SSP SOLUTIONS INC
Form 10-Q
November 15, 2002

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2002,**

**or**

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

**COMMISSION FILE NO. 000-26227**

# SSP SOLUTIONS, INC.

(EXACT NAME OF REGISTRANT 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) (ZIP CODE)

**(949) 851-1085**

(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

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

As of November 13, 2002, the registrant had 24,600,830 shares of common stock outstanding.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

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

| | DECEMBER 31, 2001 | SEPTEMBER 30, 2002 |
|---|---|---|
| | | (UNAUDITED) |

| | DECEMBER 31, 2001 | SEPTEMBER 30, 2002 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 3,257 | $ 619 |
| Investment in trading securities | 1,360 | 120 |
| Accounts receivable (net of allowance for doubtful accounts of $254 and $244 as of December 31, 2001 and September 30, 2002, respectively) | 4,358 | 1,590 |
| Inventories | 436 | 338 |
| Prepaid expenses | 601 | 262 |
| Other current assets | 401 | 427 |
| Total current assets | 10,413 | 3,356 |
| Property and equipment, net | 361 | 108 |
| Other assets | 28 | 649 |
| Goodwill | 25,930 | 25,930 |
| Other intangibles, net | 691 | 622 |
| | $ 37,423 | $ 30,665 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current installments of long-term debt | $ 1,695 | $ 456 |
| Accounts payable | 9,495 | 6,235 |
| Accrued liabilities | 3,343 | 1,329 |
| Note payable to related party | 392 | |
| Deferred revenue | 203 | 238 |
| Accrued rent | 1,064 | 314 |
| Total current liabilities | 16,192 | 8,572 |
| Long-term debt, less current installments, net of unamortized debt issuance costs | 2,500 | 1,158 |
| Deferred revenue | 46 | |
| Accrued rent | 1,107 | 987 |
| Total liabilities | 19,845 | 10,717 |
| Commitments & contingencies (Notes 8 & 11) | | |
| Stockholders' equity: | | |
| Preferred stock, $.01 par value; Authorized 5,000,000 shares; no shares issued or outstanding | | |
| Common stock, $.01 par value; Authorized 100,000,000 shares; issued and outstanding 20,630,754 and 23,511,243 and shares at December 31, 2001 and September 30, 2002, respectively | 206 | 235 |
| Additional paid-in capital | 118,608 | 127,802 |
| Note receivable from stockholder | (500) | |
| Deferred compensation | (1,193) | (375) |
| Accumulated deficit | (99,543) | (107,714) |
| Total stockholders' equity | 17,578 | 19,948 |

| | DECEMBER 31, 2001 | SEPTEMBER 30, 2002 |
|---|---|---|
| | $ 37,423 | $ 30,665 |

See accompanying notes to condensed consolidated financial statements.



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

| | THREE MONTHS ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| | SEPTEMBER 30, 2001 | SEPTEMBER 30, 2002 | SEPTEMBER 30, 2001 | SEPTEMBER 30, 2002 |
| Revenues: | | | | |
| Product | $ 4,693 | $ 3,273 | $ 14,732 | $ 6,502 |
| License and service | 462 | 659 | 1,251 | 2,395 |
| Total revenues | 5,155 | 3,932 | 15,983 | 8,897 |
| Cost of sales: | | | | |
| Product | 4,007 | 1,256 | 11,689 | 3,200 |
| License and service | 126 | 182 | 376 | 643 |
| Total cost of sales | 4,133 | 1,438 | 12,065 | 3,843 |
| Gross margin | 1,022 | 2,494 | 3,918 | 5,054 |
| Operating Expenses: | | | | |
| Selling, general and administrative | 1,775 | 1,736 | 5,229 | 6,378 |
| Research and development | 1,625 | 1,124 | 4,317 | 4,178 |
| Research and development Wave Systems Corp. | 278 | (625) | 1,111 | 1,041 |
| Amortization of intangibles | 181 | 23 | 228 | 69 |
| In-process research and development | 3,300 | | 3,300 | |
| Total operating expenses | 7,159 | 2,258 | 14,185 | 11,666 |
| Operating income (loss) | (6,137) | 236 | (10,267) | (6,612) |
| Non-operating Expenses: | | | | |
| Realized loss (gain) on trading securities | 1,127 | (2) | 1,127 | 120 |
| Interest expense, net | 38 | 170 | 66 | 487 |
| Non-cash interest and financing expense (Note 4) | | 441 | | 808 |
| Other expense, net | 2 | 57 | 2 | 141 |

| | THREE MONTHS ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| Total non-operating expenses | 1,167 | 666 | 1,195 | 1,556 |
| Loss before income taxes | (7,304) | (430) | (11,462) | (8,168) |
| Provision for income taxes | 51 | | 54 | 2 |
| Net loss | $ (7,355) | $ (430) | $ (11,516) | $ (8,170) |
| Net loss per share basic and diluted | $ (0.52) | $ (0.02) | $ (1.02) | $ (0.39) |
| Shares used in per share computations basic and diluted | 14,218 | 21,909 | 11,238 | 21,084 |

