SSP SOLUTIONS INC
Form 10QSB
May 20, 2003

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

FORM 10-QSB

(Mark One)

[X] Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended MARCH 31, 2003

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from __________ to __________

Commission file number: 000-26227

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

DELAWARE	33-0757190
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

17861 CARTWRIGHT ROAD, IRVINE, CALIFORNIA 92614
(Address of principal executive offices)

(949) 851-1085
(Issuer's telephone number, including area code)

NOT APPLICABLE.
(Former name, former address and former fiscal year, if changed since last report)

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

The number of shares outstanding of the registrant's only class of common stock, $.01 par value, was 25,291,943 on May 16, 2003.

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

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SSP SOLUTIONS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

	Decem 2 -----
ASSETS (note 5)	
Current assets:	
Cash and cash equivalents	$
Investment in trading securities	
Accounts receivable (net of allowance for doubtful accounts of $187 as of December 31, 2002 and March 31, 2003)	

Inventories	
Prepaid expenses	
Other current assets	

Total current assets	
Property and equipment, net	
Other assets	
Equity investment in affiliate	
Goodwill	

	$
	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:	
Current installments of long-term debt (note 5)	$
Accounts payable	
Accrued liabilities	
Deferred revenue	

Total current liabilities	
Commitments and contingencies (notes 1,4,5,6,and 7)	
Subsequent events (note 10)	
Shareholders' equity:	
Preferred stock, $0.01 par value; Authorized 5,000,000 shares; no shares issued or outstanding	
Common stock, $0.01 par value; Authorized 100,000,000 shares; issued or issuable 24,821,235 and 25,067,576 shares at December 31, 2002 and March 31,2003, respectively	
Additional paid-in capital	
Note receivable from shareholder	
Deferred compensation	
Accumulated deficit	(

Total shareholders' equity	

	$
	=====

See accompanying notes to condensed consolidated financial statem

SSP SOLUTIONS, INC. AND SUBSIDIARIES
CONDENSED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(UNAUDITED)

	Three Months Ended March 31,	
	2002	2003

Revenues:		
Product	$ 1,071	$ 1,0
Service	537	1,0
License	119	1,2
Total revenues	1,727	3,3
Cost of Sales:		
Product	503	2
Service	229	3
License	53	4
Total cost of sales	785	1,0
Gross margin	942	2,2
Operating Expenses:		
Selling, general and administrative	2,065	1,5
Research and development	1,639	1,1
Research and development - Wave Systems Corp.	833	
Amortization of goodwill and other intangibles	23	
Total operating expenses	4,560	2,6
Operating (loss)	(3,618)	(4
Non-operating Expenses (Income):		
Unrealized loss on trading securities	1	
Interest expense, net	125	2
Non-cash interest and financing expense	--	5
Loss from equity investee	--	2
Other (income) expense, net	14	
Total non-operating expenses (income)	140	1,0
Operating loss before income taxes	(3,758)	(1,5
Provision for income taxes	3	
Loss from continuing operation	(3,761)	(1,5
Loss from discontinued operations	(266)	
Loss on disposal of discontinued operations (less no applicable taxes)	--	(
Net Loss	$ (4,027)	$ (1,6
Loss per share of common stock, basic and diluted	$ (.19)	$ (.
Loss per share from discontinued operations, basic and diluted	(.01)	
Loss per share from continuing operations, basic and diluted	(.18)	(.
Shares used in per share computations--basic and diluted	20,651	25,0

See accompanying notes to condensed consolidated financial statements

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SSP SOLUTIONS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	Three Months March 3
	2002
Cash flows from operating activities:	
Net loss	$ (4,027)
Adjustments to reconcile net loss to net cash used in operating activities:	
Operating activities:	
Non-cash interest	--
Loss from equity investee	--
Common stock issued for rent expense	--
Common stock issued for interest expense	--
Provision for losses on receivables	12
Depreciation and amortization	108
Deferred compensation	104
Unrealized loss on trading securities	1
Changes in assets and liabilities:	
Accounts receivable	2,907
Inventories	66
Prepaid expenses	201
Other current assets	(55)
Other assets	17
Accounts payable	(1,715)
Accrued liabilities	410
Deferred revenue	(52)
Net cash (used in) continuing operating activities	(2,023)
Net cash provided by discontinued operations	238
Net cash (used in) operating activities	(1,785)
Cash flows used in investing activities:	
Investment in equity investee	--
Purchases of property and equipment	(2)
Proceeds from sale of trading securities	917
Net cash provided by (used in) investing activities	915
Cash flows from financing activities:	
Principal repayment	--
Stock options exercised	60
Borrowings on revolving note payable	1,103
Repayment or insurance financing	(173)
Principal payments (increases) on revolving line of credit	(2,262)
Principal payments on note payable to related party	(392)
Net cash (used in) provided by in financing activities ..	(1,664)

Net (decrease) in cash	(2,534)
Cash and cash equivalents and beginning of period	3,257
Cash and cash equivalents at end of period	$ 723
Supplemental disclosures of cash flow information	
Cash paid during the period for:	
Interest	$ 92
Income taxes	3

See accompanying notes to condensed consolidated financial statements

SSP SOLUTIONS, INC. AND SUBSIDIARIES
CONDENSED STATEMENTS OF CASH FLOWS (CONTINUED)
(IN THOUSANDS)
(UNAUDITED)

	Three Months March 31	
	2002	
Supplemental disclosure of non-cash financing activities information:		
Deferred Compensation	$ 303	$
Payment of rent in common stock	--	
Warrants issued to note holders	--	
Payment of interest in common stock	--	

See accompanying notes to condensed consolidated financial statements.

SSP SOLUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2003
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

(1) GENERAL INFORMATION

CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

In the opinion of the management of SSP Solutions, Inc. (the "Company"), the accompanying unaudited condensed consolidated financial statements contain all adjustments (which are normal recurring accruals) necessary to present fairly the financial position as of March 31, 2003; the results of operations for the three months ended March 31, 2002 and 2003; and the statements of cash flows for the three months ended March 31, 2002 and 2003. Interim results for the three months ended March 31, 2003, are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. The interim financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2002, included in the Company's Form 10-K/A, filed in April 2003.

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

DETAILS OF THE DISPOSAL

Through December 31, 2002, the Company had operated in two business segments: information security solutions and network solutions businesses. During the three month period ended March 31, 2003 the Company discontinued its network solution segment, which was conducted through Pulsar, as the Company determined that this segment would not return to operating profits in a reasonable time period. The total estimated cost to exit the segment at March 31, 2003 is $106 of which $9 has been incurred by March 31, 2003 and the estimated remaining exit cost of $97 was accrued at March 31, 2003. The network solution segment assets did not require an impairment write down as there was no remaining book value of assets in existence at the date the decision to exit the business was made. As a result, there is no gain or loss on the discontinued operation relating to the network solution facility segment. In addition, as a result of the discontinuance of the network solution segment, the Company now only operates in one reporting segment.

REVENUE RECOGNITION

Revenue from some data security hardware products contains embedded software. However, the embedded software is incidental to the hardware product sale. Data security license revenue is recognized upon delivery if an executed license exists, a delivery as defined under the license has occurred, the price is fixed and determinable, and collection is probable. Prior to 2002, post-contract customer support revenue was not separately identified and priced. Therefore, sufficient vendor specific objective evidence could not be established for the value or cost of such services. Furthermore, prior to 2002, revenue for the entire license, including bundled post-contract customer support was recognized ratably over the life of the license. Commencing in 2002, software delivered under a license requires a separate annual maintenance contract that governs the conditions of post-contract customer support. Post-contract customer support services can be purchased under a separate contract on the same terms and at the same pricing, whether purchased at the time of sale or at a later date. Revenue from these separate maintenance support contracts is recognized ratably over the maintenance period.

Revenue from cost-plus-award-fee support and development contracts is recognized on the basis of hours incurred plus other reimbursable contract costs incurred during the period. Prior to 2002, any award fee earned under a cost-plus-award-fee contract was not recognized until the award fee notice was received. Beginning in 2002, for a cost-plus-award-fee support contract, the Company exercised the contract clause to bill and collect one-half of the award fee ratably over the term of the contract. Revenue is recognized concurrently with the billings based on the performance of the contract requirements and reasonable assurance of collection. Based upon historical results, the Company has received final awards in excess of one-half of the full award fees. A post-contract period performance review conducted by the customer determines the remaining amount of the award fee to be received, which amount is then recognized as earned revenue together with interest paid on the unpaid balance. Award fees under development contracts are recognized when confirmed by the customer.

Revenue from network deployment products is recognized upon transfer of title, generally upon verification of delivery to the customer, which represents evidence delivery has occurred, under a sales order represented by a government purchase order that contains a fixed purchase price. When the Company fulfills the elements of the government purchase order, collection of the revenue recorded is reasonably assured.

Service and license revenues from the Company's high assurance token fixed-price contract were recognized in accordance with SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." The Company recognized this revenue on a percentage of completion method, based on total cost incurred to total estimated cost (cost-to-cost percentage of completion).

The Company's revenue recognition policies are in accordance with the Securities and Exchange Commission's Staff Accounting Bulletin No. 101.

NEW ACCOUNTING PRONOUNCEMENTS

In May 2003, the Financial Accounting Standards Board ("FASB") issued Statement No.150, entitled "Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity." Statement No. 150 established the accounting guidance related to how an "issuer" classifies/measures certain financial instruments where those instruments have characteristics of both liabilities and equity. The guidance in Statement No.150 requires reclassification of certain financial instruments from the equity section of the balance sheet to the liability section of the balance sheet. Specifically Statement No.150 requires three classes of freestanding financial instruments to be classified as liabilities: mandatorily - redeemable financial instruments, obligations to repurchase equity shares by transferring assets, and certain obligations to insure a variable number of shares. Statement No. 150 is effective for financial instruments entered into after May 31, 2003 and otherwise effective at the beginning of the first interim period beginning after June 15, 2003 (July 1, 2003 for SSP) and is to be implemented by reporting a cumulative effect of a change in accounting principles for financial instruments created before the May 15, 2003 issuance of Statement No.150. The Company expects no material changes to its financial statements upon adoption of Statement No.150.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2003, the Company had deficit working capital of $6,901, and the Company had incurred a loss from operations for the three months then ended. The Company expects to continue to incur substantial additional losses in 2003. Given the March 31, 2003 cash balance and the projected operating cash requirements, the Company anticipates that existing capital resources will not be adequate to satisfy cash flow requirements through December 31, 2003. The Company will require additional funding. The Company's cash flow estimates are based upon achieving certain levels of sales, reductions in operating expenses and liquidity available under its accounts receivable financing, new debt and/or equity financing. Should sales be less than forecast, expenses be higher than forecast or the liquidity not be available through additional financings of debt and/or equity, the Company will not have adequate resources to fund its operations. During 2002, the Company incurred defaults, other than for the payment of principal and interest, under both the Company's accounts receivable financing and the Company's long-term convertible notes. The Company was not able to obtain waivers for defaults on the long-term convertible notes and has therefore classified such notes as short-term on the balance sheet as of December 31, 2002 and March 31, 2003. The Company does not expect future fixed obligations to be paid from operations and the Company intends to satisfy fixed obligations from additional financings, use of the accounts receivable financing, extending vendor payments and issuing stock as payment on obligations.

The Company's current financial condition is the result of several factors, including the fact that operating results were below expectations.

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

- the ability to extend terms received from vendors
- the market acceptance of products and services
- the levels of promotion and advertising that will be required to launch new products and services and attain a competitive position in the market place
- research and development plans
- levels of inventory and accounts receivable
- technological advances
- competitors' responses to our products and services
- relationships with partners, suppliers and customers
- projected capital expenditures
- reduction in the valuation of marketable investment securities
- downturn in economy
- defaults on financing which will impact the availability of borrowings

In addition to the Company's current deficit working capital situation, current operating plans show a shortfall of cash during 2003. The Company intends to mitigate its position through one or more of the following:

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

- Additional convertible debt -- Depending upon the market conditions, the Company may issue an additional debt instrument. The types of instruments available in the market would likely contain a provision for the issuance of warrants and may also be convertible into equity.

- Off balance sheet financing -- The Company's operations are not relatively capital intensive. However, should the Company need to add equipment or decide to expand the facilities, the Company may use an operating lease transaction to acquire the use of capital assets. An operating lease would not appear on the Company's balance sheet and would be charged as an expense as payments accrue. The Company plans to use third party financing for a subsidiary whereby the subsidiary would become less than wholly-owned.

- Receivables financing - Effective in October 2002, the Company executed a new factoring agreement with Bay View Funding ("BVF") for the financing of the Company's accounts receivable. The Company also terminated its remaining agreement with Wells Fargo Business Credit ("WFBC"). The Company plans to continue to generate cash by financing receivables in conjunction with its BVF agreement.

- Sale of investments - The Company will sell its remaining investments to generate cash. The market value of trading securities was approximately $60 at March 31, 2003.

- Negotiate with vendors - The Company has successfully negotiated extended payment terms with a number of vendors. The Company will continue to negotiate term-out agreements with vendors to extend the payment terms of existing accounts payable.

- Advance payments - Under current or future contracts the Company may obtain cash deposits toward work to be performed or products to be delivered. In addition, the Company may offer early payment discounts to customers whose receivables are not financed under the BVF agreements.

- Deferral of cash payments - The Company may defer cash payments through suspension of development projects.

- Issuance of stock as payment for existing and future obligations - The Company may pay some of its accrued liabilities or accounts payable through the issuance of common stock. During the three months ended March 31, 2003, the Company issued 34,600 shares of its common stock for payments relating to its facility lease.

- Issuance of stock to pay interest - The Company may issue common stock to pay interest on long-term debt. During the three months ended March 31, 2003, the Company issued 211,700 shares of its common stock in the payment of interest expense.

- Reductions in work force - The Company has reduced its workforce and decreased the cash compensation paid to the remaining workforce. The Company may be forced to make further reductions in the future if sales plans are not achieved.

- If the Company does not receive adequate financing, the Company could be forced to merge with another company or cease operations.

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

While the Company has a history of selling products in government markets, new products that are just entering production after years of development have no sales history. Additionally, the Company is entering commercial markets with products and is still developing acceptance of Company product offerings. Considerable uncertainty currently exists with respect to the adequacy of current funds to support the Company's activities beyond March 31, 2003. This uncertainty will continue until a positive cash flow from operations is achieved. Additionally, the Company is uncertain as to the availability of financing from other sources to fund any cash deficiencies.

In order to reduce this uncertainty, the Company continues to evaluate additional financing options and may therefore elect to raise capital, from time to time, through equity or debt financings in order to capitalize on business opportunities and market conditions and to insure the continued marketing of current product offerings together with development of new technology, products and services. There can be no assurance that the Company can raise additional financing in the future.

Based upon forecasted sales and expense levels, the Company currently anticipates that existing cash, cash equivalents, investments, term-out arrangements with vendors and the current availability under our BVF factoring agreement will not be sufficient to satisfy Company contemplated cash requirements for the next twelve months. However, the Company's forecast is based upon certain assumptions, which may differ from actual future outcomes. The Company has incurred defaults under its financing agreements in the past. The BVF agreement states among other things that a default occurs if the Company is generally not paying debts as they become due or if the Company is left with unreasonably small capital. The Company has notified BVF of its failure to make certain payments on a timely basis and have requested a waiver of such default. The Company therefore may not be able to draw funds in the future, which would affect the Company's ability to fund its operations. Additionally, without a substantial increase in sales or a reduction in expenses, the Company will continue to incur operating losses.

STOCK-BASED COMPENSATION FOR EMPLOYEES AND NON-EMPLOYEES

The Company accounts for its employee stock option plans using the intrinsic value method. When stock options are granted to employees with exercise prices less than the fair value of the underlying common stock at the date of grant, the difference is recognized as deferred compensation expense, which is amortized over the vesting period of the options.

The Company accounts for stock options issued to non-employees using the fair value method. The associated cost is recorded in the same manner as if cash were paid.

At March 31, 2003, the Company had three stock-based employee compensation plans. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. The following table illustrates the effect on net loss and earnings per share if the Company had applied the fair value recognition provisions of Statement No. 123:

	THREE MONTHS END MARCH 31, 2002	
Net loss, as reported	$ 4,027	$
Add: Stock compensation cost reported in accordance with APB No. 25	--	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effect	373	
Pro forma net loss	$ 4,400	$
Earnings per share		
Net loss per share as reported -- basic and diluted	$ (.19)	$
Pro forma net loss per share -- basic and diluted	$ (.21)	$

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions in 2002 and 2003: risk-free interest rate of 3.92%; dividend yield of 0.00%; and volatility of 129% for both periods. The Black-Scholes model, as well as other currently accepted option valuation models, was developed to estimate the fair value of freely-tradable, fully-transferable options without vesting restrictions, which significantly differ from the Company's stock option plans. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated fair value on the grant date.

A summary of the status of the Company's warrants as of March 31, 2003 and changes during the three months ending March 31, 2003 is presented below (shares in thousands):

	MARCH 31, 2003	
WARRANTS	NUMBER OF UNDERLYING SHARES	WEIGHTED-AVERAGE EXERCISE PRICE
Outstanding at beginning of year	4,081	$2.82
Granted	505	$1.02
Cancelled	--	$ --
Exercised	--	$ --
Outstanding at end of year	4,586	$2.63

Warrants exercisable at year-end	4,586
Weighted-average fair value of warrants granted during the year	$0.60

The following table summarizes information about warrants outstanding at March 31, 2003 (shares in thousands):

	WARRANTS OUTSTANDING			WARRANTS EXERCIS	
RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED-AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGH EXER
$0.60 - $16.39	4,216	2.4	$ 1.26	4,216	$
$16.40 - $18.15	370	1.2	$ 18.15	370	$
	4,586	2.3	$ 2.63	4,586	$

OPTIONS

A summary of the status of the Company's stock option plans as of March 31, 2003 and changes during the three months ending March 31, 2003 is presented below (shares in thousands):

..

