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PUBLICARD INC  
Form 10-Q  
May 03, 2002

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002

OR

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

For the transition period from \_\_\_ to \_\_\_.

COMMISSION FILE NUMBER 0-29794

PUBLICARD, INC.  
(Exact name of registrant as specified in its charter)

PENNSYLVANIA  
(State or other jurisdiction of incorporation or organization)

23-0991870  
(I.R.S. Employer Identification Number)

620 FIFTH AVENUE, 7TH FLOOR, NEW YORK, NY  
(Address of principal executive offices)

10020  
(Zip code)

Registrant's telephone number, including area code: (212) 651-3102

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    X    No        .  
-----        -----

Number of shares of Common Stock outstanding as of April 30, 2002: 24,153,402

PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

PUBLICARD, INC.

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AND SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE SHEETS AS OF  
MARCH 31, 2002 AND DECEMBER 31, 2001  
(IN THOUSANDS EXCEPT SHARE DATA)

MARCH  
2002  
-----  
(unaudi

## ASSETS

Current assets:

Cash, including short-term investments of \$3,463 in 2002 and \$4,199 in 2001	\$ 3,
Trade receivables, less allowance for doubtful accounts (2002 - \$194, 2001 - \$216)	1,
Inventories	
Other	
	-----
Total current assets	5,
	-----

Equipment and leasehold improvements, net

Goodwill

Other assets

2,  
6,  
-----  
\$ 15,  
=====

## LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:

Trade accounts payable	\$ 3,
Accrued liabilities	-----
Total current liabilities	4,

Other non-current liabilities

5,  
-----

Total liabilities	9, -----
-------------------	-------------

Shareholders' equity:

Class A Preferred Stock, Second Series, no par value: 1,000 shares authorized; 780 shares issued and outstanding	3,
Common shares, \$0.10 par value: 40,000,000 shares authorized; 24,153,402 shares issued and outstanding	2,
Additional paid-in capital	107,
Accumulated deficit	(105,
Other comprehensive loss	(1, -----
Total shareholders' equity	6, -----

\$ 15,  
=====

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The accompanying notes to consolidated financial statements are an integral part of these balance sheets.

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENTS OF INCOME (LOSS)  
FOR THREE MONTHS ENDED MARCH 31, 2002 AND 2001  
(IN THOUSANDS EXCEPT SHARE DATA)  
(UNAUDITED)

	2002	2001
	-----	-----
Net sales	\$ 1,199	\$ 1,520
Cost of sales	636	832
	-----	-----
Gross margin	563	688
	-----	-----
Operating expenses:		
General and administrative	933	1,302
Sales and marketing	427	1,293
Product development	119	922
Stock compensation	--	15
Goodwill amortization	--	660
	-----	-----
	1,479	4,192
	-----	-----
Loss from operations	(916)	(3,504)
	-----	-----
Other income (expenses):		
Interest income	14	207
Interest expense	(15)	(19)
Cost of pensions - non-operating	(206)	(216)
Other income (expenses)	(2)	23
	-----	-----
	(209)	(5)
	-----	-----
Net loss	\$ (1,125)	\$ (3,509)
	=====	=====
Basic loss per common share	\$ (.05)	\$ (.14)
	=====	=====
Weighted average shares outstanding	24,153,402	24,237,402
	=====	=====

The accompanying notes to the consolidated financial statements are an integral part of these statements.

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2002  
(IN THOUSANDS EXCEPT SHARE DATA)  
(UNAUDITED)

	Class A Preferred Stock -----	Common Shares Issued -----	Amount -----	Additional Paid-in Capital -----	Accumulat Deficit -----
Balance - December 31, 2001	\$ 3,900	24,153,402	\$ 2,415	\$ 107,098	\$ (104,83
Comprehensive Loss:					
Net loss	--	--	--	--	(1,12
Foreign currency translation adjustment	--	--	--	--	--
Comprehensive loss	-----	-----	-----	-----	-----
Balance - March 31, 2002	\$ 3,900 =====	24,153,402 =====	\$ 2,415 =====	\$ 107,098 =====	\$ (105,95 =====

The accompanying notes to the consolidated financial statements are an integral part of this statement.