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)**

| | NINE MONTHS ENDED | |
|---|---|---|
| | SEPTEMBER 30, 2001 | SEPTEMBER 30, 2002 |
| Cash flows from operating activities: | | |
| Net loss | $ (11,516) | $ (8,170) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Provision for losses on receivables | 240 | 244 |
| Depreciation and amortization | 745 | 330 |
| Discount on note receivable from stockholder | | 153 |
| In process research and development | 3,300 | |
| Non-cash interest and financing expense | | 716 |
| Gain on vendor settlements | | (270) |
| Revision of estimated liability | | (463) |
| Gain on a settlement of Wave Systems Corp. contract | | (1,181) |
| Deferred compensation | 42 | 241 |
| Realized loss on trading securities | 1,127 | 120 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 888 | 2,524 |
| Inventories | (297) | 98 |
| Prepaid expenses | (288) | 340 |
| Other current assets | (699) | (26) |
| Other assets | 256 | (439) |
| Accounts payable | 5,477 | (2,363) |
| Accrued liabilities | 333 | 2,255 |
| Accrued rent | | (871) |

| | NINE MONTHS ENDED | |
|---|---|---|
| Deferred revenue | (156) | (10) |
| Net cash used in operating activities | (548) | (6,772) |
| Cash flows used in investing activities: | | |
| Purchases of property and equipment | (52) | (8) |
| Net cash paid for merger with BIZ Interactive Zone, Inc. | (590) | |
| Proceeds from sale of trading securities | 107 | 1,120 |
| Net cash provided by (used in) investing activities | (535) | 1,112 |
| Cash flows from financing activities: | | |
| Stock options exercised and employee stock purchases | 3 | 83 |
| Stock issued for services | | 28 |
| Borrowings on revolving note payable | 13,988 | 1,902 |
| Proceeds from insurance financing | 25 | |
| Proceeds from issuance of debt | | 4,000 |
| Repayment of insurance financing | (377) | (173) |
| Principal payments on revolving note payable and long-term notes payable to bank | (15,482) | (3,426) |
| Repayment of note receivable from related party | | 347 |
| Issuance of common stock | | 653 |
| Principal payments on note payable to related party | | (392) |
| Net cash provided by (used in) financing activities | (1,843) | 3,022 |
| Net decrease in cash | (2,926) | (2,638) |
| Cash and cash equivalents at beginning of period | $ 4,120 | $ 3,257 |
| Cash and cash equivalents at end of period | $ 1,194 | $ 619 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 198 | $ 135 |
| Income taxes | $ 2 | $ |
| Supplemental disclosures of non-cash investing and financing activities: | | |
| Merger costs | (750) | |
| Fair value of net assets | 3,231 | |
| Fair value of net liabilities | (3,047) | |
| Goodwill and other intangible assets | 61,182 | |
| In-process research and development | 3,300 | |
| Deferred compensation | 29 | |
| Market value of common stock issued and options and warrants assumed related to merger with BIZ | 63,945 | |
| Settlement of Wave Systems Corp. contract | | |
| Issuance of debt | | 270 |
| Exchange of debt for common stock | | 2,160 |
| Debt issuance costs in exchange for warrants | | 183 |

| | NINE MONTHS ENDED |
|---|---|
| Debt issuance discount | 5,796 |
| Conversion of accrued interest to common stock | 194 |

See accompanying notes to condensed consolidated financial statements.



**SSP SOLUTIONS, INC.**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**SEPTMEBER 30, 2001 AND 2002**
**(UNAUDITED)**
**(IN THOUSANDS, EXCEPT PER SHARE DATA)**

**(1) GENERAL INFORMATION:**

**Condensed Consolidated Financial Statements**

In the opinion 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 September 30, 2002; the results of operations for the three and nine months ended September 30, 2001 and 2002; and the statements of cash flows for the nine months ended September 30, 2001 and 2002. Interim results for the three and nine months ended September 30, 2002, are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. The interim financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2001, included in the Company's Form 10-K/A, filed in April 2002.

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.

**Liquidity and Capital Resources**

At September 30, 2002, the Company had a working capital deficit of $5,216 and had incurred a loss from operations for the nine months then ended of $6,612. The Company expects to continue to incur additional losses during the remainder of 2002. Given the September 30, 2002 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, 2002. 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 the accounts receivable 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, the Company will not have adequate resources to fund its operations.