	MARCH 31, 2003	
OPTIONS	NUMBER OF UNDERLYING SHARES	WEIGHTED-AVERAGE EXERCISE PRICE
Outstanding at beginning of year	2,039	$2.40
Granted	515	$0.60
Cancelled	(117)	$2.75
Exercised	--	--
Outstanding at end of year	2,437	$2.00
Options exercisable at year-end	1,110	$2.12
Weighted-average fair value of options granted during the year	$0.93	

The following table summarizes information about stock options outstanding at March 31, 2003 (shares in thousands):

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING: NUMBER OUTSTANDING AT 3/31/03	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED-AVERAGE EXERCISE PRICE	OPTIONS: NUMBER EXERCISABLE A 3/31/03
$0.60 - $1.51	1,418	9.8	$1.02	537
$1.52 - $2.43	446	7.9	$2.06	353
$2.43 - $3.34	337	8.1	$3.02	101
$3.35 - $4.26	71	7.9	$3.67	40
$4.27 - $6.09	3	7.9	$4.81	1
$6.10 - $7.00	115	9.4	$6.82	49
$7.01 - $8.83	29	6.6	$8.75	18
$8.84 - $9.75	18	6.7	$9.75	11
	2,437	9.1	$2.00	1,110

The weighted average remaining contractual life of stock options outstanding at March 31, 2003 was 9.1 years.

BIZ ACQUISITION

In accordance with Statement No. 142, the Company had up until June 30, 2002 to complete the initial test for impairment as of January 1, 2002, the adoption date of Statement No. 142. In accordance with the transition provisions of Statement No. 142, the Company conducted the first step of the impairment tests. The Company assessed the fair value of its two reporting units by considering their projected cash flows, using risk-adjusted discount rates. Given consideration of relevant factors, the Company concluded that, as of December 31, 2001, an impairment write-down of $36,299 was required related to the BIZ acquisition. Subsequently, the Company reviewed the assumptions used in the original analysis as of March 31, 2002, June 30, 2002, September 30, 2002 concluded that such analyses continued to be adequate and that no additional write-down was required. In accordance with Statement No. 142, the Company stopped amortizing goodwill in 2002. Accordingly, the Company does not anticipate there to be any amortization expense for the next five years related to intangible assets. The following table provides a reconciliation of the reported net loss adjusted for amortization charges for each respective three month period:

	THREE MONTHS ENDED MARCH 31: 2002	2003
Reported net (loss)	$ (4,027)	$ (1,618)
Add back goodwill amortization:	(23)	--
Adjusted net loss	$ (4,004)	$ (1,618)

Basic earnings per share:		
Reported net (loss)	$ (.19)	$ (.06)
Add back goodwill amortization:	--	--
Adjusted net loss	$ (.20)	$ (.06)

The Company performed an assessment of the fair value of the goodwill of its information security products and services reporting unit as of December 31, 2002 using a multi-period discounted cash flow method, a variation of the income forecast approach. The process is used to determine the fair value of an asset by estimating its future cash flows and then discounting the cash flows to present day utilizing a discount rate that reflects the time value of money and the risk inherent in the asset. The present value of the cash flows was determined using a discount rate of 30%, which was found to be the weighted average cost of capital for the Company. The results of the analysis indicated that there was no impairment as of the valuation date of December 31, 2002.

The Company is required to perform reviews for impairment at least annually that may result in future write-downs. Tests for impairment between annual tests may be required if events occur or circumstances change that would more likely than not reduce the fair value of the net carrying amount.

As the markets for the Company's products are characterized by rapidly changing technology, evolving industry standards, and the frequent introduction of new products and enhancements, it is reasonably possible in the near-term that the estimates of the anticipated future gross revenues, the remaining estimated economic life, or both will be reduced. Reasonably possible is defined as more than remote but less than likely. As a result, the remaining goodwill of $25,930 at December 31, 2002, may be reduced within the next year.

(2) INVESTMENTS

The Company has an investment that is classified as trading securities. The securities are comprised of Class A Common Stock of Wave Systems Corp., par value $0.01, received in the BIZ acquisition. As of March 31, 2003, the Company had 57 shares with an aggregate value of $60. For the three months ended March 31, 2002 and 2003, the Company recorded realized loss on trading securities of $1 and $0, respectively.

(3) INVENTORIES

A summary of inventories follows:

	DECEMBER 31, 2002	MARCH 31, 2003
Raw materials	$ 23	$ 57
Work-in-process	82	43
Finished goods	133	185
	$ 238	$ 285

(4) EQUITY INVESTMENT IN AFFILIATE

In January 2002, the Company formed a wholly-owned subsidiary, now known as SSP Gaming, LLC, a Nevada limited liability company ("SSP Gaming"). The entity was formed to conduct all business and any required financing activities relative to the gaming industry. In June 2002, SSP Gaming and the Venetian Casino Resort, LLC, a Nevada limited liability company based in Las Vegas, Nevada, ("Venetian"), executed an operating agreement to form Venetian Interactive, LLC, a Nevada limited liability company ("VI"). The purpose of VI is to provide management services, consulting services, financial services, intellectual property licensing services, and equipment to the online gaming industry in venues where such activity complies with all regulatory requirements, and to develop and operate Venetian branded casino sites.

To begin the process of developing online casino sites, engage vendors to construct the sites and obtain the required licenses in the regulated venues where such operations are authorized, VI began hiring employees in July 2002, including one employee from the Company who was subsequently terminated by VI in January 2003. The VI staff has forecast development and operational costs, which are updated as new information becomes available. A VI related entity, V.I. Ltd., was awarded both an Interactive Gaming License and an Electronic Betting Center License by the Alderney Gambling Control Commission. The licenses permit V.I. Ltd. to conduct Internet gaming activities under the name "Venetian Interactive." The Venetian Casino site is currently under development and is anticipated to go live before the end of the third quarter of 2003.

The current VI development budget estimates costs of $4,000 to bring the Venetian Casino to live status, and an additional $2,200 to support startup operations. Since beginning development in July 2002, VI has expensed all operating costs and capitalized third party software development costs incurred under a fixed price contract. As of March 31, 2003 development costs capitalized totaled $955. The VI operating agreement calls for SSP Gaming to fund two-thirds of the development costs and for Venetian to fund the remaining one-third of the costs. As of March 31, 2003, SSP had invested $800 in SSP Gaming, with those funds being invested in VI. In the three months ended March 31, 2003, SSP Gaming recorded $269 as loss from equity investee, which represents its pro rata portion of the VI net loss. This amount is included in non-operating expenses in the condensed consolidated statement of operations for the three months ended March 31, 2003, and as a reduction of the equity investment in affiliate.

The following represents summarized financial information for the VI:

BALANCE SHEET
MARCH 31, 2003
(UNAUDITED)

Current Assets	$ --	Current Liabilities	$ --
Site Development	955	Members' Equity	955
Total Assets	$ 955	Total Members' Equity & Liabilities	$ 955

STATEMENT OF OPERATIONS
THREE MONTHS ENDED MARCH 31, 2003
(UNAUDITED)

Selling, general & admin	$404
Net Loss	($404)

SSP Gaming's ownership interest decreases over time based upon the distribution of cashflow from VI. The operating agreement provides for SSP Gaming to receive two-thirds of the distributable cashflow until SSP Gaming receives the return of the full amount of capital invested in VI. After receiving the return of its invested capital, SSP Gaming is to receive the following portions of distributable cashflow: 50% of the first $2,000, 40% of the next $2,000 and 20% thereafter. Based upon forecasted operations, the ownership and distribution percentage held by SSP Gaming should be reduced to the 20% level within the first two full years of operation. Venetian and SSP Gaming each are to appoint three managers to oversee general management of VI, with an additional Manager appointed by mutual consent of the parties. Members owning at least 75% of the percentage interests of VI must approve defined major decisions. Based upon this forecasted scenario and the fact that Venetian will have voting control upon achieving forecasted operations, the Company deems control to be temporary, and therefore, the Company is accounting for SSP Gaming's interest in VI using the equity method, and is not consolidating VI operating results into the records of SSP Gaming. The operating agreement commits SSP Gaming to fund up to $2,000. As of March 31, 2003, SSP Gaming had funded $800.

SSP Gaming is currently in negotiations with financial sources to provide interim and long-term funding to satisfy the VI investment requirements. If the negotiations are successful, SSP Gaming would become a less than wholly-owned subsidiary. If the negotiations are not successful, SSP Gaming's percentage interest in the VI may be reduced and amounts invested by SSP in SSP Gaming will be at risk.

In January 2003, the FASB issued Interpretation 46, "Consolidation of Variable Interest Entities, and Interpretation of ARB No.51." Interpretation 46 addresses consolidation by business enterprises of variable interest entities which have one or both of the following characteristics: (1) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity; (2) the equity investors lack one or more of the following essential characteristics of a controlling financial interest: (a) the direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights, (b) the obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities, or (c) the right to receive the expected residual returns of the entity, if they occur, which is the compensation for the risk of absorbing expected losses. Interpretation 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains and interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Company is currently assessing the impact of Interpretation 46. The Company has, however, identified VI as an entity that may be required to be consolidated beginning in the third quarter of 2003. As of March 31, 2003, relative to VI the Company recorded a net investment in affiliate carried with other assets on its condensed consolidated balance sheet of approximately $283. The Company currently adjusts the carrying value of the investment in affiliate for any losses incurred by the entity through earnings. While this entity may be considered a variable interest entity, the Company has not yet determined if it will need to be consolidated.

(5) LONG-TERM DEBT

A summary of long-term debt follows:

	DECEMBER 31 2002
Secured convertible promissory notes with an interest rate of 10% per annum, interest payable quarterly, due December 31, 2005	$ 5,796
Secured convertible promissory notes with an interest rate of 30% per annum, interest payable quarterly, due November 14, 2003	500
Secured promissory note with an interest rate of 15% per annum, interest payable quarterly, due on or before December 31, 2005	--
Secured promissory notes at various interest rates from 15% to 60% per annum, interest payable quarterly, due in July 2003	--
Note payable related to restructuring of facilities leases due in installments on or before September 19, 2003, without interest	425
Promissory note due July 18, 2003 with interest at 6.75% per annum, interest payable at maturity	429
Promissory note due July 18, 2003 without interest	27
Note payable secured by interest in SSP Gaming, payable in monthly installments of $15,000, including interest at 6% per annum	196
Bay View Funding accounts receivable financing, discount rate of 1.25% of the receivables factored, interest payable upon payment of receivable ...	259
	7,632
Less unamortized value of warrants related to debt issued	4,806
Long-term debt, net of debt discounts of $4,806 at December 31, 2002 and $4,578 at March 31, 2003	2,826
Less current installments	2,826
Long-term debt, net of debt discounts of $4,806 at December 31, 2002 and $4,578 at March 31, 2003	$ --

The Company is in default on notes relative to the timely payment of obligations as they come due. The noteholders have not granted waivers of the default. This means the noteholders have the right to declare the Company in default and call all of their debt due and immediately payable. With the potential of the notes being called for payment, the Company classified the related debt as short-term debt in the condensed consolidated balance sheet as of December 31, 2002 and March 31, 2003.

SECURED SUBORDINATED CONVERTIBLE NOTES

On April 16, 2002, the Company raised $5,000 in cash through the issuance of $4,000 in 10% secured convertible promissory notes ("10% Convertible Notes"), $653 in unsecured non-convertible promissory notes ("Non-convertible Notes", $153 held by co-chairman Kris Shah and $500 held by co-chairman Marvin Winkler) and the pre-payment of a $500 note receivable due to the Company from Kris Shah, less a discount of $153 . In connection with the issuance of the 10% Convertible Notes, the Company incurred approximately $626 of issuance costs, which primarily consisted of amortization of warrant costs, investment banking fees and legal and other professional fees. These notes mature December 31, 2005 and bear interest at a rate of 10% per annum to be paid quarterly in cash, or at the Company's discretion, in common shares based upon the trailing 30-day average prior to the interest due date. The $4,000 in 10% Convertible Notes are convertible, in whole or in part, at the option of the holder into an aggregate of 4,000,000 shares of the Company's common stock at any time prior to maturity, at a conversion price of $1.00 per share, subject to adjustment under certain conditions, and have detachable warrants exercisable for three years to purchase up to an additional 2,400,000 shares at $1.30 per share, subject to adjustment under certain conditions. In conjunction with the closing of the sale of the 10% Convertible Notes, $1,750 of principal and $46 of accrued interest of the Subordinated Notes were exchanged for the 10% Convertible Notes and detachable warrants to purchase 1,077,667 shares at $1.30 per share.

The 10% Convertible Notes automatically convert prior to maturity if the Company's common shares trade at or above $3.00 per share with average volume of 100,000 shares per day for 20 consecutive trading days. The Company is subject to restrictive covenants related to the Convertible Notes and Non-convertible Notes that prevent the Company from pledging intellectual property as collateral. In June 2002, Kris Shah and Marvin Winkler exchanged their Non-convertible Notes, together with accrued interest, for 119,000 and 391,000 shares, respectively, of the Company's common stock based upon an above-market exchange price of $1.30 per common share.

The 10% Convertible Notes contain a beneficial conversion feature. When a convertible security contains a conversion price that is less than the quoted trading price of a company's common stock at the date of commitment, then the difference between the conversion price and the common stock price is called a beneficial conversion feature. Emerging Issues Task Force ("EITF") Issue No. 00-27, which amends EITF Issue No. 98-5, requires both recordation of a discount to recognize the intrinsic value of the conversion feature and amortization of the amount recorded over the term of the security.

Of the aggregate $5,796 in 10% Convertible Notes issued, the Company allocated approximately $2,644 to the value of the warrants and the remaining $3,152 to the beneficial conversion feature of the debt instruments, which were ascribed to these components on a pro rata basis of fair values calculated for the warrants using a Black Scholes valuation model and the intrinsic value of the beneficial conversion feature. These amounts have been recorded as discounts from the face value of the debt, with an equal increase to additional paid-in capital. Based on EITF No. 00-27, the governing accounting pronouncement, the discounts are being amortized over the period from the date of issuance to the maturity date of the notes. Amortization of the discounts totaled $1,107 for the year ended December 31, 2002.

In connection with issuances of the 10% Convertible Notes and warrants, the Company incurred approximately $741 of debt issuance costs comprised of legal and professional fees, in addition to $182 in value calculated for the 110,000 warrants issued to the underwriter in the transaction. These costs, which are included in other assets, are being amortized over the term of the 10% Convertible Notes. Amortization of these costs totaled $142 for the year ended December 31, 2002.

As of December 31, 2002, the Company was in violation of certain provisions of the 10% Convertible Notes. These violations are related to the Company's failure to pay debts and obligations as they become due. During the first quarter of 2003, the Company requested waivers for each of the aforementioned violations for past and for anticipated future events of default through June 30, 2003, but has not been granted such waivers. While waivers have been granted in the past, the holders of the 10% Convertible Notes have not granted such waivers and may declare the principal and unpaid interest immediately due and payable.

On April 16, 2002, with the exception of Mr. Winkler and Mr. Shah, the holders of the Subordinated Notes converted their Subordinated Notes into 10% Subordinated Notes . In June 2002, Mr. Winkler and Mr. Shah exchanged their Non-convertible Notes and their Subordinated Notes, together with accrued but unpaid interest, for shares of the Company's common stock at an above market per shares price of $1.30.

SECURED PROMISSORY NOTES

On January 22, 2003, the Company issued to Richard P. Kiphart a $500 promissory note that bears interest at a rate of 15% per year, with a minimum interest charge of $50. Accrued interest is payable quarterly in arrears beginning March 31, 2003. Principal and accrued but unpaid interest are due upon the earlier of December 31, 2005 and the Company's closing of a $5,000 or more in equity or debt financing. Mr. Kiphart has the right to exchange the principal and outstanding interest on the note for securities that the Company issues in such an equity or debt financing. If the Company does not repay the note prior to June 30, 2003, the Company will be required to issue to Mr. Kiphart a three-year warrant to purchase up to 125,000 shares of common stock at an exercise price of $1.30 per share and to register for resale the shares of common stock underlying the warrant. The note is secured by all of the unencumbered assets of SSP and its subsidiaries, including without limitation, intellectual property assets and any and all receivables due to the Company from SSP Gaming.

SECURED PROMISSORY NOTES

On March 18, 2003 and March 19, 2003, the Company issued to each of Crestview Capital Fund II, L.P. and Richard P. Kiphart $100 promissory notes that are secured by all of the Company's assets, including SSP Gaming and any

rights belonging to SSP Gaming. In addition, on March 28, 2003, Marvin Winkler agreed to pledge 350,000 shares of common stock held by JAW Financial, L.P., an entity controlled by Mr. Winkler, as security for the notes the Company issued on March 18, March 19 and March 28, 2003. The notes bear interest in an amount equal to the following percentage of the principal balance: 10%, if the notes are repaid within 30 days; 12%, if the note are repaid within 60 days; 15%, if the notes are repaid within 90 days; and 20%, if the notes are repaid at maturity. Principal and interest under the notes are due upon the sooner of 120 days from the dates of the notes and the Company's raising of at least $3,500 in equity or debt financing. Each note was accompanied by a five-year warrant to purchase up to 50,000 shares of common stock at an exercise price of $0.60. The Company will be required to issue to each holder warrants to purchase up to an additional 50,000 shares of common stock upon repayment of the notes, depending upon the date of repayment. The exercise price of the warrants and the number of shares underlying the warrants are subject to anti-dilution adjustments in connection with dividends or distributions of assets to holders of our common stock and subdivisions or combinations of our common stock. The warrants contain a cashless exercise provision. The shares of common stock underlying the warrants bear registration rights.