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE THREE MONTHS ENDED MARCH 31, 2002 AND 2001  
(IN THOUSANDS)  
(UNAUDITED)

	2002 -----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	\$ (1,125)
Adjustments to reconcile net loss to net cash used in operating activities:	
Goodwill amortization	--
Stock compensation expense	--
Depreciation	47
Changes in operating assets and liabilities	243

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Net cash used in operating activities	(835)
<hr/>	
CASH FLOWS FROM INVESTING ACTIVITIES:	
Capital expenditures	--
Investment in TecSec, Incorporated	--
Proceeds from discontinued operations	24
<hr/>	
Net cash provided by investing activities	24
<hr/>	
CASH FLOWS FROM FINANCING ACTIVITIES:	
Costs incurred from private placement of Class A Preferred Stock	--
<hr/>	
Net cash used in financing activities	--
<hr/>	
Effect of exchange rate changes on cash and cash equivalents	(1)
<hr/>	
Net decrease in cash	(812)
Cash - beginning of period	4,479
<hr/>	
Cash - end of period	\$ 3,667
<hr/>	

The accompanying notes to the consolidated financial statements are an integral part of these statements.

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

##### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

###### DESCRIPTION OF THE BUSINESS

PublicARD, Inc. ("PublicARD" or the "Company") was incorporated in the Commonwealth of Pennsylvania in 1913. PublicARD entered the smart card industry in early 1998, and began to develop solutions for the conditional access, security, payment system and data storage needs of industries utilizing smart card technology. In 1998 and 1999, the Company made a series of acquisitions to enhance its position in the smart card industry. In March 2000, PublicARD's Board of Directors (the "Board"), together with its management team, determined to integrate its operations and focus on deploying smart card solutions, which facilitate secure access and transactions. To effect this new business strategy, in March 2000, the Board adopted a plan of disposition pursuant to which the Company divested its non-core operations. See Note 4 for a discussion on the disposition plan.

In July 2001, after evaluating the timing of potential future revenues, PublicARD's Board decided to shift the Company's strategic focus. While the Board remained confident in the long-term prospects of the smart card business, the timing of public sector and corporate initiatives in wide-scale, broadband

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environments utilizing the Company's smart card reader and chip products had become more uncertain. Given the lengthened time horizon, the Board did not believe it would be prudent to continue to invest the Company's current resources in the ongoing development and marketing of these technologies. Accordingly, the Board determined that shareholders' interests will be best served by pursuing strategic alliances with one or more companies that have the resources to capitalize more fully on the Company's smart card reader and chip-related technologies. In connection with this shift in the Company's strategic focus, workforce reductions and other measures were implemented to achieve cost savings.

At present, PublicARD's sole operating activities are conducted through its Infineer Ltd. subsidiary ("Infineer"), which designs smart card platform solutions for educational and corporate sites. The Company's future plans revolve around an acquisition strategy focused on businesses in areas outside the high technology sector while continuing to support the expansion of the Infineer business.

### LIQUIDITY AND GOING CONCERN CONSIDERATIONS

These consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred operating losses, a substantial decline in working capital and negative cash flow from operations for the three months ended March 31, 2002 and years 2001, 2000 and 1999. The Company has also experienced a substantial reduction in its cash and short-term investments, which declined from \$17.0 million at December 31, 2000 to \$3.7 million at March 31, 2002, and has an accumulated deficit of \$106 million at March 31, 2002.

Although the Company believes that existing cash and short term investments may be sufficient to meet the Company's obligations and capital requirements at its currently anticipated levels of operations through December 31, 2002, additional working capital will be necessary in order to fund the Company's current business plan and to ensure it is able to fund its pension and environmental obligations. While the Company is actively considering various funding alternatives, the Company has not secured or entered into any arrangements to obtain additional funds. There can be no assurance that the Company will be able to obtain additional funding on acceptable terms or at all. If the Company cannot raise additional capital to continue its present level of operations it may not be able to meet its obligations, take advantage of future acquisition opportunities or further develop or enhance its product offering, any of which could have a material adverse effect on its business and results of operations and could lead the Company being required to seek bankruptcy protection. These conditions raise substantial doubt about the Company's ability to

PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### PRINCIPLES OF CONSOLIDATION

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The consolidated financial statements include the accounts of PublicARD and its majority-owned subsidiaries. All significant intercompany transactions are eliminated in consolidation.

### BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements reflect all normal and recurring adjustments that are, in the opinion of management, necessary to present fairly the financial position of the Company and its subsidiary companies as of March 31, 2002 and the results of their operations and cash flows for the three months ended March 31, 2002 and 2001. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K for the year ended December 31, 2001, as amended.

### EARNINGS (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is based on net income divided by the weighted average number of common shares outstanding during each period. Diluted net income (loss) per common share assumes issuance of the net incremental shares from stock options, warrants and convertible preferred stock at the later of the beginning of the year or date of issuance. Diluted net income (loss) per share was not computed for 2002 and 2001 as the effect of stock options, warrants and convertible preferred stock were antidilutive.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS No. 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142").

SFAS No. 141 addresses financial accounting and reporting for business combinations. This new statement requires that all business combinations be accounted for using one method (the purchase method), intangible assets be recognized apart from goodwill if they meet certain criteria and disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. The provisions of this statement apply to all business combinations initiated after June 30, 2001.

SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. Under this new statement, goodwill and intangible assets that have indefinite useful lives will not be amortized, but rather will be tested at least annually for impairment based on the specific guidance of this statement. In addition, this statement requires disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required. The provisions of this statement are required to be applied starting with fiscal years beginning after December 15, 2001. However, goodwill and intangible assets acquired after June 30, 2001 will be subject immediately to the non-amortization and amortization provisions of this statement. The Company adopted this statement on January 1, 2002. In accordance with this statement, no amortization expense for goodwill will be recorded in current and future periods. Goodwill and other intangibles will be subject to an annual review for impairment or earlier if circumstances or events indicate that impairment has occurred. This may result in future write-downs or the write-off of such assets. Excluding goodwill amortization,

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the pro forma

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

net loss for the three months ended March 31, 2001, was \$2,849,000, or \$.12 per share.

INVENTORIES

Inventories are stated at lower of cost (first-in, first-out method) or market. The Company evaluates the need to record adjustments for impairment of inventory on a quarterly basis. Inventory in excess of the Company's estimated usage requirements is written down to its estimated net realizable value. Inherent in the estimates of net realizable value are management's estimates related to the Company's production schedules, customer demand, possible alternative uses and the ultimate realization of potentially excess inventory. Inventories as of March 31, 2002 and 2001 consisted of the following (in thousands):

	2002	2001
	----	----
Raw materials and supplies	\$302	\$389
Work-in-process	22	37
Finished goods	129	131
	----	----
	\$453	\$557
	====	====

NOTE 2 - INVESTMENTS

In December 2000, the Company acquired an ownership interest in TecSec, Incorporated, a Virginia corporation ("TecSec"), for \$5.1 million. TecSec develops and markets encryption products and solutions, which are designed to enable the next generation information security for the enterprise, multi-enterprise e-business and other markets. The TecSec investment, amounting to a 5% ownership interest on a fully diluted basis, has been accounted for at cost and could be subject to write-down in future periods if it is determined that the investment is impaired and not recoverable. The Company has certain anti-dilutive rights whereby its ownership interest may be increased following contributions of additional third-party capital. If TecSec is not successful in executing its business plan or in obtaining sufficient capital on acceptable terms or at all, the Company's investment in TecSec could be permanently impaired and subject to a significant write-down.

In conjunction with the decision to exit the smart card reader and chip business, in September 2001, the Company formed a new minority-owned affiliate, Mako Technologies LLC ("Mako"), to market its smart card reader and chip technologies. The Company contributed certain inventories and equipment valued at \$238,000, in exchange for a 31% fully diluted ownership interest in Mako. The Company also granted a perpetual license of its reader and chip technology to



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Mako in exchange for royalties based on sales over the next two years. After reducing headcount and reassessing business potential, a decision was made to liquidate Mako and terminate the license agreement. Pending the final disposition of this venture, the Company has established a reserve against the entire investment in Mako. The reserve was accumulated through liquidation sales in 2002 of previously reserved inventory.

