prevailing market price. Dilutive securities are not included in the weighted average number of shares when inclusion would increase the earnings per share or decrease the loss per share. As of September 30, 2004 there were 8,360,000 potentially dilutive securities outstanding.

Note F - Equity

During the three months ended September 30, 2004, the Company issued a total 2,156,900 shares of the Company's Class A Common Stock. Included were 2,099,400 shares issued upon exercise of outstanding warrants and options generating approximately \$1.1 million in proceeds to the Company. The balance of 57,500 shares, valued at \$59,900 fair market value, were issued in exchange for

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services rendered to the Company.

The Company also declared dividends on the Company's preferred shares during the quarter and paid the dividends-in-kind through the issuance of 147,800 shares of Series A Preferred Stock valued at \$221,700 and 1,500 shares of Series B Preferred Stock valued at \$15,000. The Preferred Stock is more fully discussed in the Form-10KSB for the year ended June 30, 2004.

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### Note G -Industry Segment Data

Information concerning operations by industry segment follows (unaudited):

	Three Months 2004	Ended 09/30 2003
	-----	-----
Revenue		
Data Storage	\$ 1,365,700	\$ 1,035,400
RFID Technology	371,500	2,000
	-----	-----
Total Revenue	1,737,200	1,037,400
	=====	=====
Gross Profit		
Data Storage	479,900	395,900
RFID Technology	141,500	(3,300)
	-----	-----
Total Gross Profit	621,400	392,600
	-----	-----
Gross Margin		
Data Storage	35.1%	38.2%
	-----	-----
RFID Technology	38.1%	n/a
	-----	-----
Overall Gross Margin	35.8%	37.8%
	-----	-----
Selling, General and Administrative Expense		
Data Storage	445,200	418,000
RFID Technology	690,000	496,300
	-----	-----
Total Segment Operating Expense	1,135,200	914,300
	-----	-----
Operating Profit (Loss)		
Data Storage	34,700	(22,100)
RFID Technology	(548,500)	(499,600)
Corporate Expense	(383,500)	(205,500)
	-----	-----
Operating Loss	(897,300)	(727,200)
	=====	=====
Depreciation and Amortization		
Data Storage	5,500	8,000
RFID Technology	78,500	76,900
Corporate	700	2,100
	-----	-----
Total Depreciation and Amortization	\$ 84,700	\$ 87,000
	=====	=====

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### Note H - Related Party Transactions

The Company has a line of credit agreement ("Agreement"), more fully discussed in the Company's Form 10-KSB for the year ended June 30, 2004, with a private trust controlled by Mr. Donald Anderson, a greater than five percent stockholder and a member of the Company's Board of Directors.

### Note I - Line of Credit

At September 30, 2004, the Company has an outstanding balance of \$500,000, which is presented as line of credit balance due. The balance is under a \$1.3 million line of credit agreement with a private trust ("Lender"), entered

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into in June 2002 and modified in April and October of 2003. Under the line of credit agreement, the Company must maintain a minimum balance due under the line of at least \$500,000 through the July 1, 2005 expiration date. At September 30, 2004, the Company had \$800,000 available under the line of credit agreement.

### Note J - Litigation

The Company continues to be a defendant in litigation that relates to the acquisition, in May of 2002, of substantially all the assets of Technology Systems International, Inc., a Nevada corporation. No significant new activity has occurred subsequent to our report of litigation in our Form 10-KSB filed for the year ended June 30, 2004. The Company's management, in consultation with legal counsel, believes the plaintiff's claims are without merit and the Company will aggressively defend against the action. Litigation previously reported as arising from an expired property lease between the Company's subsidiary, Arraid, Inc., and Arraid Property L.L.C., a Limited Liability Company, has been deemed immaterial.

### Note K - Subsequent Events

On October 12, 2004 the Company announced notification from Spectrum Human Services Inc., a Michigan-based private prison operator, that its affiliate, Spectrum Juvenile Justice Services, had selected the Alanco proprietary tracking technology for installation at its new Calumet II juvenile detention facility to be constructed at Highland Park, Michigan. The present construction plan anticipates completion of the TSI PRISM system in early spring 2005, with an estimated contract value of approximately \$500,000. The Calumet II project will be Alanco's second juvenile facility TSI PRISM installation in the state of Michigan, following completion of the W. J. Maxey Boys Training School in 2003.