On March 28, 2003, the Company issued to Richard P. Kiphart, Crestview Capital Fund II, L.P., Kris Shah and Marvin Winkler promissory notes in the aggregate principal amount of $440, of which $180 was funded prior to March 31, 2003. The notes are secured by all of the Company's assets and the assets of SSP Gaming. In addition, Mr. Winkler agreed to pledge 350,000 shares of common stock held of record by JAW Financial, L.P. as security for the notes the Company issued on March 18, March 19 and March 28, 2003. The notes bear interest at the rate of 18% per year, with interest payable in cash monthly in arrears. The Company is required to use the proceeds of the notes only for payment of operating expenses. Principal and accrued but unpaid interest under the notes are due upon the sooner of July 26, 2003 and the Company's raising of $3,500 in equity or debt financing. The notes were accompanied by five-year warrants to purchase up to an aggregate of 230,000 shares of common stock. The exercise price of the warrants has not yet been fixed. The exercise price will be equal to the greater of $0.70 per share or the conversion price of securities the Company may issue in a proposed financing, not to exceed $1.30 per share. The exercise price of the warrants and the number of shares underlying the warrants will be subject to anti-dilution adjustments in connection with dividends or distributions of assets to holders of the Company's common stock and subdivisions or combinations of the Company's common stock. The warrants contain a cashless exercise provision.

NOTE PAYABLE FOR RESTRUCTURING FACILITY LEASE

In restructuring existing facility lease agreements, the Company agreed to pay $500 in installments without interest. The first payment of $75 was made as scheduled in December 2002, with additional payments scheduled of $100 due in March 2003, $150 due in June 2003 and a final payment of $175 due in September 2003. The Company has not made the $100 payment that was due in March 2003. (Note 10).

NOTE TO REPURCHASE INTEREST IN SSP GAMING

In October 2002, the Company entered into a mutual settlement and release regarding the default by a party that had contracted to finance the investment of SSP Gaming, a then wholly-owned subsidiary. The party defaulted under the financing agreement. To preserve the underlying business relationships, the Company and the other party executed an agreement whereby the Company repurchased the party's interest by issuing a note for $250, the amount invested by the party, and agreed to repay such amount by making an initial $40 payment and additional monthly payments of $15 per month, including interest at 6%, until paid in full. The note is secured by the Company's interest in SSP Gaming, and includes an acceleration clause whereby the then principal balance will be paid upon separate SSP Gaming financing of $2,000 or more.

SECURED CONVERTIBLE NOTE

In November 2002, the Company issued three one-year notes totaling $500, bearing interest at 30% per annum ("Secured Convertible Notes"), which have detachable warrants exercisable for five years to purchase up to an additional 500,000 shares (depending upon the date of repayment) at $1.30 per share subject to adjustment under certain conditions. SSP Gaming used the proceeds for investment into the joint venture with Venetian. After they have been outstanding for more than six months, the Secured Convertible Notes may be converted into the Company's common stock at a conversion price of $1.30 per share. The Secured Convertible Notes are due upon a Company financing of $3,500 or more, and are secured behind the Secured Subordinated Convertible Notes described above.

The fair value of the detachable warrants associated with the Secured Convertible Notes were estimated at $154 using the Black Scholes valuation model, based on the following assumptions: risk-free interest rate of 4.85%;

dividend yield of 0.00%; and volatility of 119%. The amounts have been recorded as discounts from the face value of the debt with an equal increase to additional paid-in capital. The relative fair value of the warrants have been allocated as a debt discount and is being amortized over the period from the date of issuance to the maturity date of the Secured Convertible Notes. Amortization of the discounts totaled $38 for the year ended December 31, 2002.

PROMISSORY NOTES

In April 2002, the Company issued two promissory notes due in July 2003 as payment for goods sold by Pulsar's network solutions business. The note, with an original balance of $679, bears interest at 6.75% per annum, with interest payable at maturity. The note in the amount of $27 does not bear interest.

In March 2003, the Company executed documents to settle the action brought against the Company by Integral Systems, Inc. As part of the settlement, the Company entered into a Forbearance Agreement dated March 12, 2003 with Integral Systems that would allow Integral Systems to enter a judgment against the Company should the Company default in the $20 per month payments due under the agreement. The Company also issued to Integral Systems a warrant exercisable for three years to purchase 150,000 at an exercise price of $1.30 per common share. Additionally, if the Company does not payoff the agreed to obligation, at a discount, by June 30, 2003, we agreed to place 400,000 of our common stock in a third party escrow as additional security for our performance under the Forbearance Agreement.

ACCOUNTS RECEIVABLE FINANCING

During November 2001, both the Company and its wholly-owned subsidiary, Pulsar, entered into separate financing agreements with Wells Fargo Business Credit, Inc. ("WFBC"), which provided for the factoring of accounts receivable. The agreements contained no limit on the dollar volume of receivable financing, but provided for WFBC's approval of credit limits for non-government customers. The agreements contained a discount rate of 1.25% of the gross receivable factored, which would be increased by .0625% per day for accounts that extended beyond the 30-day period from the date the account was purchased. At the time of purchase, terms called for WFBC to advance 85% of the gross receivable, with the balance remitted after collection of the invoice less the discount and any other charges. The combined agreements contained minimum quarterly fees and discounts totaling $63. In July 2002, the Company signed amendments to the financing agreements, which increased the discount rate charged to 1.95% of the gross receivable and revised the daily rate to .063% for accounts extending beyond 30 days. The minimum quarterly fees and discounts were also reduced to $15. All other terms and conditions remained. During the third quarter of 2002, the Company terminated the WFBC agreement related to Pulsar.

In October 2002, the Company terminated its remaining financing arrangement with WFBC and entered into a new financing arrangement with Bay View Funding ("BVF"). The new factoring agreement contains a maximum advance of $750, and was for an initial term of three months, which at the Company's option, is renewable for additional three-month periods, which has been renewed by the Company. The agreement contains a factoring fee, which is based on 1.25% of the gross face value of the purchased receivable for every thirty day period from the date of purchase by BVF until the invoice is paid in full. For invoices outstanding more than the thirty day period, a finance fee will be charged at the rate of .063% of the gross face value of the purchased receivable for every one day period beyond the 30th day from the original date of purchase. At the time of purchase, terms call for BVF to advance 85% of the gross receivable, with the balance remitted after collection of the invoice less the factoring and finance fee, if applicable. The agreement contains certain representations, warranties and covenants and requires a monthly minimum fee, including the factoring and financing fees, of .25% of the maximum advance of $750, or approximately $2 per month. The BVF states among other things that a default occurs if we do not pay debts as they become due or if maintain unreasonably small capital. We have notified BVF of our failure to make certain payments on a timely basis and have therefore recently requested a waiver of such default.

Gross receivables transferred to WFBC and WFBC/BVF amounted to $2,105 and $2,873 in 2001 and 2002, respectively. The Company is obligated to repurchase certain accounts receivable under the program and, therefore, the transaction does not qualify as a sale.

Factored receivables included in the accounts receivable balance as of December 31, 2002 and March 31, 2003 were $314 and $371, respectively

(6) RELATED PARTY TRANSACTIONS

KRDS REAL PROPERTY LEASE

In 1999, the primary shareholders of Litronic, Inc. formed KRDS, Inc., (KRDS) for the sole purpose of purchasing real estate property. KRDS's operations primarily consisted of a mortgage obligation, interest, depreciation and rental income from the Company related to the real estate property.

In February 2000, KRDS leased a building to the Company for its corporate headquarters. The lease expires in February 2007. The facility has an annual rent of approximately $429. In April 2002, the Company and KRDS entered into an agreement whereby upon 60 days' notice, either party may cancel the remaining balance of the facility lease with no future liability. Neither party has exercised the exit clause.

NOTE RECEIVABLE FROM SHAREHOLDER

The note receivable from shareholder consists of a note acquired as part of the BIZ acquisition. The $500 note was received by BIZ from the Company's co-chairman, Kris Shah, in conjunction with the issuance of BIZ common shares prior to the BIZ acquisition, and therefore was shown as a reduction of shareholders' equity until paid. The note had a stated interest rate of 5% per annum and was due on July 24, 2005. On April 12, 2002, in a transaction approved the Company's board of directors, Mr. Shah prepaid the note by paying to the Company $347, and the Company recorded a discount of $153 which was charged against income in the second quarter of 2002. The discount was computed based upon a present value calculation using a discount rate of 20%.

FACILITIES RELATED PARTY LEASING

During 2001, the Company arranged for the lease of two buildings approximating 63 square feet that were under construction and were subsequently completed. In October 2002, the Company restructured its lease obligations with landlord, Research Venture, LLC, for the two buildings located in the Spectrum area of Irvine, California. This restructuring and settlement provided the basis for revising the estimate of costs relative to resolving the liability incurred under the original leases. In 2001 the Company recorded an estimated liability of $2,171, which was net of then anticipated offsetting sublease income. As a result of the restructuring and settlement, the Company increased stockholders' equity by $1,650 through the issuance of common stock valued for financial reporting purposes at $956 and recorded a gain of $700 for the year ended December 31, 2002. The settlement required the Company to issue 959,323 shares of common stock, pay $500 in cash over a one-year period, cancel the lease on one building approximating 23 square feet, and take occupancy of the other building under a seven-year operating lease for the facility with approximately 40 square feet for an initial monthly rental rate of $55, plus common area costs beginning in December 2002. The monthly rental rate on the seven-year lease is scheduled to increase to $73, plus common area costs, at the beginning of the third year. The Company records rent expense on a straight-line basis. At the Company's option, a portion of the rental rate may be paid either in stock or in cash during the first two years of the lease under certain circumstances through conversion of a $360 subordinated convertible promissory note that the Company issued as prepaid rent. In August 2002, Mr. Shah surrendered his 25% ownership interest in the entity that owns the two buildings. At the time of surrendering his interest, the buildings were encumbered by one or more construction loans for which the lender required personal guarantees for renewal of the financing. As there was little, if any, equity in the project and Mr. Shah was unwilling to personally guarantee the loans, Mr. Shah chose to surrender his membership interest.

(7) CONCENTRATION OF CREDIT 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, 2002 and March 31, 2003, accounts receivable included $133 and $895, respectively, due from the U.S. government and related agencies. Sales to the U.S. government and related agencies accounted for 19% and 50% of total revenues for the three months ended March 31, 2002 and 2003, respectively.

The Company had sales that represented 25%, 12%, and 10% of the total revenues for the three months ended March 31, 2002. The Company had sales that represented 41%, 11%, and 10% of total revenues for the three months ended March 31, 2003. No other customers accounted for more than 10% of total Revenues during the three months ended March 31, 2002 and March 31, 2003. Trade accounts receivable totaled $165 and $1,148 from these major customers as of December 31, 2002 and March 31, 2003, respectively.

Some key components used in the manufacture of the Company's products can only be obtained from single sources.

(8) LOSS PER SHARE

The calculation of diluted net loss per share excludes potential common shares if the effect is anti-dilutive. Potential common shares are composed of incremental shares of common stock issuable upon the exercise of stock options and warrants. The following table sets forth potential common shares that were excluded from the diluted net loss per share calculation for the three months ended March 31, 2002 and 2003 because they are anti-dilutive for the periods indicated (shares in thousands):

	2002	2003

Warrants	394	4,586
Stock options	1,535	2,437
	1,929	7,023

(9) CONTINGENT LIABILITIES

Because 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 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 the direct expenses attributable to the contract, plus a percentage based upon overhead, material handling, and general administrative expenses. The overhead, material handling, and general administrative rates are estimates. Accordingly, if the actual rates as determined by the Defense Contract Audit Agency are 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.

The Company is involved from time to time in various litigation matters that arise in the ordinary course of business. The Company is unable to estimate a potential loss or potential range of loss associated with any of the pending claims described herein.

In November 2000, the Company executed an Alliance Agreement with Electronic Data Systems Corporation ("EDS") for the marketing of Company products to EDS customers ("Alliance"). The Alliance calls for a joint working relationship between the two companies, which is non-exclusive and has a term of ten (10) years. In February 2001, the Company and EDS executed an engagement letter for EDS to provide certain information technology and consulting services for both the Company's organizational structure and for a specific customer project.

On August 27, 2001, EDS and the Company executed a letter of intent and temporary working agreement whereby EDS supplied software and hardware for re-sale to Pulsar customers ("Pulsar Agreement"). Under the Pulsar Agreement, as of December 31, 2002, $1,049 remained outstanding and unpaid to EDS for purchases of hardware and software and is recorded in accounts payable in the consolidated balance sheet. The Company stopped doing business with EDS and as a result, we are subject to a monthly charge of $44. This amount will be charged against operations as incurred.

The Company and EDS executed a Master Services Agreement ("MSA") dated as of November 14, 2001, whereby beginning December 1, 2001 and ending December 31, 2006, the Company and EDS established a strategic teaming relationship to implement, sell and deliver a set of secure transaction processing offerings based upon a Trust Assurance Network ("TAN"). The MSA task order ("Task Order") requires that the Company to pay a monthly fee of $44 for account, test and lab management services beginning January 1, 2002. The obligations for these services could have terminated beginning January 1, 2003 by giving ninety (90) days prior written notice and payment of $400, or beginning January 1, 2004 by giving ninety (90) days prior written notice and payment of $200. Further, the Task Order provides for EDS to provide TAN hosting and implementation in exchange for an implementation fee of $45 payable October 1, 2002. Once installation of the production environment TAN is complete, EDS agrees to host the TAN in exchange for a monthly service fee of $59 for thirty-six (36) months and $60 per month for the remaining months of the MSA. The Company could have but did not delay implementation of the TAN by paying a fee of $200 prior to January 31, 2003. The Company may terminate the Task Order without cause by paying $400 after January 1, 2004 and providing ninety (90) days prior written notice. In the event the Company is unable to obtain intellectual property rights or licensing consents that may be required, if any, prior to January 1, 2003, and the parties determine there are no software alternatives, then after giving ninety (90) days prior written notice the Company may terminate the Task Order by paying $450. As of March 31, 2003, $353 remained outstanding and unpaid to EDS relative to the Task Order. The Company has not made any payments since December 31, 2002 relative to the balance outstanding as of that date.

The Company is currently in discussions with EDS regarding the restructuring of its relationship with EDS relative to the MSA and Task Order. EDS has not provided services as outlined in the agreements and there is no prospect of such services being required in the near future. However, the Company cannot predict the outcome of these discussions as they pertain to the fees associated with early termination of the contract, and portions of the charges may be incurred.

On January 16, 1998, G2 Resources Inc. ("G2") filed a complaint against Pulsar Data Systems, Inc. ("Pulsar") in the Fifteenth Judicial Circuit in 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. In August 2002 the case was moved from Division AF to Division AH of the Fifteenth Judicial Circuit in Palm Beach County Court, Civil Division. The Company believes that the claims made by G2 and Classical against Pulsar are without merit and intends to vigorously defend against these claims.

In May 2002, Contemporary Services Corporation filed an action against the Company alleging breach of contract, fraud, negligent misrepresentation and violation of California Corporations Code section 25400. The action relates to a term sheet agreement that the Company entered into with the plaintiff in October 2001 in connection with a potential strategic relationship between the plaintiff and the Company. The Company filed an answer and cross-complaint. While the Company continued to believe we would prevail at trial, in February 2003, we reached an agreement to settle the case for less than $50,000, which will be jointly paid by the Company's insurance carrier and the Company. The Company's estimated portion of the settlement has been accrued in the results of the year ended December 31, 2002.

In July 2002, Synnex Technology ("Synnex") filed a lawsuit against the Company in the Superior Court of Orange County, alleging that the Company failed to pay $120,986 for products purchased by us for resale. The Company and Synnex agreed to settle the matter by payment of ten equal installments of $12,099, pursuant to a stipulation for entry of judgment that is to be held by counsel for Synnex and not filed with the court absent breach by the Company. The last payment is due on or before June 9, 2003, at which time the action will be dismissed.

In restructuring existing facility lease agreements, the Company agreed to pay $500 in installments without interest. The first payment of $75 was made as scheduled in December 2002, with additional payments scheduled of $100 due in March 2003, $150 due in June 2003 and a final payment of $175 due in September 2003. The Company has not made the full $100 payment that was due in March 2003,

which means the Company is currently in default under the settlement facilities settlement agreement and the landlord could enter a stipulated judgment. Also, if we are delisted from The Nasdaq National Market, Research Venture, LLC would be entitled to entry of a stipulated judgment against the Company in the maximum aggregate amount of $3,100, less consideration the Company pays prior to any entry of the judgment.

During the second quarter of 2001 Microsoft notified the Company regarding the alleged sales of unlicensed copies of Microsoft Office. The software in question was purchased from a major computer hardware manufacturer and was resold to one of the Company's customers in a package that included both hardware and software. The Company is currently investigating the matter, and does not anticipate that the outcome will have a material impact on its results of operations, financial condition or liquidity.

The Company currently holds multiple contracts with the federal government for the resale of network deployment products. In particular, three of these contracts permit the Company to provide goods and services to various federal government agencies. An administrative agency recently informed the Company that one of the contracts would not be renewed unless purchase activity was conducted under the contract. The Company is negotiating with a party for the sale of the contract. It is possible the other contracts may not be renewed or may be cancelled by the federal government due to the Company's inability to perform as required under the contracts.