### NOTE 3 - SEGMENT DATA

As a result of the disposition of certain operations (See Note 4) and because the Company predominantly operates in one industry, that being the deployment of smart card solutions which facilitate secure access and transactions, the Company reports as a single segment. Sales by geographical areas for the three months ended March 31, 2002 and 2001 are as follows (in thousands):

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	2002 -----	2001 -----
United States	\$ 283	\$ 635
Europe	896	822
Rest of world	20	63
	-----	-----
	\$1,199	\$1,520
	=====	=====

The Company has operations in the United States and United Kingdom. Identifiable assets by country as of March 31, 2002 and December 31, 2001 are as follows (in thousands):

	2002 -----	2001 -----
United States	\$10,847	\$12,037
United Kingdom	2,290	2,557
	-----	-----
	\$13,137	\$14,594
	=====	=====

### NOTE 4 - DISCONTINUED OPERATIONS

In March 2000, the Company's Board adopted a plan to dispose of the operations of the Company's Greenwald Industries Inc. ("Greenwald"), Greenwald Intellicard Inc. ("Greenwald Intellicard"), Greystone Peripherals, Inc. ("Greystone") and Amazing Smart Card Technologies, Inc. ("Amazing") subsidiaries. These subsidiaries designed, manufactured and distributed mechanical and smart card laundry solutions, hard disk duplicators and smart

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cards. In the fourth quarter of 1999, the Company recorded a loss of \$2.0 million related to the disposition plan, net of the expected gain on the disposition of these businesses. The loss provision was based on estimates of the proceeds expected to be realized on the dispositions and the results of operations through the disposition or wind-down dates.

On June 29, 2000, the Company completed the sale of substantially all of the assets of Greenwald and Greenwald Intellicard to The Eastern Company ("Eastern") for \$22.5 million in cash, less \$1.75 million held in escrow to secure the payment of certain indemnification obligations. As part of the transaction, Eastern assumed certain liabilities of Greenwald and Greenwald Intellicard, including certain contractual liabilities, accounts payable and accrued liabilities. In the third quarter of 2000, the Company recognized a gain of \$4.3 million principally related to the sale of Greenwald and Greenwald Intellicard.

In the second quarter of 2001, the Company revised its estimates of proceeds and expenses associated with the wind-down of Amazing and Greystone, which has been substantially completed, and recognized a gain of \$2.4 million, which had been previously deferred pending resolution of certain contingencies. The amounts the Company will ultimately realize from its discontinued operations could differ from the amounts estimated and could therefore result in additional charges or gains in future periods.

The results of the operations of Greenwald, Greenwald Intellicard, Amazing and Greystone have been reflected as discontinued operations. Summarized balance sheet information with respect to the discontinued operations as of March 31, 2002 is as follows (in thousands):

Non-current assets (cash held in escrow)	\$ 2,128
Disposition reserves	(1,256)
	-----
Net assets of discontinued operations	\$ 872
	=====

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### NOTE 5 - SUPPLEMENTAL CASH FLOW INFORMATION

Changes in operating assets and liabilities reflected in the Consolidated Statements of Cash Flows consisted of the following for the three months ended March 31, 2002 and 2001 (in thousands):

	2002	2001
	-----	-----
Trade receivables	\$ 44	\$ 54
Inventories	94	(618)
Other current assets	400	(120)
Other assets	(9)	(96)
Trade accounts payable	(468)	101
Accrued liabilities	328	(457)
Other non-current liabilities	(146)	(109)
	-----	-----
	\$ 243	\$(1,245)
	=====	=====

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No cash was paid for interest or income taxes in 2002 and 2001.

### NOTE 6 - SUBSEQUENT EVENT

The Company sponsors a defined benefit pension plan that was frozen in 1993. The assets of the defined benefit pension plan are managed by an outside trustee and invested primarily in equity and fixed income securities. PublicARD common stock represented 1.2% of plan assets as of December 31, 2001. Contributions to the plan were \$1.1 million and \$1.2 million in fiscal 2001 and 2000, respectively. For 2002, the minimum required contributions are expected to be \$1.1 million. The Company failed to make the required quarterly contribution to the plan due April 15, 2002, in the amount of \$253,000. Pursuant to Federal tax law, interest will begin accruing on the obligation.