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

Except for historical information, the statements contained herein are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All such forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by those statements. These risks and uncertainties include, but are not limited to, the following factors: general economic and market conditions; reduced demand for information technology equipment; competitive pricing and difficulty managing product costs; development of new technologies which make the Company's products obsolete; rapid industry changes; failure by the Company's suppliers to meet quality or delivery requirements; the inability to attract, hire and retain key

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personnel; failure of an acquired business to further the Company's strategies; the difficulty of integrating an acquired business; undetected problems in the Company's products; the failure of the Company's intellectual property to be adequately protected; unforeseen litigation; the ability to maintain sufficient liquidity in order to support operations; the ability to maintain satisfactory relationships with lenders and to remain in compliance with financial loan covenants and other requirements under current banking agreements; and the ability to maintain satisfactory relationships with suppliers and customers.

### General

Information on industry segments is incorporated by reference from Note G - Segment Reporting to the Condensed Consolidated Financial Statements.

### Critical Accounting Policies and Estimates

Management's discussion and analysis of financial condition and results of operations are based upon the condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of our financial statements requires the use of estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of

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contingent liabilities. On an ongoing basis, estimates are revalued, including those related to areas that require a significant level of judgment or are otherwise subject to an inherent degree of uncertainty. These areas include allowances for doubtful accounts, inventory valuations, carrying value of goodwill and intangible assets, estimated profit on uncompleted contracts in process, income and expense recognition, income taxes, ongoing litigation, and commitments and contingencies. Our estimates are based upon historical experience, observance of trends in particular areas, information and/or valuations available from outside sources and on various other assumptions that we believe to be reasonable under the circumstances and which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual amounts may differ from these estimates under different assumptions and conditions.

Accounting policies are considered critical when they are significant and involve difficult, subjective or complex judgments or estimates. We considered the following to be critical accounting policies:

Principles of consolidation - The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

Revenue recognition - The Company recognizes revenue from the Data Storage Segment, net of anticipated returns, at the time products are shipped to customers, or at the time services are provided. Revenue from material long-term contracts (in excess of \$250,000 and over a 90-day completion period) in both the Data Storage Segment and the RFID Technology Segment are recognized on the percentage-of-completion method for individual contracts, commencing when significant costs are incurred and adequate estimates are verified for substantial portions of the contract to where experience is sufficient to estimate final results with reasonable accuracy. Revenues are recognized in the ratio that costs incurred bear to total estimated costs. Changes in job performance, estimated profitability and final contract settlements would result in revisions to cost and income, and are recognized in the period in which the

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revisions were determined. Contract costs include all direct materials, subcontracts, labor costs and those direct and indirect costs related to contract performance. General and administrative costs are charged to expense as incurred. At the time a loss on a contract becomes known, the entire amount of the estimated ultimate loss is accrued.

Long-lived assets and intangible assets - The Company reviews carrying values at least annually or whenever events or circumstances indicate the carrying values may not be recoverable through projected discounted cash flows.

### Results of Operations

(A) Three months ended 9/30/2004 versus 9/30/2003

#### Revenues

Consolidated revenue for the quarter ended September 30, 2004 was \$1,737,200, compared to \$1,037,400 for the comparable quarter of the previous year, an increase of \$699,800, or 67.5%. The increase is attributed to revenue increases in both the RFID Technology segment, which increased to \$371,500 in the current quarter from \$2,000 reported for the three months ended September 30, 2003, and the Data Storage segment, which reported a 31.9% revenue increase to \$1,365,700 in the quarter ended September 30, 2004 compared to \$1,035,400 for the comparable quarter in the prior fiscal year. The increase in RFID Technology revenue resulted from system expansions at current TSI PRISM systems locations and the initial revenue from the current contract in progress. The same quarter in the prior fiscal year had been negatively affected by prison contract and funding postponements caused by fiscal budgetary constraints. The increase in Data Storage Segment revenues compared to the previous year resulted from increased demand for the Company's data storage products as companies increased technology expenditures in reaction to improving economic conditions.