During the last three quarters, the Company incurred technical defaults under its accounts receivable financing arrangement with Wells Fargo Business Credit, Inc. ("WFBC") and therefore under its long-term convertible notes. The Company obtained waivers for its accounts receivable financing for defaults through March 31, 2002 and for the long-term convertible notes through January 1, 2003. Subsequent to March 31, 2002, the Company remained in default under its accounts receivable financing with WFBC and did not obtained a waiver of such default. As of September 30, 2002, the Company had no net outstanding balances due to WFBC.

In October 2002, the Company terminated its remaining agreement with WFBC. The Company entered into a new agreement with Bay View Funding ("BVF") for the financing of accounts receivable, effective October 18, 2002. Further details are provided within the Subsequent Event disclosure in Note 12. The Company does not expect future fixed obligations to be paid from operations and intends to satisfy fixed obligations from additional financings, use of the accounts receivable financing, extending vendor payments, selling investments and issuing stock or securities as payment on obligations.

The Company's current financial condition is the result of several factors including the following:

- Operating results in 2001 and first nine months of 2002 were below expectations.

- The events of September 11, 2001 affected the operations and delayed the decisions of the U.S. government. This caused sales the Company had anticipated to be delayed.

- Sales of products through channels acquired in the acquisition ("Acquisition") of BIZ Interactive Zone, Inc. ("BIZ") are taking longer than originally anticipated to develop.

- Market demand for the Company's Xboard product (formerly known as CipherServer product line) did not materialize as anticipated and therefore the Company's 2001 sales were below forecast and the Company is not forecasting future sales of the Xboard product.

- Reduced credit line availability and the unwillingness of vendors to sell additional products to the Company on account had a significant adverse impact on the sales volume of the Company's Pulsar Data Systems, Inc. ("Pulsar") subsidiary in 2001 and the first nine months of 2002 and will continue to adversely impact sales volume for the remainder of 2002.

- Research and development expenses from the Acquisition increased costs.

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 vendor payment terms

- 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 the Company's products and services

- relationships with partners, suppliers and customers

- projected capital expenditures

reduction in the valuation of marketable investment securities

national and international economic conditions

defaults on financing that will impact the availability of borrowings

In addition to the Company's current working capital deficit situation, current operating plans show a shortfall of cash for the remainder of 2002. The Company intends to mitigate its position through one or more of the following:

Additional equity capital The Company will seek additional equity capital, which will most likely require the issuance of warrants causing additional dilution to current stockholders. In addition, providers of new equity capital may require other concessions.



Additional convertible debt Depending upon market conditions, the Company may issue additional debt instruments. The types of instruments demanded by the market would likely contain a provision for the issuance of warrants and may also be convertible into equity. On April 16, 2002, the Company completed a private placement of $5,000 through the issuance of $4,000 in 10% secured convertible promissory notes, $653 in secured non-convertible promissory notes ($153 held by co-chairman Kris Shah and $500 held by co-chairman Marvin Winkler) and the pre-payment of a $500 note due from Kris Shah, less a discount of $153. In June 2002, Mr. Shah and Mr. Winkler cancelled both their April 16 notes and their December 2001 notes in consideration for the issuance to them of an aggregate of 1,109 shares of common stock at the above-market price of $1.30 per share. This conversion reduced notes payable together with accrued interest by $1,442 and added the same amount to stockholders' 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 equity 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 finance receivables in conjunction with its BVF agreement to generate cash.

Liquidate investments The Company will sell investments to generate cash. The market value of trading securities at September 30, 2002 was $120. During the nine months ended September 30, 2002, the Company generated $1,120 through the sales of trading securities.

Vendor negotiations The Company has successfully negotiated and executed agreements with a number of vendors regarding payment of existing accounts payable over extended terms of up to 48 months. As of September 30, 2002, $172 was classified as long-term as a result of the executed term-out agreements. The Company is in the final stages of completing an agreement with a vendor to extend the terms of an existing accounts payable balance of $1,037. The Company will continue to negotiate term out agreements with vendors to extend the payment terms of existing accounts payable. Upon execution of such agreements, amounts that become due under the term out agreements beyond a twelve-month period will be converted to long-term notes payable on the balance sheet.

Advance payments Under current or future contracts the Company may obtain cash payments as 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.

Project suspensions  The Company may defer cash payments through suspension of development projects.

Issuance of stock as payment for existing and future obligations  The Company anticipates paying some of its accrued liabilities as of September 30, 2002, by the issuance of common stock and may also issue common stock as payment for obligations incurred subsequent to September 30, 2002.

Issuance of stock to pay interest  The Company may issue common stock to pay interest on long-term debt. On October 1, 2002 the Company issued 127 shares of common stock to pay interest accrued during the quarter ended September 30, 2002.