The Company will provide notice of its failure to make the required contribution to the Pension Benefit Guaranty Corporation by May 15, 2002 and to the plan participants by June 15, 2002. Should the Company fail to make the required contributions to the plan for 2002, it could be subject to interest, penalties, liens on assets and ultimately a forced plan termination. There is no assurance that the Company will make the required contributions.

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

#### THREE MONTHS ENDED MARCH 31, 2002 AND 2001

Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Form 10-Q contains forward-looking statements, including (without limitation) statements concerning possible or assumed future results of operations of PublicARD preceded by, followed by or that include the words "believes," "expects," "anticipates," "estimates," "intends," "plans" or similar expressions. For those statements, we claim the protection of the safe harbor for forward-looking statements contained in the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions. You should understand that such statements made under "Factors That May Affect Future Results" and elsewhere in this document could affect our future results and could cause those results to differ materially from those expressed in such forward-looking statements.

#### OVERVIEW

PublicARD was incorporated in the Commonwealth of Pennsylvania in 1913. PublicARD entered the smart card industry in early 1998, and began to develop solutions for the conditional access, security, payment system and data storage needs of industries utilizing smart card technology. In 1998 and 1999, the Company made a series of acquisitions to enhance its position in the smart card industry. In March 2000, PublicARD's Board, together with its management team, determined to integrate its operations and focus on deploying smart card solutions, which facilitate secure access and transactions. To effect this new business strategy, in March 2000, the Board adopted a plan of disposition pursuant to which the Company divested its non-core operations. See Note 4 to the Consolidated Financial Statements for a discussion on the disposition plan.

In July 2001, after evaluating the timing of potential future revenues, PublicARD's Board decided to shift the Company's strategic focus. While the Board remained confident in the long-term prospects of the smart card business,

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the timing of public sector and corporate initiatives in wide-scale, broadband environments utilizing the Company's smart card reader and chip products had become more uncertain. Given the lengthened time horizon, the Board did not believe it would be prudent to continue to invest the Company's current resources in the ongoing development and marketing of these technologies. Accordingly, the Board determined that shareholders' interests will be best served by pursuing strategic alliances with one or more companies that have the resources to capitalize more fully on the Company's smart card reader and chip-related technologies. In connection with this shift in the Company's strategic focus, workforce reductions and other measures were implemented to achieve cost savings.

At present, PublicARD's sole operating activities are conducted through its Infineer subsidiary, which designs smart card platform solutions for educational and corporate sites. The Company's future plans revolve around an acquisition strategy focused on businesses in areas outside the high technology sector while continuing to support the expansion of the Infineer business.

PublicARD's financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the Consolidated Financial Statements, the Company has incurred operating losses and requires additional capital to meet its obligations and accomplish the Company's business plan, which raises substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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### RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2002 COMPARED TO THREE MONTHS ENDED MARCH 31, 2001

**SALES.** Revenues are generated from product sales, licenses of software products, maintenance contracts and software development services. Revenue from product sales is recorded upon shipment of the product. Provisions are recorded for estimated warranty repairs, returns and bad debts at the time the product is shipped. Software license fees are recognized upon shipment if a signed contract exists, the fee is fixed and determinable and the collection of the resulting receivable is probable. Revenue from maintenance and support fees is recognized ratably over the contract period. Consolidated net sales decreased to \$1.2 million in 2002 compared to \$1.5 million for 2001. The 2001 figure included \$480,000 of revenues associated with the smart card reader and chip business, which the Company exited in July 2001. Sales related to smart card platform solutions for educational and corporate sites increased 15% from the prior year period.

**GROSS MARGIN.** Cost of sales consists primarily of material, personnel costs and overhead. Gross margin as a percentage of net sales increased slightly to 47% in 2002 from 45% in 2001. The increase in gross margin is attributed to the exiting of its smart card reader and chip business, which carried lower gross margins than sales of smart card platform solutions for educational and corporate sites.

**SALES AND MARKETING EXPENSES.** Sales and marketing expenses consist primarily of personnel and travel costs, public relations, trade shows and marketing materials. Sales and marketing expenses were \$427,000 in 2002 compared to \$1.3 million in 2001. The decrease is mainly due to headcount reductions associated with the Company's July 2001 repositioning action.