The Company is currently in negotiations with the various government agencies that it contracts with to initiate and implement the corrective measures necessary to insure the uninterrupted continuity of the contracts. Although there is no assurance that the contracts will be renewed or that they will not be cancelled, the Company has reason to believe they will be renewed. However, if the contracts are not renewed or if they are cancelled, then a significant portion of the Company's revenues will be lost which would have a significant impact on the Company's financial condition, results of operations and liquidity.

As of March 31, 2003, accounts payable totaled $4,405. Of that amount, $2,987 is aged at least 90 days. Unless payment is made or satisfactory payment plans agreed to, it is likely that the vendors will eventually initiate legal actions to collect the amounts owed to them. Currently, the Company has the intent to satisfy its vendor obligations through a combination of payment negotiations, which include extending the terms over time, partial payments of the obligations due as payment in full and converting obligations to long term notes payable.

In late 2002 and early 2003, the Company received letters from the staff of the Securities and Exchange Commission ("SEC Staff") making certain comments and inquiries regarding the Company's Form 10-K for the year ended December 31, 2001 and Form 10-Q's for the quarters ended March 31, 2002, June 30, 2002 and September 30, 2002. The Company submitted responses to all of the comments of the SEC Staff. The SEC Staff have orally indicated that all of their questions have been answered and that pending review of the Company's Form 10-K for the year ended December 31, 2002, their comments have been fully addressed. While the final effect of this inquiry cannot be determined until the SEC Staff has reviewed the Company's Form 10-K/A for the year ended December 31, 2002, the Company currently does not anticipate any material adjustments to the consolidated financial statements reported for the periods involved.

(10) SUBSEQUENT EVENTS

On April 1, 2003, the Company issued to Richard P. Kiphart a $240,000 promissory note that bears interest at a rate of 18% per annum. Principal and accrued but unpaid interest are due upon the earliest of July 31, 2003 or the Company obtaining $3.5 million in equity or debt financing. The note also contains a provision to issue a warrant to purchase 120,000 shares of common stock at an exercise price equal to the greater of $.70 or the conversion price of a proposed financing, not to exceed $1.30 per share.

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

The following discussion and analysis should be read in conjunction with our consolidated financial statements and notes to financial statements included elsewhere in this report. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. We intend that the forward-looking statements be subject to the safe harbors created by those sections.

The forward-looking statements generally include our management's plans and objectives for future operations, including plans, objectives and expectations relating to our future economic performance, business prospects, revenues, working capital, liquidity, ability to obtain financing, generation of income and actions of secured parties not to foreclose on our assets. The forward-looking statements may also relate to our current beliefs regarding revenues we might earn if we are successful in implementing our business strategies. The forward-looking statements generally can be identified by the use of the words "believe," "intend," "plan," "expect," "forecast," "project," "may," "should," "could," "seek," "pro forma," "estimates," "continues," "anticipate" and similar words. The forward-looking statements and associated risks may include, relate to, or be qualified by other important factors, including, without limitation:

- anticipated trends in our financial condition and results of operations (including expected changes in our gross margin and general, administrative and selling expenses);

- the projected growth or contraction in the information security products and services markets in which we operate;

- our ability to finance our working capital and other cash requirements;

- our business strategy for expanding our presence in the Internet data security market; and

- our ability to distinguish ourselves from our current and future competitors.

We do not undertake to update, revise or correct any forward-looking statements. The forward-looking statements are based largely on our current expectations and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. Important factors to consider in evaluating forward-looking statements include:

- the shortage of reliable market data regarding the Internet data security market;

- changes in external competitive market factors or in our internal budgeting process that might impact trends in our results of operations;

- changes in our business strategy or an inability to execute our strategy due to unanticipated changes in the contract support services markets; and

- various other factors that may prevent us from competing successfully in the marketplace.

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. Before deciding to buy or maintain a position in our common stock, you should carefully review and consider the various disclosures we made in this report, and in our other materials filed with the Securities and Exchange Commission that discuss our business in greater detail and that disclose various risks, uncertainties and other factors that may affect our business, results of operations or financial condition. In particular, you should review the "Risk Factors" section of this report.

Any of the factors described above or in the "Risk Factors" section of this report could cause our financial results, including our net income (loss) or growth in net income (loss) to differ materially from prior results, which in turn could, among other things, cause the price of our common stock to fluctuate substantially.

OVERVIEW

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 PKI, which is the standard technology for securing Internet-based commerce and communications. In addition, Pulsar, one of our wholly-owned subsidiaries, is a computer and networking product reseller that focused 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. Due to the intensive capital requirements and low margin returns, subsequent to December 31, 2002, we decided to exit the Pulsar line of business and as a result, we are not accepting new orders and we are currently in the final stages of completing a wind down of the Pulsar operations.

Before 1990, we were solely a provider of electronic interconnect products to government and commercial entities. In 1990, we formed our data security division, which is the basis of our operations today. The data security division was engaged primarily in research and development until 1993, when it began to generate meaningful revenue. In September 1997, we sold our Intercon division, which consisted of the assets relating to our interconnect operations, for cash to Allied Signal Inc., an unrelated publicly traded company.

Our lack of liquidity and shortage of working capital has limited our operations. If we do not raise additional capital within the next several months, we face the prospect of filing for protection to reorganize our debts and financial obligations. To date, creditors and vendors generally have cooperated with us, which has given us time to reduce our operating expenses and realize increases in revenues in our core business. We have done both in the last two quarters of our operations. If we are unable to make payments on the extended term agreements or pay our current vendors, or if holders of our notes declare us in default and call their notes, we would not have the financial resources to satisfy all of these obligations. The results of our operations and liquidity discussions in this section of this report contain further comments on our limited resources and our dependency on continued creditor cooperation for us to continue our operations.

To meet our existing obligations, we will need to continue improving our sales and continue controlling our operating expenses. We will also require time to realize the financial benefits of improved operating results together with the continued cooperation of our creditors. We are in discussions with several financing sources regarding additional capital and have executed a term sheet for a minimum financing of $10 million that would have a dilutive effect. However, the investors may fail to provide the financing or may wish to change the terms called for in the term sheet. There is no assurance that the investors will close the transaction, or if the transaction does close, that it will be on the terms outlined in the executed term sheet. If this proposed transaction does not close, we will seek other sources of funding, explore the sale of product lines or intellectual property rights, or evaluate merger partners. We may be forced to sell company assets or merge at a price below what we might otherwise realize. We are at a critical juncture for the continued survival of our company.

CRITICAL ACCOUNTING POLICIES

This "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this report discusses our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements.

We based our estimates and judgments on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe the following critical accounting policies, among others, affect significant judgments and estimates used in the preparation of our consolidated financial statements. For a detailed discussion of the application of these and other accounting policies, see the notes to our condensed consolidated financial statements included in this report.

- REVENUE RECOGNITION. We recognize revenue from product sales, including hardware (with embedded software) and software, upon shipment unless contract terms call for a later date. Revenue from network deployment products is recognized upon transfer of title, generally upon delivery. Revenue from the Company's high assurance token contract is recognized under the cost-to-cost method of percentage of completion. We record an allowance to cover estimated warranty costs in cost of sales. Customers do not have the right of return except for product defects, and product sales are not contingent upon customer testing, approval and/or acceptance. The costs of providing post contract customer support are not significant. Revenue under service and development contracts is recorded as services are rendered. Revenue from time and material, network deployment service contracts is recognized on the basis of man-hours incurred plus other reimbursable contract costs incurred during the period.

- ALLOWANCE FOR DOUBTFUL ACCOUNTS. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make payments for services. We analyze accounts receivable, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

- VALUATION OF GOODWILL AND OTHER INTANGIBLE ASSETS. We assess the impairment of goodwill and other intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable, at least annually. Factors we consider important which could trigger an impairment review include significant underperformance relative to expected historical or projected future operating results, significant changes in the manner of our use of the acquired assets or the strategy for our overall business, and significant negative industry or economic trends. The net carrying value of goodwill and other intangible assets not recoverable is reduced to fair value. In accordance with Statement of Financial Accounting Standards Nos. 141 and 142, goodwill and other intangible assets will be reviewed for impairment at least annually.

We accounted for our August 2001 acquisition of BIZ as a purchase. Under the purchase method of accounting, the purchase price was allocated to the fair value of the identifiable tangible and intangible assets and liabilities that we acquired from BIZ. The excess of the purchase price over BIZ's tangible net assets resulted in goodwill and other intangible assets.

In July 2001, the FASB issued Statement No. 142, "Goodwill and Other Intangible Assets." We adopted this statement effective January 1, 2002. Under this statement, goodwill is no longer amortized and is subject to annual testing for impairment beginning January 1, 2002. The provisions of this statement require us to perform a two-step test to assess goodwill for impairment. In the first step, we compare the fair value of each reporting unit to its carrying value. If the fair value exceeds the carrying value, then goodwill is not impaired and we need not proceed to the second step. If the carrying value of a reporting unit exceeds its fair value, then we must determine and compare the implied fair value of the reporting unit's goodwill to the carrying value of its goodwill. If the carrying value of the reporting unit's goodwill exceeds its implied fair value, then we will record an impairment loss in the amount of the excess. With regard to a reporting unit's goodwill balance at January 1, 2002, we were required to perform the first step of the annual testing for impairment by June 30, 2002. If the results of that step indicated that goodwill may be impaired, we would then be required to complete the second step as soon as possible, but no later than December 31, 2002.

As of December 31, 2001, we assessed the fair value of our two reporting units by comparing the book value of our equity interests to the fair value of our equity interests based upon the terms of a financing we completed in April 2002. Given consideration of this comparison and relevant factors, we concluded that as of December 31, 2001, an impairment write-down of approximately $36.3 million was required. We reviewed the assumptions used in the original analysis performed as of December 31, 2001 for dates of March 31, 2002, June 30, 2002, and September 30, 2002 and concluded that such analyses continued to be adequate and no additional write-down was required.

We later performed an assessment of our Information Security Products and Services reporting unit. The assessment was performed to measure the fair value of the remaining goodwill as of December 31, 2002 using a multi-period

discounted cash flow method. The results of the analysis indicated that no additional write-down was required as of December 31, 2002.

We are required to perform tests for impairment at least annually. Tests for impairment between annual tests may be required if events occur or circumstances change that would more likely than not reduce the fair value of the net carrying amount no such events have occurred as of March 31. 2003. We cannot predict whether or when there will be additional impairment charges, or the amount of any such charges. If the charges are significant, they could cause the market price of our common stock to decline.

RESULTS OF OPERATIONS - COMPARISON OF THREE MONTHS ENDED MARCH 31, 2002 AND 2003

The following table sets forth the percentage of total 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 and notes included elsewhere in this report.

Percentage of Total Revenues

	Three Months Ended March 31,	
	2002	2003

Revenues:		
Product	62.0%	31.2%
Service	31.1	32.2
License	6.9	36.6
Total revenues	100.0	100.0
Cost of sales:		
Product	29.1	9.0
Service	13.3	10.2
License	3.1	13.0
Total cost of sales	45.4	32.2
Gross Margin	54.6	67.8
Operating expenses:		
Selling, general and administrative	119.6	46.9
Research and development	94.9	34.6
Research and development - Wave Systems Corp	48.3	--
Amortization of intangibles	1.3	--
Total operating expenses	264.0	81.5
Operating income (loss)	(209.5)	(13.7)
Non-operating expenses:		
Unrealized loss (gain) on trading securities	--	0.5
Interest expense, net	7.2	8.4
Non-cash interest and financing expense	--	15.1
Equity loss from investee	--	8.2
Other expense, net	0.8	--
Total non-operating expenses	8.1	32.2
Loss before income taxes	(217.6)	(45.8)
Provision for income taxes	0.2	--
Loss from continuing operations	(217.8)	(45.8)
Loss from discontinued operations	15.4	0.3
Loss on disposal of discontinued operations	--	2.9
Net loss	(232.5)%	(49.1)%

TOTAL REVENUES. Total revenues increased 91% from $1.7 million during the three months ended March 31, 2002 to $3.3 million during the three months ended March 31, 2003. The change was attributable to an increase in service revenues of $524,000 and an increase in license revenues of $1.1 million, which was offset by a decrease in product revenues of $41,000. We expect total revenues to continue to increase during the remainder of 2003.

During the three months ended March 31, 2002, we derived 25% of our revenues from sales to General Dynamics. During the three months ended March 31, 2003, we derived 41% of our revenues from sales to the National Security Agency ("NSA"). Sales to government agencies accounted for approximately 19% and 50% of our sales during the three months ended March 31, 2002 and 2003, respectively. During 2003, we expect or revenues to be heavily concentrated with a few key customers.

PRODUCT REVENUES. Product revenues decreased 4% or $41,000 during the three months ended March 31, 2003 as compared to the three months ended March 31, 2002. The decrease was primarily attributable to our inability to fulfill certain orders due to the lack of sufficient capital required to purchase products from vendors. We expect modest increases in product revenues during the remainder of 2003.

SERVICE REVENUES. Service revenues increased by $524,000, or 98% from $537,000 during the three months ended March 31, 2002 to $1.1 million during the three months ended March 31, 2003. The increase was primarily attributable to a $517,000 increase in revenues associated with a new contract for the development of a High Assurance Token ("HAT") for the Department of Defense ("DoD") combined with other general service contracts of $147,000 offset by a decrease of $140,000 under the subcontract with General Dynamics. We expect service revenues to continue to increase during 2003 as a result of newly signed and existing service contracts.

LICENSE REVENUES. License revenues increased by $1.1 million, or 919% from $119,000 during the three months ended March 31, 2002 to $1.2 million during the three months ended March 31, 2003. The increase was primarily attributable to additional sales of $96,000 under our contract with General Dynamics, sales to the DoD under the HAT development project of $721,000 and additional sales to other customers of $274,000. We expect licensing revenues to continue to increase during 2003 based on incremental sales under the Common Access Card ("CAC") program coupled with increased sales of our Profile Manager(TM) ("PM") software.

PRODUCT GROSS MARGIN. Product gross margin increased as a percentage of net product revenues from 53% during the three months ended March 31, 2002 to 71% during the three months ended March 31, 2003. The increase was primarily attributable to reduced costs of products sold during the quarter. We expect product gross margins to remain at similar levels for the remainder of 2003.

SERVICE GROSS MARGIN. Service gross margin increased as a percentage of net service revenues from 57% during the three months ended March 31, 2002 to 68% during the three months ended March 31, 2003. The margin percentage increase was primarily attributable to increases in labor rates charged to customers. We expect service gross margin percentages to decrease somewhat in 2003 due to the addition of a lower margin government contract to add a Java operating system to our USA Card (TM), also referred to as the High Assurance Token development (HAT) project. We also expect that certain compensation costs formerly considered research and development expense prior to 2003 would be included as cost of sales in 2003 due to the aforementioned development contract.

LICENSE GROSS MARGIN. License gross margin increased as a percentage of net license revenues from 55% during the three months ended March 31, 2002 to 65% during the three months ended March 31, 2003. The margin percentage increase was primarily attributable to increases in software sales that have lower cost of sales. We expect the annual license gross margin percentages during 2003 to remain at 2002 levels based on our projected sales mix for 2003.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative ("S,G&A") expenses decreased by $518,000, or 25% from $2.1 million during the three months ended March 31, 2002 to $1.5 million during the three months ended March 31, 2003. The decrease was primarily attributable to reductions in force, a reduction in compensation levels, reductions in professional fees and a reduction in general insurance expense during the three months ended March 31, 2003. As a percentage of total revenues, S,G&A expenses decreased from 120% during the three months ended March 31, 2002 to 47% during the three months ended March 31, 2003. The percentage decrease was the result of our success in increasing total revenues by $1.6 million despite reducing S,G&A expenses by $518,000.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development ("R&D") expenses decreased$496,000, or 25% from $1.6 million during the three months ended March 31, 2002 to $1.1 million during the three months ended March 31, 2003. The decrease was primarily attributable to reductions in force and compensation levels during the three months ended March 31, 2003. As a percentage of total revenues, R&D expenses decreased from 95% during the three months ended March 31, 2002 to 35% during the three months ended March 31, 2003.

WAVE SYSTEMS CORP. - RESEARCH AND DEVELOPMENT EXPENSES. Effective August 31, 2002, we terminated a development contract with Wave Systems Corp. By canceling the development contract, we no longer incur the monthly development charge of $277,778. This caused a reduction of $833,334 in expenses during the three months ended March 31, 2003 as compared to the three months ended March 31, 2002

AMORTIZATION OF INTANGIBLES. Amortization of intangibles ceased with the adoption of Statement No. 142 "Goodwill and other intangibles".

UNREALIZED LOSS ON TRADING SECURITIES. There was an unrealized loss on trading securities during the three months ended March 31, 2003 of $15,000, which pertained to our holding in Wave Systems Corp. We expect to sell the remaining shares of Wave during the remainder of 2003.

INTEREST EXPENSE, NET. Interest expense, net increased from $125,000 during the three months ended March 31, 2002 to $277,000 during the three months ended March 31, 2003. The increase was primarily attributable to the increase in accrued interest from notes payable and interest expense related to settlement with certain vendors. The increase in interest expense is expected to continue to increase until the level of debt is reduced.

LOSS FROM DISCONTINUED OPERATIONS AND LOSS ON DISPOSAL OF DISCONTINUED OPERATIONS. Loss from Discontinued operations decreased from $265,000 for the three months ended March 31, 2002 to $106,000 for the three months ended March 31, 2003. During the first quarter of 2003, management decided to discontinue the Pulsar operations and to focus solely on the core business of information security products and services. We expect minimal to no further losses from discontinued operations for the remainder of 2003.