#### Gross profit and Operating Expenses

Gross profit generated during the quarter amounted to \$621,400, an increase of \$228,800, or 58.3% when compared to the same quarter of the prior

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year. Gross margins decreased from 37.8% for the quarter ended September 30, 2003 to 35.8% for the current quarter. The decrease in gross margin resulted primarily from a change in product mix to lower gross margin products in the data storage segment.

Selling, general and administrative expenses for the current quarter increased to \$1,518,700, a \$398,800 increase, or 35.6%, when compared to \$1,119,900 incurred in the comparable quarter of fiscal year 2003. The major components of the increase in selling, general and administrative expense were: an increase of approximately \$120,000 in selling and marketing expenses, primarily in our RFID Technology segment; an increase in inventory reserve of \$75,000 related to new technology in the RFID Technology segment that potentially reduced the value of existing inventory; and an increase of approximately \$130,000 in legal expense related to the litigation in which the Company is currently involved. The Company will continue to pursue legal expense reimbursement from both the Company's insurance carrier as well as the Plaintiffs in the litigation matters.

#### Operating Loss

The Operating Loss for the quarter was \$897,300 compared to a loss of \$727,200 for the same quarter of the prior year, an increase of 23.4%. The increased loss resulted from increased corporate expenses and increases in the RFID Technology segment loss offset by the Data Storage segment reporting an

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operating profit for the current quarter compared to a loss in the comparable quarter of the prior fiscal year.

### Interest and Dividends Expense

Interest expense for the quarter amounted to \$16,300 compared to interest expense of \$82,700 for the same quarter in the prior year. The \$66,400 interest expense reduction resulted from a decrease in average borrowing during the quarter accomplished by the Company's effort in raising additional working capital.

The Company paid quarterly in-kind Series B Preferred Stock dividends with values of \$15,000 and \$13,500 in fiscal year 2004 and 2003, respectively. In addition, the Company declared a Series A Preferred Stock dividend during the quarter and paid the dividend in-kind through the issuance of additional Series A Preferred Stock valued at \$221,800. The dividend complied with the Series A Preferred Stock provision for a stock dividend to be declared and paid on a six-month interval.

### Net Loss Attributable to Common Stockholders

Net Loss Attributable to Common Stockholders for the quarter ended September 30, 2004 amounted to \$1,145,400, or (\$.05) per share, compared to a loss of \$820,200, or (\$.05) per share, in the comparable quarter of the prior year. Although the Company has shown improved operating results in its Data Storage segment and anticipates improved future operating results in its RFID Technology segment as the economy improves, actual results in both the Data Storage segment and the RFID Technology segment may be affected by unfavorable economic conditions and reduced capital spending budgets. If the economic conditions in the United States worsen or if a wider or global economic slowdown occurs, Alanco may experience a material adverse impact on its operating results and business conditions.

### Liquidity and Capital Resources

The Company's current assets at September 30, 2004 exceeded current liabilities by \$3,568,500, resulting in a current ratio of 2.85 to 1. At June 30, 2004 the Company's current assets exceeded current liabilities by \$3,721,000, reflecting a current ratio of 3.85 to 1. The decrease in the current ratio at September 30, 2004 when compared to June 30, 2004 resulted primarily from the reclassification of \$500,000 credit line payable to current liabilities at September 30, 2004 from long-term notes payable at June 30, 2004. The reclassification was required to reflect the July 1, 2005 termination date of the existing line of credit agreement. Accounts receivable of \$839,400 at September 30, 2004, reflects an increase of \$182,200, or 28%, when compared to the \$657,200 reported as consolidated accounts receivable at June 30, 2004. The accounts receivable balance at September 30, 2004 represented forty-four days' sales in receivables compared to fifty-eight days' sales at June 30, 2004. The decrease in days' sales in receivables resulted primarily from improvements in the RFID Technology segment.

Consolidated inventories at September 30, 2004 amounted to \$2,337,300 an increase of \$55,000, or 2%, when compared to \$2,282,300 at June 30, 2004. The September 30, 2004 reflects an inventory turnover of 1.91 compared to 2.5 at June 30, 2004. Although the September 30, 2004 balance reflects only a slight increase from the June 30, 2004 balance, it is a much larger increase when compared to inventory levels of prior reporting periods and reflects management's anticipated revenue increases for both the Data Storage segment and the RFID Technology segment.