**PRODUCT DEVELOPMENT EXPENSES.** Product development expenses include expenses associated with the development of new products and enhancements to

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existing products. Product development expenses consist primarily of personnel and travel costs, independent consultants and contract engineering services. Product development expenses amounted to \$119,000 in 2002 compared to \$922,000 in 2001. Expenses decreased in 2002 primarily due to headcount reductions associated with the Company's July 2001 repositioning action.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist primarily of personnel and related costs for general corporate functions, including finance and accounting, human resources, risk management and legal. General and administrative expenses for the quarter ended March 31, 2002 decreased by approximately 28% to \$933,000 from \$1.3 million for 2001. The decrease is mainly due to headcount reductions associated with the Company's July 2001 repositioning action.

STOCK COMPENSATION EXPENSE. Stock-based compensation recorded in 2001 principally related to the issuance of a stock award and a below market stock option grant to an executive hired in late 1999.

GOODWILL AMORTIZATION. In accordance SFAS No. 142, no amortization expense for goodwill will be recorded in current and future periods. Goodwill and other intangibles will be subject to an annual review for impairment or earlier if circumstances or events indicate that impairment has occurred. This may result in future write-downs or the write-off of such assets.

OTHER INCOME AND EXPENSE. Interest income decreased to \$14,000 for 2002 from \$207,000 for 2001 principally due to lower cash balances. Cost of pensions principally relates to pension expense associated with the Company's frozen defined benefit pension plan.

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### LIQUIDITY

The Company has financed its operations over the last three years primarily through the sale of capital stock and the sale of non-core businesses. During the three months ended March 31, 2002, cash, including short-term investments, decreased by \$812,000 to \$3.7 million as of March 31, 2002.

Operating activities utilized cash of \$835,000 for the quarter ended March 31, 2002 and principally consisted of the loss from continuing operations of \$1.1 million offset by a decrease in net operating assets and liabilities of \$252,000 and depreciation of \$47,000.

Investing activities provided cash of \$24,000 in 2002 and consisted principally of proceeds from the sale of discontinued operations.

The Company has experienced negative cash flow from operating activities in the past and expects to experience negative cash flow in 2002. In addition to funding operating and capital requirements and corporate overhead, future uses of cash include the following:

- The Company sponsors a defined benefit pension plan, which was frozen in 1993. As of December 31, 2001, the actuarial present value of accrued liabilities exceeded the plan assets by approximately \$5.5 million. The annual required contribution to the plan is expected to be approximately \$1.1 million in 2002. Since the plan is significantly underfunded, the Company expects that the annual contribution requirements beyond 2002 will continue to be significant.

In April 2002, the Company failed to make the required

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quarterly contribution to the plan due April 15, 2002, in the amount of \$253,000. Pursuant to Federal tax law, interest will begin accruing on the obligation. The Company will provide notice of its failure to make the required contribution to the Pension Benefit Guaranty Corporation by May 15, 2002 and to the plan participants by June 15, 2002. Should the Company fail to make the required contributions to the plan for 2002, it could be subject to interest, penalties, liens on assets and ultimately a forced plan termination. There is no assurance that the Company will make the required contributions.

- In April 1996, a Consent Decree among the Company, the United States Environmental Protection Agency ("EPA") and the Pennsylvania Department of Environmental Protection ("PADEP") was entered by the court which resolved all of the United States' and PADEP's claims against the Company for recovery of costs incurred in responding to releases of hazardous substances at a facility previously owned and operated by the Company. Pursuant to the Consent Decree, the Company will pay a total of \$14.4 million plus interest to the United States and the Commonwealth of Pennsylvania. Through March 31, 2002, the Company has made principal payments aggregating \$13.2 million. In January 2002, the Company and the EPA reached an agreement to extend the due date on the remaining unpaid balance. In return, the EPA was granted a security interest in certain assets held in escrow. The remaining payments totaling \$1.3 million, including interest, will be made to the EPA over the next three years and consist of \$450,000 in 2002, \$431,000 in 2003 and \$411,000 in 2004. In April 2002, the Company made the required \$450,000 payment.
- The Company leases certain office space, vehicles and office equipment under operating leases that expire over the next eight years. Minimum payments for operating leases having initial or remaining non-cancelable terms in excess of one year are \$317,000 for the remainder of 2002, \$412,000 in 2003, \$387,000 in 2004 and \$348,000 thereafter.