NON-CASH INTEREST AND FINANCING EXPENSE. Non-cash interest and financing expense was $500,000 during the three months ended March 31, 2003 and related to the convertible secured promissory notes issued on April 16, 2002, and amortization of other debt issue costs. There was no non-cash interest and financing expense during the three months ended March 31, 2002. Based on the current outstanding notes, we expect non-cash interest and financing expense to remain at or above the first quarter levels for the remainder of 2003.

The convertible secured promissory notes issued on April 16 contain a beneficial conversion feature. When a convertible security contains a conversion price that is less than quoted trading price of a company's common stock at the date of commitment, then the difference between the conversion price and the common stock price is called a beneficial conversion feature. Emerging Issues Task Force ("EITF") Issue No. 00-27, which revises EITF Issue No. 98-5, requires both the recording of a discount to recognize the computed value of the conversion feature and amortization of the amount recorded over the term of the security.

Of the aggregate $5.8 million convertible secured promissory notes issued, we allocated approximately $2.6 million to the value of the warrants and the remaining $3.2 million to the beneficial conversion feature of the debt instruments, which were ascribed to these components on a pro-rata basis of fair values calculated for the warrants using a Black Scholes valuation model and the intrinsic value of the beneficial conversion feature. The amounts have been recorded as discounts from the face value of the debt with an equal increase to additional paid-in capital. Based on EITF No. 00-27, the governing accounting pronouncement, the discounts are being amortized over the period from the date of issuance to the maturity date of the notes. Accretion of the discounts totaled $391,000 for the quarter ended March 31, 2003.

In connection with issuances of the April 16 convertible secured promissory notes and warrants, we incurred approximately $741,000 of debt issuance costs comprised of legal and professional fees, in addition to $183,000 in value calculated for the 110,000 warrants issued to the placement agent in the transaction. These costs, which are included in other assets, are being amortized over the term of the convertible secured promissory notes. Amortization of these costs totaled $43,000 for the quarter ended March 31, 2003.

OTHER EXPENSE, NET. Other expense, net, was $14,000 during the three months ended March 31, 2002. There was no other expense, net during the three months ended March 31, 2003.

INCOME TAXES. Tax expense for the three months ended March 31, 2002 was $3,000. There was no tax expense for the three months ended March 31, 2003. The tax expense for the three month period ended March 31, 2002, related to minimum franchise taxes for the State of California.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2003, we had a working capital deficit of $6.9 million. We incurred a net loss of $1.6 million for the three months then ended. We expect to continue to incur additional losses in the current year. Given our March 31, 2003 cash balance of $289,000 and the projected operating cash requirements, we anticipate that existing capital resources will not be adequate to satisfy cash flow requirements through December 31, 2003. We will require additional funding. Our cash flow estimates are based upon achieving certain levels of sales, reductions in operating expenses, liquidity available under our accounts receivable financing, as well as additional debt or equity financing. Should sales be less than forecast, expenses be higher than forecast or the liquidity not be available under the accounts receivable financing or through additional financings of debt and/or equity, we will not have adequate resources to fund our operations. We will continue to seek other sources of funding, explore the sale of product lines or intellectual property rights, or evaluate merger partners.

In October 2002, we executed a new factoring agreement with Bay View Funding ("BVF"). During the quarter ended March 31, 2003, we incurred defaults for other than payment of principal or interest under both our accounts receivable financing with BVF and the long-term convertible notes. We have requested waivers from the holders of the notes, but the noteholders did not grant such waivers. This means the noteholders have the right to declare us in default and call all of their debt due and immediately payable. With the potential of the notes being called for payment, we re-classified what would have otherwise been long-term debt as short-term debt in the consolidated balance sheets as of March 31, 2003 and December 31, 2002. The BVF agreement states among other things that a default occurs if we are generally not paying debts as they become due or if we are left with unreasonably small capital. We have notified BVF of our failure to make certain payments on a timely basis and have therefore requested a waiver of such default.

Cash used in operations for the three months ended March 31, 2003 was $1.1 million compared to cash used in operations during the three months ended March 31, 2002 of $1.8 million. The decrease in cash used in operations was primarily attributable to a reduction in operating loss for the quarter and a smaller reduction of accounts payable. The decreased uses of cash were partially offset by an increase in accounts receivable. At March 31, 2003 the balance in accounts receivable was $2.1 million and the balance in accounts payable was $4.4 million, of which approximately $3.0 million has aged 90 days or more. As of March 31, 2003, $371,000 in accounts receivable was factored under our arrangement with BVF. As a result, significant reductions in accounts receivable will not be available to provide us with cash to meet our future cash needs and we will need to continue using cash to reduce accounts payable. We expect to continue to use cash in operations due to existing current liabilities that will need to be paid in 2003.

Cash used in investing activities for the three months ended March 31, 2003 was $103,000 compared to cash provided by investing activities during the three months ended March 31, 2002 of $915,000. The cash used in investing activities during the three months ended March 31, 2003 was primarily attributable to a $100,000 capital contribution to SSP Gaming. Cash provided by investing activities during the three months ended March 31, 2002 was primarily attributable to proceeds from the sale of trading securities of $917,000. The market value of trading securities held at March 31, 2003 is approximately $60,000. We anticipate that these trading securities will all be sold prior to December 31, 2003 and thereafter will no longer be available to provide us with additional cash to meet our future cash needs. We do not expect any significant increases or decreases from cash provided by or used in investing activities in 2003.

Cash provided by financing activities for the three months ended March 31, 2003 was $881,000 compared to cash used in financing activities during the three months ended March 31, 2002 of $1.7 million. The cash provided by financing activities during the three months ended March 31, 2003 was primarily attributable to additional borrowings of $880,000 required for working capital issued under notes payable. We expect to have increases in cash provided by financing activities in 2003 due to our efforts to obtain additional working capital.

As of March 31, 2003, the balance of trading securities decreased from $76,000 as of December 31, 2002 to $60,000 due to a decline in the market value of Wave common shares, and recognizing approximately $16,000 in losses from this decline . As of March 31, 2003, accounts receivable totaled $2.1 million as compared to $1.6 million as of December 31, 2002. This increase was mainly attributable to increased revenues for the quarter primarily associated with the High Assurance Token development project for the NSA. Accounts payable remained at the same level of $4.4 million as of March 31, 2003 and December 31, 2002. Accrued liabilities increased from $1.3 million at December 31, 2002, to $1.5 million as of March 31, 2003. This increase in accrued liabilities was mainly attributable to increases in accruals for deferred compensation and interest expense. An accrual was also recorded for the remaining rent payments associated with the former Pulsar operations in the amount of $97,000. We anticipate the trend of lower accounts receivable, accounts payable and accrued liabilities to continue until sales increase and the increased operations require an expanded workforce.

We have experienced net losses and negative cash flows from operations for the last several years, and as of March 31, 2003, had an accumulated deficit of $109.7 million. We have financed our past operations principally through the issuance of common stock in a public offering and the issuance of convertible debt. The net proceeds from our public offering were approximately $35.3 million. The proceeds from the issuance of convertible debt for the year ended December 31, 2002 were $4.8 million. We raised $880,000 through the issuance of secured convertible promissory notes in January and March 2003. We have also issued notes and common stock to settle or restructure previously executed agreements.

Over the past three years, we have spent substantial sums on R&D activities. During that time period, we incurred substantial losses from continuing operations. While we believe the R&D expenditures created significant future revenue producing opportunities, some of the related products are just entering production. We are currently involved in sales pursuits relative to these products that, if successful, will generate significant revenues. However, unless we receive orders for these new products and receive significant financing, we can no longer support the current level of R&D activity. While we have reduced our staffing levels, if sales fail to materialize, we will need to further reduce expenses through additional reductions in staff.

The combination of reduced accounts receivable financing availability and the unwillingness of primary vendors of our network deployment business to sell additional product to us on open account because of significant past due amounts caused a substantial reduction in the sales and related cost of sales during the year ended December 31, 2002, which in turn reduced cash flow. The reduced cash flow impaired our ability to meet vendor commitments as they became due. Due to the intensive capital requirements and low margin returns, during the quarter, we decided to exit the Pulsar line of business and as a result, we are not accepting new orders and we are currently in the final stages of completing a wind down of the Pulsar operations.

In November 2000, we executed an Alliance Agreement with EDS for the marketing of our products to EDS customers. This alliance calls for a joint working relationship between the two companies, is non-exclusive and has a term of ten years. On August 27, 2001, EDS and we executed a letter of intent and temporary working agreement whereby EDS supplied software and hardware for re-sale to Pulsar customers. Under this agreement, as of December 31, 2002, $1.0 million remained outstanding and unpaid to EDS for purchases of hardware and software. EDS and we executed a Master Services Agreement dated as of November 14, 2001 ("MSA") whereby beginning December 1, 2001 and ending December 31, 2006, EDS and we established a strategic teaming relationship to implement, sell and deliver a set of secure transaction processing offerings based upon a trust assurance network ("TAN"). The MSA task order requires that we pay a monthly fee of $44,000 for account, test and lab management services beginning January 1, 2002. The obligations for these services could have been terminated beginning January 1, 2003 by giving 90 days prior written notice and payment of $400,000, or beginning January 1, 2004 by giving 90 days prior written notice and payment of $200,000. Further, the MSA task order provides for EDS to provide TAN hosting and implementation in exchange for an implementation fee of $45,000 payable October 1, 2002. Once installation of the production environment TAN is complete, EDS agrees to host the TAN in exchange for a monthly service fee of $59,000 for 36 months and $60,000 per month for the remaining months of the MSA. We could have but did not delay implementation of the TAN by paying a fee of $200 prior to January 31, 2003. We may terminate the MSA task order without cause by paying $400,000 after January 1, 2004 and providing 90 days prior written notice. In the event the Company is unable to obtain intellectual property rights or licensing consents that may be required, if any, prior to January 1, 2003, and the parties determine there are no software alternatives, then after giving ninety (90) days prior written notice the Company may terminate the Task Order by paying $450,000. We are expensing the $45,000 monthly fee as it is being incurred.

During 2001, we arranged for the lease of two buildings approximating 63,000 square feet that were under construction and were subsequently completed in the Spectrum area of Irvine, California from an entity that was partially

owned by our co-chairman, Mr. Shah. On one building totaling approximately 23,000 square feet, we sublet one-half of the building on terms and conditions matching the underlying lease. The sublease was with a related party company owned by our co-chairman, Mr. Winkler. While that company made a lease deposit, it did not make any monthly rent payments. In October 2002, we restructured our lease obligations with our landlord, Research Venture, LLC, for the two buildings. This restructuring and settlement revised the estimate of anticipated costs relative to the disposition of one of the building leases that was recorded in 2001 in the amount of $2.2 million, which was net of anticipated offsetting sublease income. As a result of the restructuring and settlement, we increased stockholders' equity by $1.7 million through the issuance of common stock valued for financial reporting purposes at $956,000 and recorded a gain of $700,000 for the year ended December 31, 2002. The settlement required us to issue 959,323 shares of common stock, pay $500,000 in cash over a one-year period, cancel the lease on one building approximating 23,000 square feet, and take occupancy of the other building under a seven-year operating lease for the facility with approximately 40,000 square feet for an initial monthly rental rate of $55,000 plus common area costs beginning in December 2002. The monthly rental rate on the seven-year lease is scheduled to increase to $73,000 plus common area costs, at the beginning of the third year. We record rent expense on a straight-line basis. At our option, a portion of the rental rate may be paid either in stock or in cash during the first two years of the lease under certain circumstances through conversion of a $360,000 subordinated convertible promissory note that we issued as prepaid rent. In August 2002, Mr. Shah surrendered his 25% ownership interest in the entity that owns the two buildings. At the time of surrendering his interest, the buildings were encumbered by one or more construction loans for which the lender required personal guarantees for renewal of the financing. As there was little, if any, equity in the project and Mr. Shah was unwilling to personally guarantee the loans, Mr. Shah chose to surrender his membership interest. As of March 31, 2003 the Company missed a portion of the payment due in March, 2003 and therefore maybe contingently liable for the full amount of the stipulated judgment.

In October 2002, we terminated our accounts receivable financing arrangement with Wells Fargo Business Credit, Inc. and entered into a factoring agreement with Bay View Funding ("BVF"). The new factoring agreement contains a maximum advance of $750,000, was for an initial term of three months, and automatically renews for successive three-month periods. We may terminate this agreement at any time without the payment of any early termination fees, provided that we give at least thirty days written notice to BVF prior to the end of any renewal term. The agreement contains a factoring fee, which is based on 1.25% of the gross face value of the purchased receivable for every 30-day period from the date of purchase by BVF until the invoice is paid in full. For invoices outstanding more than the 30-day period, a finance fee will be charged at the rate of .063% of the gross face value of the purchased receivable for every one day period beyond the 30th day from the original date of purchase. At the time of purchase, terms call for BVF to advance 85% of the gross receivable, with the balance remitted after collection of the invoice less the factoring and finance fee, if applicable. The agreement contains representations, warranties, and covenants and requires a monthly minimum fee, including the factoring and financing fees, of .25% of the maximum advance of $750,000 or approximately $2,000 per month. The agreement states among other things that a default occurs if we are generally not paying debts as they become due or if we are left with unreasonably small capital. We have notified BVF of our failure to make certain payments on a timely basis and have therefore recently requested a waiver of such default, but have not yet received such a waiver, and thus remain in default.

Our significant fixed commitments with respect to leases and inventory purchases as of March 31, 2003 were as follows:

	PAYMENTS FOR THE YEAR ENDING DECEMBER 31,			
	TOTAL	2003	2004 & 2005	2006 & 200
CONTRACTUAL OBLIGATIONS				
Convertible Notes Term Debt	$ 8,210,182	$ 1,891,483	$ 6,318,699	$ -
Operating Leases	6,698,855	1,090,042	2,483,176	2,281,73
Unconditional Purchase Obligations	542,029	542,029	--	-
Total Contractual Cash Obligations	$15,451,066	$ 3,523,554	$ 8,801,875	$ 2,281,73

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

- the ability to extend terms of payment to vendors;
- the market acceptance of our products and services;

- the levels of promotion and advertising that will be required to launch new products and services and attain a competitive position in the market place;
- research and development plans;
- levels of inventory and accounts receivable;
- technological advances;

- competitors' responses to our products and services;
- relationships with partners, suppliers and customers;
- projected capital expenditures;
- national and international economic conditions, and events;
- periodic analysis of our goodwill valuation that may require us to take additional write-downs in future periods;
- defaults on financing that will impact the availability of borrowings, or result in notes being declared immediately due and payable; and
- reductions in the valuation of investment in trading securities.

Our current financial condition is the result of several factors including the following:

- our operating results were below expectations;
- sales of products into the commercial markets are taking longer to develop than originally anticipated;
- lower than expected margins and reduced revenues from our Pulsar subsidiary ultimately led us to limit sales orders; and
- continued research and development expenses due to further enhancement of our products.

In addition to our current deficit working capital situation, current operating plans show a shortfall of cash for the remainder of 2003. We intend to mitigate our position through one or more of the following:

- Additional Equity Capital. We will seek additional equity capital, if available. Equity capital will most likely be issued at a discount to market and will require the issuance of warrants, which will cause dilution to current stockholders. In addition, providers of new equity capital may require additional concessions.
- Additional Convertible Debt. Depending upon the market conditions, we may issue additional debt instruments. The types of instruments available in the market would likely contain a provision for the issuance of warrants and may also be convertible into equity.
- Off Balance Sheet Financing. If we need to add equipment or decide to expand our facilities, we may use an operating lease transaction to acquire the use of capital assets. An operating lease would not appear on our balance sheet and would be charged as an expense as payments accrue.
- Financing of Receivables. We plan to generate cash by financing receivables under the new BVF agreement.

- Sale of Investments. We may sell investments to generate cash. The market value of trading securities was $60,000 at March 31, 2003. Since that date, we have not generated any funds through sale of investment securities.

- Negotiate with Vendors. We have executed settlement and/or term-out agreements with a number of vendors. We will continue to negotiate with vendors regarding payment of existing accounts payable over extended terms of up to 48 months.

- Deferral of Cash Payments. We may defer cash payments through suspension of certain development projects.

- Issuance of Stock as Payment for Existing and Future Obligations. We may pay portions of accounts payable and accrued liabilities through issuances of common stock.

- Issuance of Stock to Pay Interest. During 2002, we issued 105,861 shares and 127,035 shares as payment of interest due on our April 16, 2002 secured convertible promissory notes for the three month periods ended June 30, 2002 and September 30, 2002, respectively. During the quarter ended March 31, 2003, we issued 211,727 as payment for interest due for the three months ended December 31, 2002. We may issue additional stock in the future to pay interest on long-term debt.

- Reductions in Work Force. We reduced our work force in 2002 and decreased the cash compensation paid to the remaining workforce. We may be forced to make similar reductions in the future if we do not realize our projected sales plans.

If we do not receive adequate financing, we could be forced to merge with another company or cease operations.

While we have a history of selling products in government markets, our new products that are just entering production after years of development have no sales history. Additionally, we are entering commercial markets with our products and are still developing acceptance of our offerings. Considerable uncertainty currently exists with respect to the adequacy of current funds to support our activities beyond March 31, 2003. This uncertainty will continue until a positive cash flow from operations is achieved. Additionally, we are uncertain as to the availability of financing from other sources to fund any cash deficiencies.

In order to reduce this uncertainty, we continue to evaluate additional financing options and may therefore elect to raise capital, from time to time, through equity or debt financings in order to capitalize on business opportunities and market conditions and to insure the continued marketing of current product offerings together with development of new technology, products and services. There can be no assurance that we can raise additional financing in the future.