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At September 30, 2004, the Company had a balance of \$500,000 under a \$1.3 million formula-based revolving bank line of credit agreement with interest calculated at prime plus 4%. The line of credit agreement formula is based upon current asset values and is used to finance working capital. At September 30, 2004, the Company had \$800,000 available under the line of credit. See Line of Credit Footnote I for additional discussion of the existing line of credit agreement.

Cash used in continuing operations for the three-month period was \$919,500; an increase of \$25,000 when compared to cash used in operations of \$894,500 for the comparable period ended September 30, 2003. The increase was due primarily to increases in the loss from operations for the period.

During the three-months ended September 30, 2004, the Company reported cash flows from investing activities of \$13,200, including collecting \$30,000 in notes receivable, purchasing \$34,000 of additional equipment and raising \$19,100 from the sale of assets held for sale. For the quarter ended September 30, 2003, the Company reported \$50,100, including collecting notes receivable of \$36,800, purchasing additional equipment in the amount of \$5,900 and raising \$19,200 from the sale of property, plant & equipment and assets held for sale.

Cash provided by financing activities for the quarter ended September 30, 2004 consisted primarily of \$1.1 million in proceeds received from the exercise of warrant and options. Cash provided by financing activities during the same quarter in the prior fiscal year included the collections of subscription receivables in the amount of \$899,200 and the proceeds from the sale of preferred stock of \$105,700.

The Company believes that additional cash resources may be required for working capital to achieve planned operating results for fiscal year 2005 and, if working capital requirements exceed current availability, the Company anticipates raising capital through additional borrowing or sale of stock. The additional capital would supplement the projected cash flows from operations and the line of credit agreement in place at September 30, 2004. If additional working capital was required and the Company was unable to raise the required additional capital, it may materially affect the ability of the Company to achieve its financial plan. See Footnote F - Equity for additional information related to working capital raised by the Company during the three months ended September 30, 2004, necessary to achieve planned operating results for the current fiscal year.

### Item 3 - CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the Securities and Exchange Commission (SEC), and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on various evaluations of the Company's disclosure controls and procedures, some of which occurred during the 90 days prior to the filing date of this report, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that the Company is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required periods.

The Company also maintains a system of internal controls designed to provide reasonable assurance that: transactions are executed in accordance with management's general or specific authorization; transactions are recorded as

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necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles, and (2) to maintain accountability for assets. Access to assets is permitted only in accordance with management's general or specific authorization; and the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Since the date of the most recent evaluation of the Company's internal controls by the Chief Executive and Chief Financial Officers, there have been no significant changes in such controls or in other factors that could have significantly affected those controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

### PART II. OTHER INFORMATION

#### Item 1 - LEGAL PROCEEDINGS

The Company continues to be a defendant in litigation that relates to the acquisition, in May of 2002, of substantially all the assets of Technology Systems International, Inc., a Nevada corporation. No significant new activity has occurred subsequent to our report of litigation in our Form 10-KSB filed for the year ended June 30, 2004. The Company's management, in consultation with legal counsel, believes the plaintiff's claims are without merit and the Company will aggressively defend the actions. Litigation previously reported as arising from an expired property lease between the Company's subsidiary, Arraid, Inc. and Arraid Property L.L.C., a Limited Liability Company, has been deemed immaterial.

#### Item 2. CHANGES IN SECURITIES

During the three months ended September 30, 2004, the Company issued 147,800 shares of Series A Preferred Stock and 1,500 Shares of Series B Preferred Stock as dividend in-kind payments, 2,099,400 shares of Class A Common Stock for the exercise of existing warrants and options and 57,500 shares of Common Stock for services rendered.

#### Item 6. EXHIBITS

- 31.1 Certification of Chief Executive Officer
- 31.2 Certification of Chief Financial Officer
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer
- 99.1 Nominating Committee Charter
- 99.2 Code of Conduct

#### SIGNATURE

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 thereunder duly authorized.

ALANCO TECHNOLOGIES, INC.  
(Registrant)

/s/ John A. Carlson  
John A. Carlson  
Executive Vice President and  
Chief Financial Officer



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EXHIBIT 31.1

Certification of  
Chairman and Chief Executive Officer  
of Alanco Technologies, Inc.