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

Ultimately, the Company's ability to continue as a going concern is dependent upon its ability to successfully sell existing products & services launch its new products, increase revenue, improve operating efficiencies, sustain a profitable level of operations and attract new sources of capital. If the Company does not receive adequate financing or is not otherwise able to generate sufficient cash, the Company could be forced to merge with another company or cease operations.

**BIZ Acquisition**

On August 24, 2001, pursuant to an Agreement and Plan of Reorganization dated July 3, 2001 with BIZ, the Company completed the Acquisition, whereby BIZ became a wholly-owned subsidiary of the Company. In connection with the Acquisition, the Company issued an aggregate of 10,875 shares of its common stock in exchange for all of the outstanding shares of BIZ common stock and preferred stock. In addition, the Company reserved for issuance an aggregate of approximately 860 shares of its common stock for issuance upon exercise of BIZ options and warrants assumed by the Company.

The Acquisition has been accounted for under the purchase method of accounting in accordance with generally accepted accounting principles. The Company recorded a one-time charge for purchased in-process research and development ("IPR&D") expenses of $1,600 in the year ended December 31, 2001.

The total purchase price and allocation among the fair value of tangible and intangible assets and liabilities (including purchased in-process research and development) are summarized as follows:

| | | |
|---|---|---|
| Tangible assets | $ | 3,231 |
| Liabilities | | 3,047 |
| Net tangible assets | | 184 |
| Identifiable intangible assets: | | |
| In-process research and development | | 1,600 |
| Completed technology | | 6,200 |
| Strategic relationships | | 2,800 |
| Goodwill | | 53,882 |
| Deferred compensation | | 29 |
| | $ | 64,695 |

The Company believes the assumptions used in determining the income forecast associated with the IPR&D products were reasonable. No assurance can be given, however, that the underlying assumptions used to estimate the income forecast, the ultimate revenues and costs on such projects, or the events associated with such projects, will transpire as estimated. During the fourth quarter of 2001, the Company terminated development on one of the technologies classified as IPR&D. To date, the Company has spent approximately $1,112 on the IPR&D projects and the estimated cost to complete the two on-going projects is $4,025.

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 that the estimates of the anticipated future gross revenues, the remaining estimated economic life, or both, will be reduced within the next year. Reasonably possible is defined as more than remote but less than likely. While the Company adjusted goodwill in 2001, the remaining goodwill of $25,930 related to the Acquisition at September 30, 2002 is subject to impairment analysis and write down both as noted in the following section.



**Goodwill and Other Intangibles**

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 141, Business Combinations ("SFAS 141"), and SFAS No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets separate from goodwill. SFAS 142 requires the use of an amortization and non-amortization approach to account for purchased goodwill and certain intangibles. Under a non-amortization approach, goodwill and certain intangibles are not to be amortized into results of operations, but instead would be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. The amortization and non-amortization provisions of SFAS 142 are to be applied to all goodwill and intangible assets acquired after June 30, 2001. The provisions of each statement that apply to goodwill and intangible assets acquired prior to June 30, 2001 was adopted by the Company on January 1, 2002.

The Network Solutions Market intangible asset consists of the following components:

| | INTANGIBLE |
|---|---|
| As of September 30, 2002 | |
| Gross carrying amount | $ 5,058 |
| Accumulated amortization | (4,437) |
| | $ 622 |
| As of December 31, 2001 | |
| Gross carrying amount | $ 5,058 |
| Accumulated amortization | (4,368) |
| | $ 691 |

The estimated aggregate amortization expense related to the contracts/relationships intangible asset for each of the next five years is $92.

In accordance with SFAS 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 SFAS 142. In accordance with the transition provisions of SFAS 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 approximately $36,300 was required. Subsequently, the Company reviewed the assumptions used in the original analysis as of March 31, 2002, June 30, 2002, and September 30, 2002 and concluded that such analyses continue to be adequate and no additional write-down was required. 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.

The Company amortizes intangible assets relating to businesses acquired and costs in excess of the fair value of net assets of businesses acquired using the straight-line method over the estimated useful lives of the intangible assets. The straight-line amortization reflects the consumption pattern of the economic benefit of the intangible assets.

**(2) INVESTMENT**

The Company has an investment that is classified as trading securities. The securities consist of Class A common stock of Wave Systems Corp. ("Wave") received in the Acquisition. The investment is presented and recorded in accordance with SFAS 115. Management determines the appropriate classification of its investments in debt and marketable equity securities at the time of purchase and reevaluates such designation as of each balance sheet date. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity. Trading securities are carried at fair value with the unrealized gains and losses, net of applicable taxes, reported in earnings in the statement of operations. The cost of securities sold is based upon the specific identification method. As of December 31, 2001 and September 30, 2002, the Company owned 607 shares wi