Based upon forecasted sales and expense levels, we currently anticipate that existing cash, cash equivalents, investments, term-out arrangements with vendors and the current availability under our BVF factoring agreement will not be sufficient to satisfy our contemplated cash requirements for the next twelve months. However, our forecast is based upon certain assumptions, which may differ from actual future outcomes. We have incurred defaults under our financing agreements in the past. As discussed above, the BVF agreement states among other things that a default occurs if we are generally not paying debts as they become due or if we are left with unreasonably small capital. We have notified BVF of our failure to make certain payments on a timely basis and have therefore requested a waiver of such default. We therefore may not be able to draw funds in the future, which would affect our ability to fund our operations. Additionally, without a substantial increase in sales or a reduction in expenses, we will continue to incur operating losses.

RISK FACTORS

AN INVESTMENT IN SHARES OF OUR COMMON STOCK INVOLVES A HIGH DEGREE OF RISK. IN ADDITION TO THE OTHER INFORMATION CONTAINED OR INCORPORATED BY REFERENCE IN THIS REPORT, YOU SHOULD CAREFULLY CONSIDER THE FOLLOWING RISK FACTORS BEFORE DECIDING TO INVEST OR MAINTAIN AN INVESTMENT IN SHARES OF OUR COMMON STOCK. THIS REPORT CONTAINS OR INCORPORATES BY REFERENCE FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF CERTAIN FACTORS, INCLUDING THOSE SET FORTH IN THE FOLLOWING RISK FACTORS AND ELSEWHERE IN THIS REPORT. IF ANY OF THE FOLLOWING RISKS ACTUALLY OCCURS, IT IS LIKELY THAT OUR BUSINESS, FINANCIAL CONDITION AND OPERATING RESULTS WOULD BE HARMED. AS A RESULT, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE, AND YOU COULD LOSE PART OR ALL OF YOUR INVESTMENT.

WE HAVE A HISTORY OF LOSSES AND MAY INCUR FUTURE LOSSES THAT MAY ADVERSELY IMPACT OUR BUSINESS AND OUR STOCKHOLDERS BY, AMONG OTHER THINGS, MAKING IT DIFFICULT FOR US TO RAISE ADDITIONAL DEBT OR EQUITY FINANCING TO THE EXTENT NEEDED FOR OUR CONTINUED OPERATIONS OR FOR PLANNED EXPANSION.

We may not become profitable or significantly increase our revenue. We incurred net losses of $8.6 million, $53.2 million and $1.6 million for the years 2002 and 2001 and the three months ended March 31, 2003, respectively. To achieve profitability, we will need to generate and sustain sufficient revenues while maintaining reasonable cost and expense levels. We expect to continue to incur significant operating expenses primarily to support research and development and expansion of our sales and marketing efforts. These expenditures may not result in increased revenues or customer growth. We do not know when or if we will become profitable. We may not be able to sustain or increase profitability on a quarterly or annual basis.

Our losses from operations, our use of cash in operating activities, and our accumulated deficit and working capital deficiency at December 31, 2002 and 2001, among other factors, raised substantial doubt about our ability to continue as a going concern and led our independent auditors to include in their opinions contained in our consolidated financial statements as of December 31, 2002 and 2001 and for each of the years in the three-year period ended December 31, 2002 an explanatory paragraph related to our ability to continue as a going concern. Analysts and investors generally view reports of independent auditors questioning a company's ability to continue as a going concern unfavorably. These reports may make it difficult for us to raise additional debt or equity financing to the extent needed for our continued operations or for planned expansion, particularly if we are unable to attain and maintain profitable operations in the future. Consequently, future losses may adversely affect our business, prospects, financial condition, results of operations and cash flows. We urge potential investors to review the reports of our independent auditors and our consolidated financial statements before making a decision to invest in our company.

WE MAY BE UNABLE TO OBTAIN ADDITIONAL FUNDING ON SATISFACTORY TERMS, WHICH COULD INTERFERE WITH OUR EXISTING AND PLANNED OPERATIONS, DILUTE OUR STOCKHOLDERS OR IMPOSE BURDENSOME FINANCIAL RESTRICTIONS ON OUR BUSINESS.

Historically, we have relied upon cash from financing activities to fund a significant portion of the cash requirements of our operating and investing activities, and there is no assurance we will be able to generate sufficient cash from our operating activities in the future. We do not expect future fixed obligations to be paid from operations during 2003 and intend to satisfy fixed obligations by obtaining additional debt and/or equity financing, using accounts receivable financing, extending vendor payments, selling investments and issuing stock as payment on obligations.

Some of our secured convertible promissory notes contain the grant of a continuing security interest in substantially all of our assets and restrict our ability to obtain debt and/or equity financing. In addition, deteriorating global economic conditions and the effects of military actions may cause prolonged declines in investor confidence in and accessibility to capital markets.

Any future financing may cause significant dilution to existing stockholders. Any debt financing or other financing of securities senior to common stock will likely include financial and other covenants that will restrict our flexibility. At a minimum, we expect these covenants to include restrictions on our ability to pay dividends on our common stock. Any failure to comply with these covenants would adversely affect our business, prospects, financial condition, results of operations and cash flows. Financing arrangements to raise additional funds may require us to relinquish rights to certain technologies, products or marketing territories. Our failure to raise capital when needed and on terms acceptable to us could adversely affect our business, operating results, financial condition and prospects by impairing our ability to fund our existing and planned operations.

DEFAULTS UNDER OUR SECURED CREDIT ARRANGEMENTS COULD RESULT IN A FORECLOSURE ON OUR ASSETS BY OUR CREDITORS.

All of our assets are pledged as collateral to secure portions of our debt. We were not able to obtain waivers for past covenant defaults, and we may in the future default under certain covenants of these credit arrangements. This means that if we are unable to obtain waivers in the future or if we incur a monetary default on our secured debt obligations, our indebtedness could become immediately due and payable and the lenders could foreclose on our assets.

WE HAVE NOT GENERATED ANY SIGNIFICANT SALES OF OUR PRODUCTS WITHIN THE COMPETITIVE COMMERCIAL MARKET NOR HAVE WE ESTABLISHED A SUFFICIENT SALES AND MARKETING FORCE TO PROMOTE OUR PRODUCTS TO POTENTIAL COMMERCIAL CUSTOMERS, WHICH MAKES IT DIFFICULT TO EVALUATE OUR CURRENT BUSINESS PERFORMANCE AND FUTURE PROSPECTS.

Although we have had some success in selling our security solutions to government agencies, we are just beginning to enter the complex and competitive commercial market for digital commerce and communications security solutions. We believe that many potential customers in our target markets are not fully aware of the need for security products and services in the digital economy. Historically, only enterprises that had substantial resources developed or purchased security solutions for delivery of digital content over the Internet or through other means. Also, there is a perception that security in delivering digital content is costly and difficult to implement. Therefore, we will not succeed unless we can educate our target markets about the need for security in delivering digital content and convince potential customers of our ability to provide this security in a cost-effective and easy-to-use manner.

Even if we convince our target markets about the importance of and need for such security, we do not know if this will result in the sale of our products. We may be unable to establish sales and marketing operations at levels necessary for us to grow this portion of our business, especially if we are unsuccessful at selling this product into vertical markets. We may not be able to support the promotional programs required by selling simultaneously into several markets. If we are unable to develop an efficient sales system, or if our products or components do not achieve wide market acceptance, then our operating results will suffer and our earnings per share will be adversely affected.

WE FACE INTENSE COMPETITION AND PRICING PRESSURES FROM A NUMBER OF SOURCES, WHICH MAY REDUCE OUR AVERAGE SELLING PRICES AND GROSS MARGINS.

The markets for our products and services are intensely competitive. As a result, we face significant competition from a number of sources. We may be unable to compete successfully because 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 and start-up companies with which we compete from time to time. We expect competition to increase as a result of consolidation in the information security technology and product reseller industries.

The average selling prices for our products may decline as a result of competitive pricing pressures, promotional programs and customers who negotiate price reductions in exchange for longer term purchase commitments. The pricing of products depends on the specific features and functions of the products, purchase volumes and the level of sales and service support required. We expect competition to increase in the future. As we experience pricing pressure, we anticipate that the average selling prices and gross margins for our products will decrease over product lifecycles. These same competitive pressures may require us to write down the carrying value of any inventory on hand, which would adversely impact our operating results and adversely affect our earnings per share.

WE DERIVE A SUBSTANTIAL PORTION OF OUR REVENUE FROM A SMALL NUMBER OF CUSTOMERS, AND THE LOSS OF ONLY ONE OF THOSE CUSTOMERS COULD ADVERSELY IMPACT OUR OPERATING RESULTS.

We depend on a limited number of customers for a substantial portion of our revenue. During the three months ended March 31, 2003 and 2002, we derived 25%and 41%, respectively, of our consolidated net revenue for that period from an individual customer. Many of our contracts with our significant customers are short-term contracts. The non-renewal 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 those customers.

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OUR RELIANCE ON THIRD PARTY TECHNOLOGIES FOR THE DEVELOPMENT OF SOME OF OUR PRODUCTS AND OUR RELIANCE ON THIRD PARTIES FOR MANUFACTURING MAY DELAY PRODUCT LAUNCH, IMPAIR OUR ABILITY TO DEVELOP AND DELIVER PRODUCTS OR HURT OUR ABILITY TO COMPETE IN THE MARKET.

Our ability to license new technologies from third parties is and will continue to be critical to our ability to offer a complete suite of products that meets customer needs and technological requirements. Some of our licenses do not run for the full duration of the third party's patent for the licensed technology. We may not be able to renew our existing licenses on favorable terms, or at all. If we lose the rights to a patented technology, we may need to stop selling or may need to redesign our products that incorporate that technology, and we may lose a competitive advantage. In addition, competitors could obtain licenses for technologies for which we are unable to obtain licenses, and third parties may develop or enable others to develop a similar solution to digital communication security issues, either of which events could erode our market share. Also, dependence on the patent protection of third parties may not afford us any control over the protection of the technologies upon which we rely. If the patent protection of any of these third parties were compromised, our ability to compete in the market also would be impaired.

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

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

WE MAY FACE HARMFUL CLAIMS OF INFRINGEMENT OF PROPRIETARY RIGHTS, WHICH COULD REQUIRE US TO DEVOTE SUBSTANTIAL TIME AND RESOURCES TOWARD MODIFYING OUR PRODUCTS OR OBTAINING APPROPRIATE LICENSES.

There is a risk that our products infringe the proprietary rights of third parties. Regardless of whether 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 expenses in defending them. If any infringement 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 by preventing us from selling some or all of our products.

OUR INABILITY TO MAINTAIN AND DEVELOP NEW STRATEGIC RELATIONSHIPS WITH PARTNERS AND SUPPLIERS COULD IMPACT OUR ABILITY TO OBTAIN OR SELL OUR PRODUCTS, AND PREVENT US FROM GENERATING SALES REVENUES.

We obtain and sell many of our products through strategic alliance and supplier agreements. 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.

If alliance or supplier agreements are cancelled, modified or delayed, if alliance or supplier partners decide not to purchase our products or to purchase only limited quantities of our products, or if we are unable to enter into additional alliance or supplier agreements, our ability to produce and sell our products and to generate sales revenues could be adversely affected.

ANY COMPROMISE OF PKI TECHNOLOGY WOULD ADVERSELY AFFECT OUR BUSINESS BY REDUCING OR ELIMINATING DEMAND FOR MANY OF OUR DATA SECURITY PRODUCTS.

Many of our products are based on public key infrastructure, or PKI, technology, which is the standard technology for securing Internet-based commerce and communications. 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:

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

A SECURITY BREACH OF OUR INTERNAL SYSTEMS OR THOSE OF OUR CUSTOMERS DUE TO COMPUTER HACKERS OR CYBER TERRORISTS COULD HARM OUR BUSINESS BY ADVERSELY AFFECTING THE MARKET'S PERCEPTION OF OUR PRODUCTS AND SERVICES.

Since we provide security for Internet and other digital communication networks, we may become a target for attacks by computer hackers. The ripple effects throughout the economy of terrorist threats and attacks and military activities may have a prolonged effect on our potential commercial customers, or on their ability to purchase our products and services. Additionally, because we provide security products to the United States government, we may be targeted by cyber terrorist groups for activities threatened against United States-based targets.

We will not succeed unless the marketplace is confident that we provide effective security protection for Internet and other digital communication networks. Networks protected by our products may be vulnerable to electronic break-ins. Because the techniques used by computer hackers to access or sabotage networks change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques. Although we have not experienced any act of sabotage or unauthorized access by a third party of our internal network to date, if an actual or perceived breach of security for Internet and other digital communication networks occurs in our internal systems or those of our end-user customers, regardless of whether we caused the breach, it could adversely affect the market's perception of our products and services. This could cause us to lose customers, resellers, alliance partners or other business partners.

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

Products as complex as those we offer may contain undetected errors or may fail 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.

Because our customers rely on our products for critical security applications, we may be exposed to claims for damages allegedly 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:

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

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

Increased demand for our products largely depends 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 increases in governmental regulation and the continued ability of the Internet infrastructure and communications services to support growing demands, which ability could be adversely affected by, among other things, delays in development or adoption of new standards and protocols to handle increased levels of activity. If the use of electronic commerce and communications does not increase, or increases more slowly than we expect, demand for our products and services will be adversely impacted.

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

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. If we are unable to modify existing products and develop new products and services that are responsive to changing technology and standards and to meet customer needs in a timely and cost effective manner, our business could be adversely affected because we would be unable to sell our product and service offerings that have become obsolete.

DOING BUSINESS WITH THE UNITED STATES GOVERNMENT ENTAILS MANY RISKS THAT COULD ADVERSELY AFFECT US BY DECREASING THE PROFITABILITY OF GOVERNMENTAL CONTRACTS WE ARE ABLE TO OBTAIN AND INTERFERING WITH OUR ABILITY TO OBTAIN FUTURE GOVERNMENTAL CONTRACTS.

Sales to United States government agencies accounted for 19% and 50% of our consolidated revenues for the three months ended March 31, 2002 and 2003, respectively. Our sales to these agencies are subject to risks that include:

- early termination of our contracts;
- disallowance of costs upon audit; and
- the need to participate in competitive bidding and proposal processes, which are costly and 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 their contractors, to deem contractors unsuitable for new contract awards. Because we engage in the governmental 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 governmental contracts for a significant period of time, any of which could adversely affect our business by requiring us to spend money to pay the fines and penalties and prohibiting us from earning revenues from governmental contracts during the suspension period.

DELAYS IN DELIVERIES FROM OUR SUPPLIERS OR DEFECTS IN GOODS OR COMPONENTS SUPPLIED BY OUR VENDORS COULD CAUSE OUR REVENUES AND GROSS MARGINS TO DECLINE.

We rely on a limited number of vendors for certain components for the products we are developing. Any undetected flaws in components supplied by our vendors could lead to unanticipated costs to repair or replace these parts. We currently purchase some of our components from a single supplier, which presents a risk that the components may not be available in the future on commercially reasonable terms or at all. For example, Atmel Corporation has completed development of a specially designed Forte microprocessor that we have incorporated into a Forte PKI card. Commercial acceptance of the Forte

microprocessor will be dependent on continued development of applications to service customer requirements. Any inability to receive or any delay in receiving adequate supplies of the Forte microprocessor, whether as a result of delays in development of applications or otherwise, would adversely affect our ability to sell the Forte PKI card.

We do not anticipate maintaining a supply agreement with Atmel Corporation for the Forte microprocessor. If Atmel Corporation were unable to deliver the Forte microprocessor for a lengthy period of time or were to terminate 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, which could result in delays or reductions in product shipments that could adversely affect our business by requiring us to expend resources while preventing us from selling the Forte PKI card.

Also, if we are unable to obtain or generate sufficient funds to sustain our operations, we may damage our relationships with our vendors. Slow and delinquent payments may cause vendors not to sell products to us, or only with advance payment. If this occurs, we will not have components and services available for our products. We may not be able to replace any of our supply sources on economically advantageous terms. Further, if we experience price increases for the components for our products, we will experience declines in our gross margins.

OUR SUCCESS DEPENDS ON OUR ABILITY TO RETAIN OUR CURRENT MANAGEMENT TEAM.

Our founder, co-chairman and co-chief executive officer, Kris Shah, has been with us since 1970, and our co-chairman and co-chief executive officer, Marvin Winkler, co-founded one of our wholly-owned subsidiaries. Their experience, expertise, industry knowledge and historical company knowledge would be extremely difficult to replace if we were to lose the services of either of them. The precise impact of the loss of services of either of them is difficult to predict, but would likely result in, at a minimum, significant costs to recruit, hire and retain a successor and impaired operating results while the successor was being recruited and transitioning into the position. We do not currently maintain life insurance on the lives of either of these officers.

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 BY IMPAIRING OUR ABILITY TO EFFICIENTLY CONDUCT OUR OPERATIONS.

We may not be able to 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, to retain existing customers and attract new customers, or to efficiently conduct our operations, all of which would adversely affect our business. A high level of employee mobility characterizes the data security and networking solution industries, and the market for highly qualified individuals in 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, the hiring and retention of technical employees necessitates the issuance of stock options and other equity interests, which may dilute earnings per share.

OUR EFFORTS TO EXPAND OUR INTERNATIONAL OPERATIONS ARE SUBJECT TO A NUMBER OF RISKS, ANY OF WHICH COULD ADVERSELY AFFECT OUR FUTURE INTERNATIONAL SALES.