I, Robert R. Kauffman, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Alanco Technologies, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the period presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2004

/s/ Robert R. Kauffman  
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Robert R. Kauffman  
Chairman and Chief Executive Officer

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EXHIBIT 31.2

Certification of  
Vice President and Chief Financial Officer  
of Alanco Technologies, Inc.

I, John A. Carlson, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Alanco Technologies, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the period presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control

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over financial reporting.

Date: November 12, 2004

/s/ John A. Carlson  
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John A. Carlson  
Executive Vice President and Chief Financial Officer

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EXHIBIT 32.1

Certification of  
Chief Executive Officer and Chief Financial Officer  
of Alanco Technologies, Inc.

This certification is provided pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and accompanies this quarterly report of Form 10-QSB (the "Report") for the period ended September 30, 2004 of Alanco Technologies, Inc. (the "Issuer").

Each of the undersigned, who are the Chief Executive Officer and Chief Financial Officer, respectively, of Alanco Technologies, Inc., hereby certify that, to the best of each such officer's knowledge:

(i) the Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Issuer.

Dated: November 12, 2004

/s/ Robert R. Kauffman  
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Robert R. Kauffman  
Chief Executive Officer

/s/ John A. Carlson  
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John A. Carlson  
Chief Financial Officer

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EXHIBIT 99.1

ALANCO TECHNOLOGIES, INC.

NOMINATING COMMITTEE  
CHARTER

I. Purpose

The purpose of the Nominating Committee is to select qualified nominees to be elected to the board of directors (the "Board of Directors") of Alanco

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Technologies, Inc. (the "Corporation") by the Corporation's stockholders at the annual stockholder meeting, to select qualified persons to fill any vacancies on the Board of Directors, and to undertake such other duties and responsibilities as may from time to time be delegated by the Board of Directors to the Nominating Committee.

### II. Membership Requirements

The Nominating Committee shall be comprised of that number of directors as the Board of Directors shall determine from time to time, such number not to be less than two. The membership of the Nominating Committee shall meet all applicable requirements of the NASDAQ and the Securities and Exchange Commission (the "SEC") and any other applicable laws, rules and regulations with respect to independence, as determined by the Board. The members of the Nominating Committee shall be appointed annually by the Board of Directors and may be removed at any time, with or without cause, by the Board of Directors. Unless a Chairman of the Nominating Committee is elected by the full Board of Directors, the members of the Nominating Committee may designate a Chairman by majority vote of the full Nominating Committee membership.

### III. Authority

In discharging its responsibilities, the Nominating Committee shall have authority to retain outside counsel or other consultants in the Nominating Committee's sole discretion. The Nominating Committee shall also have sole authority to approve the fees and other retention terms of such consultants and to terminate such consultants. The Nominating Committee shall have the authority to create subcommittees with such powers as the Nominating Committee shall from time to time confer.

### IV. Responsibilities

The following are the general responsibilities of the Nominating Committee and are set forth only for its guidance. The Nominating Committee may assume such other responsibilities as it deems necessary or appropriate in carrying out its purpose.

The Nominating Committee shall:

1. Select a replacement Director when a vacancy on the Board of Directors occurs or is anticipated;

2. Establish the criteria for evaluating and evaluate the qualifications of individuals for election as members of the Board of Directors, which criteria shall include, at a minimum, the following:

- a. compliance with the independence and other applicable requirements of NASDAQ and the SEC, all other applicable laws, rules, regulations and listing standards, and the criteria, policies and principles set forth in the Corporation's Articles of Incorporation, Bylaws, Code of Conduct, and this Charter; and
- b. the ability to contribute to the effective management of the Corporation, taking into account the needs of the Corporation and such factors as the individual's experience, perspective, skills, time availability, knowledge of the industries in which the Corporation operates, and such other criteria as the Committee shall determine to be relevant at the time.

3. Consider stockholder recommendations for possible nominees for election as

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members of the Board of Directors;

4. Annually evaluate the qualifications of current members of the Board of Directors who are available for reelection, in light of the characteristics of independence, skills, experience, availability of service to the Corporation and tenure of its members, and of the Board's anticipated needs;

5. Upon a significant change in a Director's personal circumstances or in the event a significant ongoing time commitment arises that may be inconsistent with a Director's service to the Board, review, as appropriate and in light of the then current Board policies as reflected in the Code of Conduct or other corporate governance principles, the continued Board membership of such member;

6. Report to the Board of Directors its conclusions with respect to the matters that the Nominating Committee has considered;

7. Review and reassess the adequacy of this Charter of the Nominating Committee annually and submit any proposed modifications to the Board of Directors for approval; and

8. Review and evaluate the Nominating Committee's performance annually with the committee or individual designated by the Board of Directors to undertake such review.