We plan to increase our international sales. Our inability to obtain or maintain 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:

- increased collection risks;
- trade restrictions;
- export duties and tariffs;
- uncertain political, regulatory and economic developments; and
- inability to protect our intellectual property rights.

WE ARE UNABLE TO PREDICT THE EXTENT TO WHICH THE RESOLUTION OF LAWSUITS PENDING AGAINST US AND OUR SUBSIDIARY COULD ADVERSELY AFFECT OUR BUSINESS BY, AMONG OTHER THINGS, SUBJECTING US TO SUBSTANTIAL COSTS AND LIABILITIES AND DIVERTING MANAGEMENT'S ATTENTION AND RESOURCES.

G2 Resources, Inc. and Classical Financial Services, LLC have filed complaints against Pulsar Data Systems, Inc., or Pulsar, alleging that Pulsar breached a contract by failing to make payments to G2 Resources, Inc. in connection with services allegedly provided by G2 Resources, Inc. In April 2001, the court dismissed, for lack of prosecution activity for more than twelve months, the original complaint that G2 Resources, Inc. had filed against Pulsar in January 1998. G2 Resources, Inc. re-filed the action in May 2001. In 2002, the court moved this case into the same division handling other matters related to G2 and Classic Financial Services, LLC. The Company intends to vigorously defend against the plaintiffs' claims and has asserted defenses and counterclaims.

In May 2002, Contemporary Services Corporation filed an action against us alleging breach of contract, fraud, negligent misrepresentation and violation of California Corporations Code section 25400. The action relates to a term sheet agreement that we entered into with the plaintiff in October 2001 in connection with a potential strategic relationship between the plaintiff and us. We filed an answer and cross-complaint. While we continued to believe we would prevail at trial, in February 2003, we reached an agreement to settle the case for less than $50,000, which will be jointly paid by our insurance carrier and us. Our estimated portion of the settlement has been accrued in the results of the year ended December 31, 2002.

In May 2002, Integral Systems, Inc. filed an action against us alleging that we breached a promissory note for the payment of $389,610 and then obtained a confessed judgment for approximately $327,250. In March 2003 we executed settlement papers that would permit Integral Systems to file a stipulated judgment against us in the amount of the unpaid balance if we default on a payment schedule that requires us to make payments of $20,000 per month until the balance is paid in full.

In June 2002, Research Venture, LLC filed two lawsuits against us alleging unlawful detainer and seeking possession of two leased properties, alleged damages and lost rent. We surrendered possession of both properties and negotiated a restructuring of our obligations under the leases. Under the restructuring arrangement, we agreed to make cash payments to Research Venture aggregating $500,000, and we issued 959,323 shares of common stock and a subordinated convertible promissory note in the principal amount of $360,000 that represents prepaid rent on a property we are leasing from Research Venture and is convertible into an aggregate of up to 276,923 shares of common stock. Research Venture will be entitled to entry of the stipulated judgment in the maximum aggregate amount of $3.1 million, less consideration we pay prior to any entry of the judgment, if we do not comply with the terms of the restructuring arrangement through December 2004. As of May 16, 2003 we have not paid $50,000 of the $100,000 installment due in March 2003. Research Venture, LLC therefore has the right, but to date has not elected to file the stipulated judgment.

In July 2002, Synnex Technology filed a lawsuit against us in the Superior Court of Orange County, Case No. 02CC12380, alleging that we failed to pay $120,986 for products purchased by us for resale. Synnex and we agreed to settle the matter by payment of ten equal installments of $12,099, pursuant to a stipulation for entry of judgment that is to be held by counsel for Synnex and not filed with the court absent breach by us. The last payment is due on or before June 9, 2003, at which time the action will be dismissed.

Any or all of these litigation matters could subject us to substantial costs and liabilities and divert our management's attention and resources during our current and future financial reporting periods. If we believe it is probable that we will incur an estimable amount of expenses in connection with a litigation matter, we will include the estimated amount of expenses in accounts payable or accrued liabilities. If we feel unable to make a reasonable judgment as to the ultimate outcome of, or to assess or quantify our exposure relating to, a litigation matter, we will not include in our financial statements an estimated amount of expenses for that matter. Consequently, if we are unable during any financial reporting period to accurately estimate our potential liability in connection with a litigation matter, our financial condition and results of operations in future financial reporting periods may be adversely affected when we record any unreserved costs or liabilities we actually have incurred in connection with a litigation matter.

A NUMBER OF VENDORS HAVE FILED OR THREATENED TO FILE LAWSUITS TO COLLECT AMOUNTS DUE FROM US. IF WE ARE UNABLE TO REACH A FAVORABLE RESOLUTION OF THESE MATTERS, WE MAY HAVE TO DEFEND OURSELVES IN COSTLY LITIGATION AND BE SUBJECT TO SUBSTANTIAL MONETARY JUDGMENTS.

During 2002, several vendors filed or threatened to file suits against us related to outstanding account balances that are included within our accounts payable. We reached oral agreement with several vendors, including one vendor who had filed suit against us. We are making payments on the amount owed to the vendor who filed suit against us and executed an agreement to extend the terms of the existing accounts payable balance. The vendor has indicated that it will execute and return the agreement to us, and did so in April, 2003. If the collection suit goes to judgment, there would be an adverse impact on our financial condition and liquidity.

GOVERNMENTAL REGULATIONS AFFECTING SECURITY OF INTERNET AND OTHER DIGITAL COMMUNICATION NETWORKS COULD LIMIT THE MARKET FOR OUR PRODUCTS AND SERVICES.

The United States government and foreign governments have imposed controls, export license requirements and restrictions on the import or export of some technologies, including encryption technology. Any additional governmental regulation of imports or exports or failure to obtain required export approval of encryption technologies could delay or prevent the acceptance and use of encryption products and public networks for secure communications and could limit the market for our products and services. In addition, some foreign competitors are subject to less rigorous controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than us in the United States and in international security markets for Internet and other digital communication networks. In addition, governmental agencies such as the Federal Communications Commission periodically issue regulations governing the conduct of business in telecommunications markets that may negatively affect the telecommunications industry and us.

BIZ ACQUISITION-RELATED ACCOUNTING CHARGES MAY CONTINUE TO DELAY OR REDUCE OUR PROFITABILITY AND CAUSE THE MARKET PRICE OF OUR COMMON STOCK TO DECLINE.

We accounted for our August 2001 acquisition of BIZ as a purchase. Under the purchase method of accounting, the purchase price was allocated to the fair value of the identifiable tangible and intangible assets and liabilities that we acquired from BIZ. The excess of the purchase price over BIZ's tangible net assets resulted in goodwill and other intangible assets.

In July 2001, the FASB issued Statement No. 142, "Goodwill and Other Intangible Assets." We adopted this statement effective January 1, 2002. Under this statement, goodwill is no longer amortized and is subject to annual testing for impairment beginning January 1, 2002. The provisions of this statement require us to perform a two-step test to assess goodwill for impairment. In the first step, we compare the fair value of each reporting unit to its carrying value. If the fair value exceeds the carrying value, then goodwill is not impaired and we need not proceed to the second step. If the carrying value of a reporting unit exceeds its fair value, then we must determine and compare the implied fair value of the reporting unit's goodwill to the carrying value of its goodwill. If the carrying value of the reporting unit's goodwill exceeds its implied fair value, then we will record an impairment loss in the amount of the excess. With regard to a reporting unit's goodwill balance at January 1, 2002, we were required to perform the first step of the annual testing for impairment by June 30, 2002. If the results of that step indicated that goodwill may be impaired, we would then be required to complete the second step as soon as possible, but no later than December 31, 2002.

As of December 31, 2001, we assessed the fair value of our two reporting units by comparing the book value of our equity interests to the fair value of our equity interests based upon the terms of a financing we completed in April 2002. Given consideration of this comparison and relevant factors, we concluded that as of December 31, 2001, an impairment write-down of approximately $36.3 million was required. We reviewed the assumptions used in the original analysis performed as of December 31, 2001 for dates of March 31, 2002, June 30, 2002, and September 30, 2002 and concluded that such analyses continued to be adequate and no additional write-down was required.

We later performed an assessment of our Information Security Products and Services reporting unit. The assessment was performed to measure the fair value of the remaining goodwill as of December 31, 2002 using a multi-period discounted cash flow method. The results of the analysis indicated that no additional write-down was required as of December 31, 2002.

We are required to perform tests for impairment at least annually. Tests for impairment between annual tests may be required if events occur or circumstances change that would more likely than not reduce the fair value of the net carrying amount no such events have occurred as of March 31. 2003. We cannot predict whether or when there will be additional impairment charges, or the amount of any such charges. If the charges are significant, they could cause the market price of our common stock to decline.

A RELOCATION OF OUR SOFTWARE DEVELOPMENT TO INDIA COULD PROVE TO BE UNPROFITABLE DUE TO RISKS INHERENT IN INTERNATIONAL BUSINESS ACTIVITIES.

We may relocate portions of our software development activities to India in an effort to reduce our operating expenses. We are subject to a number of risks associated with international business activities that could adversely affect any operations we may develop in India and could slow our growth. These risks generally include, among others:

- difficulties in managing and staffing our Indian operations;
- difficulties in obtaining or maintaining regulatory approvals or in complying with Indian laws;
- reduced or less certain protection for intellectual property rights;
- differing technological advances, preferences or requirements;
- trade restrictions;
- foreign currency fluctuations; and
- general economic conditions, including instability, in the Indian market.

Any of these risks could adversely affect our business and results of operations.

CONFLICTS INVOLVING INDIA COULD ADVERSELY AFFECT ANY OPERATIONS WE MAY ESTABLISH IN INDIA, WHICH COULD INTERFERE WITH OUR ABILITY TO CONDUCT ANY OR ALL OF OUR OTHER OPERATIONS.

South Asia has from time to time experienced civil unrest and hostilities among neighboring countries, including India and Pakistan. In April 1999, India and Pakistan conducted long-range missile tests. Since May 1999, military confrontations between India and Pakistan have occurred in disputed regions. In October 1999, the leadership of Pakistan changed as a result of a coup led by the military. Additionally, recent events have significantly heightened the tensions between India and Pakistan. If a major armed conflict or nuclear war involving India and any of its neighboring countries occurs, it could, among other things, prevent us from establishing or maintaining operations in India. If the successful conduct of operations in India becomes critical to any or all of our other operations, our business would be harmed to the extent we are unable to establish or maintain operations in India.

WE ARE EXPOSED TO LIABILITY FOR ACTIONS TAKEN BY OUR DOMESTIC EMPLOYEES WHILE ON ASSIGNMENT AND MAY ALSO BE EXPOSED TO LIABILITY FOR ACTIONS TAKEN BY ANY FOREIGN EMPLOYEES WE MAY HIRE.

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 exposed to liability for actions taken by our employees while on assignment. In addition, to the extent we hire employees in India or other foreign locations, we may also be exposed to liability for actions taken by those employees in the scope of their employment.

NASDAQ MAY DELIST OUR COMMON STOCK, WHICH COULD DECREASE THE MARKET PRICE OF OUR COMMON STOCK AND MAKE IT MORE DIFFICULT FOR OUR STOCKHOLDERS TO DISPOSE OF OR OBTAIN QUOTATIONS FOR OUR COMMON STOCK AND FOR US TO OBTAIN FINANCING. DELISTING ALSO WOULD ENTITLE A THIRD PARTY TO FILE A POTENTIALLY SUBSTANTIAL STIPULATED JUDGMENT AGAINST US.

The quantitative listing standards of The Nasdaq National Market require, among other things, that listed companies maintain a minimum bid price of $1.00. In November 2002, we received a notice from Nasdaq indicating that our common stock had failed to maintain the required minimum bid price of $1.00 for

the last 30 consecutive trading days and that, therefore, we had until February 20, 2003 to regain compliance with that requirement. We did not timely regain compliance with that requirement. In March 2003, we received a notice from Nasdaq that the period to regain compliance with the $1.00 minimum bid price has been extended an additional 90 days, through May 21, 2003.

Nasdaq quantitative listing standards also require that listed companies maintain a minimum market value of publicly held shares of $5,000,000. In May 2003, we received a notice from Nasdaq indicating that our common stock had failed to maintain the required minimum market value for the last 30 consecutive trading days and that, therefore, we have until August 7, 2003 to regain compliance with that requirement.

If we fail to timely regain compliance with minimum bid price requirement or the minimum market value requirements, or if we fail to maintain compliance with any other listing requirement, Nasdaq staff likely will provide written notice to us that our common stock will be delisted. At that time, we intend to appeal the staff's determination to a listing qualifications panel for consideration. Alternatively, we may be permitted to submit an application to transfer the listing of our common stock to The Nasdaq SmallCap Market if we satisfy the continued inclusion requirements for The Nasdaq SmallCap Market. The successful transfer of the listing of our common stock to The Nasdaq SmallCap Market would make available an extended grace period through August 19, 2003 for the minimum $1.00 bid price requirement and would make available an additional 180 calendar day grace period if we meet the initial listing criteria for The Nasdaq SmallCap Market.

In addition to minimum bid price and minimum market value requirements, Nasdaq's qualification standards require, among other things, that issuers apply for initial inclusion on Nasdaq following a change of control. Nasdaq looks at many factors in determining whether a change of control has occurred, including without limitation, changes in the management, board of directors, voting power and ownership of a company. Depending on the terms and conditions of any future financings or other transactions we may enter into, if Nasdaq determines that a change of control has occurred, we would need to file a new listing application if we want to maintain our Nasdaq listing. We do not know whether, at the time, if any, that we would file a new listing application with Nasdaq, we would meet the initial listing standards of either The Nasdaq National Market or The Nasdaq SmallCap Market.

If we are delisted from The Nasdaq National Market, our stock price could decline further and the ability of any potential or future investors to achieve liquidity from our common stock could be severely limited, particularly if we are unable to transfer the listing of our common stock to The Nasdaq SmallCap Market. This could inhibit, if not preclude, our ability to raise additional working capital on acceptable terms, if at all. Also, if we are delisted from The Nasdaq National Market, Research Venture, LLC, a party with whom we have entered into a litigation settlement, would be entitled to entry of a stipulated judgment against us in the maximum aggregate amount of $3.1 million, less consideration we pay prior to any entry of the judgment.

THE NON-CASH INTEREST EXPENSE REQUIRED IN CONNECTION WITH THE DETACHABLE WARRANTS AND BENEFICIAL CONVERSION FEATURES OF OUR APRIL 2002 FINANCING MAY ADVERSELY AFFECT OUR STOCK PRICE.

The secured convertible promissory notes we issued in April 2002 are convertible into shares of our common stock at a conversion price below the market price of our common stock at the commitment date for the notes. In addition, the notes were accompanied by common stock purchase warrants with an exercise price below the market price of our common stock at the commitment date. Accordingly, under accounting guidelines, we were required to record a substantial non-cash charge as interest expense, with an offsetting increase to our paid-in-capital. While recording this entry had no effect on our stockholders' equity, the entry substantially increased our reported loss for the year ended December 31, 2002 and may cause a decline in our stock price.

OUR COMMON STOCK PRICE IS SUBJECT TO SIGNIFICANT VOLATILITY, WHICH COULD RESULT IN SUBSTANTIAL LOSSES FOR INVESTORS AND IN LITIGATION AGAINST US.

The stock market as a whole and individual stocks historically have experienced extreme price and volume fluctuations, which often have been unrelated to the performance of the related corporations. During the 52-week period ended May 16, 2003, the high and low closing sale prices of our common stock were $1.77 and $.50, respectively. The market price of our common stock may exhibit significant fluctuations in the future in response to various factors, many of which are beyond our control and which include:

- variations in our annual or quarterly financial results, which variations could result from, among other things, the timing, size, mix and customer acceptance of our product and service offerings and those of our competitors, and the timing and magnitude of required capital expenditures;

- company-issued earnings announcements that vary from consensus analyst estimates;

- changes by financial research analysts in their recommendations or estimates of our earnings;

- conditions in the economy in general or in the information technology service sector in particular;

- announcements of technological innovations or new products or services by us or our competitors; and

- unfavorable publicity or changes in applicable laws and regulations, or their judicial or administrative interpretations, affecting the information technology service sector and us.

If our operating results in future quarters fall below the expectations of market makers, securities analysts and investors, the price of our common stock likely will decline, perhaps substantially. In the past, securities class action litigation often has been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and liabilities and could divert management's attention and resources. Consequently, the price at which you purchase shares of our common stock may not be indicative of the price that will prevail in the trading market. You may be unable to sell your shares of common stock at or above your purchase price, which may result in substantial losses to you.

A SIGNIFICANT NUMBER OF SHARES OF OUR COMMON STOCK ARE OR WILL BECOME ELIGIBLE FOR PUBLIC SALE, AND SALES OF LARGE NUMBERS OF OUR SHARES COULD ADVERSELY AFFECT THEIR MARKET PRICE AND MAKE IT DIFFICULT FOR US TO RAISE ADDITIONAL CAPITAL THROUGH SALES OF EQUITY SECURITIES.

As of May 16, 2003, we had issued and outstanding 25,291,943 shares of common stock, a majority of which were unrestricted, were eligible for resale without registration under Rule 144 of the Securities Act of 1933, or were registered for resale or issued with registration rights. Our common stock historically has been thinly traded. Our average daily trading volume between May 17, 2002 and May 16, 2003 was 9,935 shares. If our stockholders seek to sell numbers of shares significantly in excess of our typical volume, the market price of our shares may decline. Any adverse effect on the market price for our common stock could make it more difficult for us to sell equity securities at a time and at a price that we deem appropriate.

THE MARKET PRICE OF OUR COMMON STOCK AND THE VALUE OF YOUR INVESTMENT COULD SUBSTANTIALLY DECLINE IF ALL OR A SIGNIFICANT PORTION OF OUR OUTSTANDING DERIVATIVE SECURITIES WERE CONVERTED INTO OR EXERCISED FOR SHARES OF OUR COMMON STOCK AND RESOLD INTO THE MARKET, OR IF A PERCEPTION EXISTS THAT A SUBSTANTIAL NUMBER OF SHARES WILL BE ISSUED UPON CONVERSION OR EXERCISE AND THEN RESOLD INTO THE MARKET.

As of May 16, 2003, we had outstanding 25,291,943 shares of common stock and also had outstanding options, warrants and promissory notes that were exercisable for or convertible into approximately 14,650,000 shares of our common stock. If the conversion or exercise prices at which our outstanding derivative securities are converted or exercised are lower than the price at which you made your investment, immediate dilution of the value of your investment will occur. In addition, sales of a substantial number of shares of common stock issued upon conversion or exercise of our outstanding derivative securities, or even the perception that such sales could occur, could adversely affect the market price of our common stock. You could, therefore, experience a substantial decline in the value of your investment as a result of both the actual and potential conversion or exercise of our outstanding derivative securities and the actual and potential resale of the underlying shares into the market.

IF OUR SECURITY HOLDERS ENGAGE IN SHORT SALES OF OUR COMMON STOCK, INCLUDING SALES OF SHARES TO BE ISSUED UPON CONVERSION OR EXERCISE OF DERIVATIVE SECURITIES, THE PRICE OF OUR COMMON STOCK MAY DECLINE.

Selling short is a technique used by a security holder to take advantage of an anticipated decline in the price of a security. A significant number of short sales or a large volume of other sales within a relatively short period of time can create downward pressure on the market price of a security. The decrease in market price would allow holders of our derivative securities that have conversion or exercise prices based upon a discount on the market price of our common stock to convert or exercise their derivative securities into or for an increased number of shares of our common stock. Further sales of

common stock issued upon conversion or exercise of our derivative securities could cause even greater declines in the price of our common stock due to the number of additional shares available in the market, which could encourage short sales that could further undermine the value of our common stock. You could, therefore, experience a decline in the value of your investment as a result of short sales of our common stock.

IF WE ARE UNSUCCESSFUL IN COMPLYING WITH OUR REGISTRATION OBLIGATIONS, WE MAY BE IN DEFAULT UNDER OUR SECURED CONVERTIBLE PROMISSORY NOTES AND LITIGATION SETTLEMENTS AND COULD FACE SIGNIFICANT PENALTIES AND A SUBSTANTIAL STIPULATED JUDGMENT.

The agreements we entered into in connection with our issuance of secured convertible promissory notes and related warrants and in connection with settlement of litigation require us to, among other things, register for resale the shares of common stock issued or issuable under those arrangements and to maintain the effectiveness of the registration statements for an extended period of time. If we are unable to timely obtain and maintain effectiveness of the required registration statements, or if we default under the arrangements for any other reason, then the holders of the notes could, among other things, require us to pay substantial penalties, require us to repay the notes at a premium and/or foreclose upon their security interest in our assets, and the parties to the settlement arrangements could take action against us that could include the filing of a substantial stipulated judgment. Any of these events would adversely affect our business, operating results, financial condition, and ability to service our other indebtedness by negatively impacting our cash flows.

A SMALL NUMBER OF STOCKHOLDERS, WHO INCLUDE CERTAIN OF OUR OFFICERS AND DIRECTORS, HAVE THE ABILITY TO CONTROL STOCKHOLDER VOTES AND TO TAKE ACTION BY WRITTEN CONSENT WITHOUT A MEETING OF STOCKHOLDERS.

As of March 31, 2003, Kris Shah, Marvin Winkler and certain of their family members and affiliates owned, in the aggregate, approximately 54.1% of our outstanding common stock. Those stockholders, if acting together, have the ability to elect our directors and to determine the outcome of corporate actions requiring stockholder approval, irrespective of how our other stockholders may vote. Further, those stockholders have the ability to take action by written consent on those matters without a meeting of stockholders. Those matters could include the election of directors, changes in the size and composition of the board of directors, and mergers and other business combinations involving our company. In addition, through control of the board of directors and voting power, they may be able to control certain decisions, including decisions regarding the qualification and appointment of officers, dividend policy, access to capital (including borrowing from third-party lenders and the issuance of additional equity securities), and the acquisition or disposition of our assets. Also, the concentration of voting power in the hands of those individuals could have the effect of delaying or preventing a change in control of our company, even if the change in control would benefit our stockholders, and may adversely affect the market price of our common stock.

ITEM 3. CONTROLS AND PROCEDURES

(a) Our co-chief executive officers and chief financial officer, after evaluating the effectiveness of our "disclosure controls and procedures" (as defined Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) as of May 15, 2003 ("Evaluation Date"), have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.

(b) There were no significant changes in our internal controls or in other factors that could significantly affect our internal controls and procedures subsequent to the Evaluation Date.

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Research Venture, LLC filed a complaint against us on June 4, 2002 and filed first amended complaints against us on August 6 and August 7, 2002 in the Superior Court for the State of California, County of Orange, Central Justice Center (Case Nos. 02CC10109 and 02CC10111) alleging unlawful detainer and seeking possession of two leased properties, alleged damages and lost rent. We surrendered possession of both properties and negotiated a restructuring of our obligations under the leases. The restructuring involved, among other terms, our

entry on October 23, 2002 into a stipulation for entry of judgment that will permit Research Venture, LLC to file a judgment against us in the maximum aggregate amount of $3.1 million, less consideration we pay prior to any entry of the judgment, if we do not comply with the terms of the restructuring arrangement for the next two years. We have issued 959,323 shares of common stock with an agreed upon value of $1.2 million as payment toward the maximum aggregate amount. As of May 16, 2003 we have not paid $50,000 of the $100,000 installment due in March 2003. Research Venture, LLC therefore has the right, but to date has not elected to file the stipulated judgment.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

In January 2003, we issued an aggregate of 211,727 shares of common stock to four entities and two individuals upon conversion of $146,094 of interest due to them on 10% secured convertible promissory notes due December 31, 2005.

In each of January, February, and March of 2003, we issued 11,538 shares of common stock to Research Venture as payment of a portion the monthly rent due under a facility lease.

On January 22, 2003, we issued to Richard P. Kiphart, an accredited investor, a $500,000 promissory note that bears interest at a rate of 15% per year, with a minimum interest charge of $50,000. Accrued interest is payable quarterly in arrears beginning March 31, 2003. Principal and accrued but unpaid interest are due upon the earlier of December 31, 2005 and our closing of a $5.0 million or more equity or debt financing. Mr. Kiphart has the right to exchange the principal and outstanding interest on the note for securities that we issue in such an equity or debt financing. If we do not repay the note prior to June 30, 2003, we will be required to issue to Mr. Kiphart a three-year warrant to purchase up to 125,000 shares of common stock at an exercise price of $1.30 per share and to register for resale the shares of common stock underlying the warrant. The note is secured by all of our previously unencumbered assets of SSP and its subsidiaries, including without limitation, intellectual property assets and any and all receivables due to us from our SSP Gaming, LLC subsidiary, or SSPG.

On March 18, 2003 and March 19, 2003, we issued to each of Crestview Capital Fund II, L.P., an accredited investments fund of which Kingsport Capital Partners, LLC is the general partner, and Mr. Kiphart $100,000 promissory notes that are secured by all of our assets, including SSPG and any rights belonging to SSPG. In addition, on March 28, 2003, Marvin J. Winkler agreed to pledge 350,000 shares of common stock held by JAW Financial, L.P., an entity controlled by Mr. Winkler, as security for the notes we issued on March 18, March 19 and

March 28, 2003. The notes bear interest in an amount equal to the following percentage of the principal balance: 10%, if the notes are repaid within 30 days; 12%, if the note are repaid within 60 days; 15%, if the notes are repaid within 90 days; and 20%, if the notes are repaid at maturity. Principal and interest under the notes are due upon the sooner of 120 days from the dates of the notes and our raising of at least $3.5 million in equity and debt financing. Each note was accompanied by a five-year warrant to purchase up to 50,000 shares of common stock at an exercise price of $0.60. We will be required to issue to each holder warrants to purchase up to an additional 50,000 shares of common stock upon repayment of the notes, depending upon the date of repayment. The exercise price of the warrants and the number of shares underlying the warrants are subject to anti-dilution adjustments in connection with dividends or distributions of assets to holders of our common stock and subdivisions or combinations of our common stock. The warrants contain a cashless exercise provision. The shares of common stock underlying the warrants bear registration rights.

On March 28, 2003, we issued to Mr. Kiphart, Crestview Capital Fund II, L.P., Kris Shah and Mr. Winkler promissory notes in the aggregate principal amount of $440,000. The notes are secured by all of our assets and the assets of SSPG. In addition, Mr. Winkler agreed to pledge 350,000 shares of common stock held by JAW as security for the notes we issued on March 18, March 19 and March 28, 2003. The notes bear interest at the rate of 18% per year, with interest payable in cash monthly in arrears. We are required to use the proceeds of the notes only for payment of operating expenses. Principal and accrued but unpaid interest under the notes are due upon the sooner of July 26, 2003 or our raising of $3.5 million in equity and debt financing. The notes were accompanied by five-year warrants to purchase up to an aggregate of 230,000 shares of common stock. The exercise price of the warrants has not yet been fixed. The exercise price will be equal to the greater of $0.70 per share or the conversion price of securities we issue in a proposed financing, not to exceed $1.30 per share. The exercise price of the warrants and the number of shares underlying the warrants will be subject to anti-dilution adjustments in connection with dividends or distributions of assets to holders of our common stock and subdivisions or combinations of our common stock. The warrants contain a cashless exercise provision.

In February and March of 2003, in accordance with the term of the Secured Convertible Notes issued in November 2002, holders of the Secured Convertible Notes earned warrants to purchase a total of 100,000 shares of common stock. The additional warrants issued are exercisable at $1.30 per share subject to adjustment under certain conditions, and have a term of five years. In the year ended December 31, 2002, the Company recorded an accounting estimate related to the value of these warrants. These estimated amounts have been recorded as discounts from the face value of the debt, with an equal increase to additional paid-in capital. The discount is being amortized as non-cash interest expense over the life of Secured Convertible Notes.

In May 2002, Integral Systems, Inc. filed an action against us in the Circuit Court for Montgomery County, Maryland, Case No. 232706, alleging that we breached a promissory note for the payment of $389,610. Integral Systems then obtained a confessed judgment against us for approximately $327,250, and amounts related the judgment have been accrued in the financial statements for the year ending December 31, 2002. In March 2003, we executed settlement papers that would permit Integral Systems to file a stipulated judgment against us in the amount of the unpaid balance if we default on a payment schedule that requires us to make payments of $20,000 per month until the balance is paid in full. In

March 2003 we also issued a warrant to purchase up to 150,000 shares of our common stock at an exercise price of $1.30 per share as part of the settlement. The warrant has a three-year term and contains a cashless exercise provision. The shares of common stock underlying the warrants bear registration rights.

Exemption from the registration provisions of the Securities Act of 1933 for the transactions described above is claimed under Section 4(2) of the Securities Act of 1933, among others, on the basis that such transactions did not involve any public offering and the purchasers were sophisticated or accredited with access to the kind of information registration would provide. In each case, appropriate investment representations were obtained, stock certificates were issued with restricted stock legends, and stop transfer orders were placed with our transfer agent.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

We entered into a factoring agreement with Bay View Funding as further described elsewhere in this report. During the current quarter ended March 31, 2003, we were in violation of the covenant to pay debts and obligations as they come due, which is not related to the payment of principal or interest under our obligations for long-term and short-term debt.

In October 2002, we executed a new factoring agreement with Bay View Funding ("BVF") . During the quarter ended March 31, 2003, we incurred defaults not related to payment of principal or interest under both our accounts receivable financing with BVF and our obligations for long-term and short-term debt due December 31, 2005. We requested waivers from the holders of the notes, but the noteholders declined to grant such waivers. This means the noteholders have the right to declare us in default and call all of their debt due and immediately payable. With the potential of the notes being called for payment, we re-classified what would have otherwise been long-term debt as short-term debt in our consolidated balance sheets as of December 31, 2002 and March 31, 2003. The agreement with BVF states among other things that a default occurs if we are generally not paying debts as they become due or if we are left with unreasonably small capital. We have notified BVF of our failure to make certain payments on a timely basis and have therefore requested a waiver of such default.

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

(a) Exhibits.

Exhibit Number	Description
10.1	Waiver and Acknowledgment dated January 28, 2003 among Crestview Capital Fund, L.P., Crestview Capital Fund II, L.P.,

	Crestview Offshore Fund, Inc., Robert Geras, Richard P. Kiphart and Nefilim Associates, LLC, LLC Wave Systems Corp. (1)
10.2	Second Amended and Restated Operating Agreement of SSP Gaming, LLC dated April 7, 2003 by SSP Solutions, Inc., the sole member of SSP Gaming, LLC (1)
10.3	Forbearance Agreement dated March 12, 2003 between SSP Solutions, Inc. and Integral Systems, Inc., effective September 1, 2002 (1)
10.4	Employment Agreement dated March 6, 2003 between SSP Solutions, Inc. and Kris Shah (1) (#)
10.5	Employment Agreement dated March 6, 2003 between SSP Solutions, Inc. and Marvin J. Winkler (1) (#)
10.6	Promissory Note dated January 22, 2003 in the principal amount of $500,000 made by SSP Solutions, Inc. in favor of Richard P. Kiphart (1)
10.7	Form of Promissory Notes dated March 18, 2003 and March 19, 2003, respectively, made by SSP Solutions, Inc. in favor of Crestview Capital Fund, L.P. and Richard P. Kiphart, respectively, each in the principal amount of $100,000 (1)
10.8	Form of Warrants to Purchase Common Stock dated March 18, 2003 and March 19, 2003, respectively, issued by SSP Solutions, Inc. in favor of Crestview Capital Fund L.P. and Richard P. Kiphart, respectively, each in the amount of 100,000 shares (1)
10.9	Form of Promissory Notes dated March 28, 2003 made by SSP Solutions, Inc. in favor of Richard P. Kiphart, Crestview Capital Fund II, L.P., Marvin J. Winkler and the Kris and Geraldine Shah Family Trust, respectively, in the principal amounts of $240,000, $160,000, $10,000 and $30,000, respectively (1)
10.10	Form of Warrants to Purchase Common Stock dated March 28, 2003 issued by SSP Solutions, Inc. in favor of Crestview Capital Fund L.P., Richard P. Kiphart, Marvin J. Winkler and the Kris and Geraldine Shah Family Trust, respectively, in the amounts of 120,000, 80,000, 5,000 and 15,000 shares, respectively (1)
10.11	Warrant to Purchase Common Stock dated March 12, 2003 by SSP Solutions, Inc. to Integral Systems, Inc. (1)
99.1	Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

(#) Management contract or compensatory plan, contract or arrangement required to be filed as an exhibit.

(1) Filed as an exhibit to the initial filing of our Form 10-K for the year ended December 31, 2002 (file no. 000-26227) and incorporated herein by reference.

(b) Reports on Form 8-K.

On January 30, 2003, we filed a Form 8-K for January 27, 2003 to report the appointment of Gregory J. Clark and Ron R. Goldie to our board of directors. The Form 8-K contained Item 5 - Other Events, and Item 7 - Financial Statements and Exhibits. The exhibits to the Form 8-K consisted of two press releases relating to the director appointments.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 20, 2003 SSP SOLUTIONS, INC.

By: /s/ MARVIN J. WINKLER

Marvin J. Winkler
CO-CHAIRMAN OF THE BOARD OF DIRECTORS,
DIRECTOR AND CO-CHIEF EXECUTIVE OFFICER
(PRINCIPAL EXECUTIVE OFFICER)

By: /s/ KRIS SHAH

Kris Shah
CO-CHAIRMAN OF THE BOARD OF DIRECTORS,
DIRECTOR AND CO-CHIEF EXECUTIVE OFFICER
(PRINCIPAL EXECUTIVE OFFICER)

By: /s/ THOMAS E. SCHIFF

Thomas E. Schiff
EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
(PRINCIPAL FINANCIAL OFFICER)

By: /s/ SHANE J. BROPHY

Shane J. Brophy
VICE PRESIDENT FINANCE
(PRINCIPAL ACCOUNTING OFFICER)

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CERTIFICATIONS

I, Marvin J. Winkler, certify that:

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

2. Based on my knowledge, this quarterly 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 quarterly report;

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

   a) Designed such disclosure controls and procedures 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 quarterly report is being prepared;

   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

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

   a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 20, 2003

/s/ MARVIN J. WINKLER

Marvin J. Winkler,
Co-Chief Executive Officer (principal executive officer)

I, Kris Shah, certify that:

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

2. Based on my knowledge, this quarterly 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 quarterly report;

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

   a) Designed such disclosure controls and procedures 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 quarterly report is being prepared;

   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

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

   a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 20, 2003

/s/ KRIS SHAH

Kris Shah,
Co-Chief Executive Officer (principal executive officer)

I, Thomas E. Schiff, certify that:

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

2. Based on my knowledge, this quarterly 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 quarterly report;

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) Designed such disclosure controls and procedures 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 quarterly report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

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

    a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 20, 2003

/s/ THOMAS E. SCHIFF

Thomas E. Schiff,
Chief Financial Officer (principal financial officer)

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EXHIBITS FILED WITH THIS REPORT

Exhibit Number	Description
99.1	Certification of Co-Chief Executive Officers and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

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