### V. Reliance

The Committee, and each member of the Committee in his or her capacities as such, shall be entitled to rely, in good faith, on information, opinions, reports or statements, or other information prepared or presented to them by (i) officers and other employees of the Corporation, which such member believes to be reliable and competent in the matters presented, (ii) counsel, public accountants or other persons as to matters which the member believes to be within the professional competence of such person.

### VI. Meetings

Subject to the Bylaws and resolutions of the Board of Directors, the Nominating Committee shall meet not less than once a year at such time as the Chairman of the Nominating Committee shall designate. The Nominating Committee shall fix its own rules of procedure, and a majority of the number of members then serving on the Nominating Committee shall constitute a quorum. The Nominating Committee shall keep minutes of its meetings, and all action taken by it shall be reported to the Board of Directors. The Committee may take action by meeting in person, telephonically, or by unanimous written action.

## EXHIBIT 99.2

Alanco Technologies, Inc.

Code of Business Conduct and Ethics

### Introduction

Alanco Technologies (the Company) is committed to conducting its business with honesty and integrity. The policies outlined in this Code are designed to ensure that the Company's employees and officers (employees) and members of its board of directors (directors) act in accordance with not only the letter but also the spirit of the laws and regulations that apply to our business. Employees and directors who violate this Code will be subject to disciplinary action.

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Employees and directors are expected to read the policies set forth in this Code and ensure that they understand and comply with them. Any questions about the Code or the appropriate course of conduct in a particular situation should be directed to the Company's General Counsel. Any violations of laws, rules, regulations or this Code should be reported immediately. The Company will not allow retaliation against an employee or director for such a report made in good faith.

Any waiver of the provisions of this Code for executive officers or directors of the Company may be made only by the board of directors or a committee of the board and must be promptly disclosed to shareholders.

### Responsibilities

#### 1. Compliance with laws, rules and regulations

All employees and directors must respect and obey all laws that apply to our business, including state and local laws in the areas in which the Company operates. Any questions as to the applicability of any law should be directed to the Company's General Counsel.

If a law conflicts with a policy in this Code, employees and directors must comply with the law. If a local custom or policy conflicts with a policy in the Code, employees and directors must comply with the Code.

#### 2. Insider trading

The Company has a securities trading policy and all employees and directors must abide by its terms. This policy, among other things, provides that employees and directors may not buy or sell shares of the Company when they are in possession of material, non-public information. They also are prohibited from passing on such information to others who might make an investment decision based on it.

Employees and directors also may not trade in stocks of other companies about which they learn material, non-public information through the course of their employment or service. Any questions as to whether information is material or has been adequately disclosed should be directed to the Company's General Counsel.

#### 3. Conflicts of interest

A conflict of interest occurs when the private interest of an employee or director interferes or appears to interfere in any way with the interests of the Company. Conflicts of interest can occur when an employee or director takes action or has interests that could reasonably be expected to make it difficult to make objective decisions on behalf of the Company or to perform his or her duties effectively. Conflicts of interest also arise when an employee or director, or a member of his or her family, receives improper personal benefits as a result of his or her position with the Company. An employee or director will not be deemed to have a conflict of interest solely on the basis of his service on the board of directors of a company, or other involvement with a company that is under common ownership, or has a business relationship, with the Company, provided such relationship or involvement is fully disclosed to the Company.

Conflicts of interest are prohibited as a matter of corporate policy, unless such conflicts are fully disclosed to the Company's Board of Directors, and if a director has the potential conflict, such director does not vote on any matter related to the potential conflict. Any employee or director who becomes aware of a conflict or potential conflict, or who has a question about whether a conflict exists, should bring it to the attention of the Company's General Counsel or the

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Company's Chief Executive Officer.

### 4. Corporate opportunities

Employees and directors are prohibited from taking for themselves personally any opportunities that arise through the use of corporate property, information or position and from using corporate property, information or position for personal gain. Employees and directors are further prohibited from competing with the Company directly or indirectly. Employees and directors owe a duty to the Company to advance its legitimate interests when the opportunity to do so arises.

### 5. Confidentiality

Employees and directors may learn information about the Company that is not known to the general public or to competitors. Confidential information includes all non-public information that might be of use to competitors, or harmful to the Company or its customers if disclosed, or information that associates of the Company have entrusted to it.

Employees and directors must maintain the confidentiality of information entrusted to them by the Company or its associates, except when disclosure is authorized or legally mandated. This obligation to protect confidential information does not end when an employee or director leaves the Company. Any questions about whether information is confidential should be directed to the Company's General Counsel.

### 6. Fair dealing

Each employee and director shall endeavor to deal fairly with the Company's shareholders, competitors, suppliers and employees. No employee or director shall take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair practice.

### 7. Protection and proper use of Company assets

Theft, carelessness and waste have a direct impact on the Company's profitability. Employees and directors have a duty to safeguard Company assets and ensure their efficient use. Company assets should be used only for legitimate business purposes, and employees and directors should take measures to ensure against their theft, damage, or misuse.

Company assets include intellectual property such as trademarks, business and marketing plans, salary information and any unpublished financial data and reports. Unauthorized use or distribution of this information is a violation of Company policy.

### 8. Recordkeeping

All of the Company's books, records, accounts and financial statements must be maintained in reasonable detail, must appropriately reflect the matters to which they relate and must conform both to applicable legal requirements and to the Company's system of internal controls. All assets of the Company must be carefully and properly accounted for. The making of false or misleading records or documentation is strictly prohibited.

The Company complies with all laws and regulations regarding the preservation of

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records. Records should be retained or destroyed only in accordance with the Company's document retention policies. Any questions about these policies should be directed to the Company's General Counsel.

### 9. Interaction with public officials

When dealing with public officials, employees and directors must avoid any activity that is or appears illegal or unethical. The giving of gifts, including meals, entertainment, transportation, and lodging, to government officials in the various branches of U.S. government, as well as state and local governments, is restricted by law. Employees and directors must obtain pre-approval from the Company's General Counsel before providing anything of value to a government official or employee. The foregoing does not apply to personal lawful political contributions.

In addition, the U.S. Foreign Corrupt Practices Act prohibits giving anything of value, directly or indirectly, to officials of foreign governments or foreign political candidates in order to obtain or retain business. Illegal payments to government officials of any country are strictly prohibited.

### Compliance standards and procedures

No code of business conduct and ethics can replace the thoughtful behavior of an ethical employee or director or provide definitive answers to all questions. Since we cannot anticipate every potential situation, certain policies and procedures have been put in place to help employees and directors approach questions or problems as they arise.

#### 1. Designated Ethics Officer

The Company's General Counsel has been designated as the Company's Ethics Officer with responsibility for overseeing and monitoring compliance with the Code. The Ethics Officer reports directly to the Chief Executive Officer and also will make periodic reports to the Company's Audit/Corporate Governance Committee regarding the implementation and effectiveness of this Code as well as the policies and procedures put in place to ensure compliance with the Code.

#### 2. Seeking Guidance

Employees and directors are encouraged to seek guidance from supervisors, managers or other appropriate personnel when in doubt about the best course of action to take in a particular situation. In most instances, questions regarding the Code should be brought to the attention of the Company's General Counsel.

#### 3. Reporting Violations

If an employee or director knows of or suspects a violation of the Code, or of applicable laws and regulations, he or she must report it immediately to the Company's General Counsel or the Chief Executive Officer. If the situation requires it, the reporting persons identity will be kept anonymous. The Company does not permit retaliation of any kind for good faith reports of violations or possible violations.

#### 4. Investigations

Reported violations will be promptly investigated. It is imperative that the person reporting the violation not conduct an investigation on his or her own.



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However, employees and directors are expected to cooperate fully with any investigation made by the Company into reported violations.

### 5. Discipline/Penalties

Employees and directors who violate this Code may be subject to disciplinary action, up to and including discharge. Employees and directors who have knowledge of a violation and fail to move promptly to report or correct it and employees and directors who direct or approve violations may also be subject to disciplinary action, up to and including discharge. Furthermore, violation of some provisions of this Code are illegal and may subject the employee or director to civil and criminal liability.