The Company will need to raise additional capital that may not be available to it. Although

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management believes that existing cash and short term investments may be sufficient to meet the Company's operating and capital requirements at the currently anticipated level through December 31, 2002, additional working capital will be necessary in order to fund the current business plan and to ensure the Company is able to fund the pension and environmental obligations. While the Company is actively considering various funding alternatives, it has not secured or entered into any arrangements to obtain additional capital. There can be no assurance that the Company will be able to obtain additional funding on acceptable terms or at all. If the Company cannot raise additional capital to continue its present level of operations it may not be able to meet its obligations, take advantage of future acquisition opportunities or further develop or enhance its product offering, any of which could have a material adverse effect on its business and results of operations.

The Company currently has no capacity for commercial debt financing. Should such capacity become available it may be adversely affected in the future by factors such as higher interest rates, inability to borrow without

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collateral, and continued operating losses. Borrowings may also involve covenants limiting or restricting its operations or future opportunities.

The Company also currently fails to meet certain requirements for the continued listing of its common stock on the Nasdaq National Market ("National Market"). The Company transferred the listing of its common stock to the Nasdaq SmallCap Market ("SmallCap Market") effective May 2, 2002. Under certain circumstances, the Company maybe eligible to transfer its listing back to the national market, however, there is no assurance (i) that the Company will remedy the identified deficiencies and continue to meet other National Market quantitative or qualitative listing criteria, (ii) that the Company will continue to meet the SmallCap Market continued maintenance requirements, (iii) that any appeal in the event of non-compliance of its common stock will be successful or (iv) that its common stock will not be delisted. Should the Company's common stock be delisted, the liquidity of the common stock would be adversely affected. This could impair the Company's ability to raise capital in the future. If additional capital is raised through the issuance of equity securities, the Company's stockholders' percentage ownership of the common stock will be reduced and stockholders may experience dilution in net book value per share, or the new equity securities may have rights, preferences or privileges senior to those of its commons stockholders.

If the Company's liquidity does not improve, it may be unable to continue as a going concern and could be required to seek bankruptcy protection. Such an event may result in the Company's common and preferred stock being negatively affected or becoming worthless.

### CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are more fully described in the Notes to the Company's Consolidated Financial Statements included in the From 10-K for the year ended December 31, 2001, as amended. Certain accounting policies require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these judgments are subject to an inherent degree of uncertainty. The Company considers certain accounting policies related to revenue recognition, estimates of reserves for receivables and inventories, valuation of investments and goodwill and pension accounting to be critical policies due to the estimation processes involved.

REVENUE RECOGNITION AND ACCOUNTS RECEIVABLE. Revenue from product sales are recorded upon shipment of the product. Software license fees are recognized upon shipment if a signed contract exists, the fee is fixed and determinable and the collection of the resulting receivable is probable. Revenue from maintenance and support fees is recognized ratably over the contract period. Provisions are recorded for estimated warranty repairs, returns and bad debts at the time the products are shipped. Should changes in conditions cause management to determine that revenue recognition criteria are not met for certain future

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transactions, revenue recognized for any reporting period could be adversely affected.

The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's credit worthiness. The Company continually monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that it has identified. While such credit losses have historically been within management's expectations and the provisions established, there is no guarantee that the

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Company will continue to experience the same credit loss rates as in the past.

**INVENTORIES.** Inventories are stated at lower of cost (first-in, first-out method) or market. The Company evaluates the need to record adjustments for impairment of inventory on a quarterly basis. Inventory in excess of the Company's estimated usage requirements is written down to its estimated net realizable value. Inherent in the estimates of net realizable value are management's estimates related to the Company's production schedules, customer demand, possible alternative uses and the ultimate realization of potentially excess inventory. During 2001, the decision to exit the smart card reader and chip business resulted in a significant inventory realizability adjustment. While management deems this adjustment to be non-recurring, a decrease in future demand for current products could result in an increase in the amount of excess inventories on hand.

**VALUATION OF INVESTMENTS.** The Company periodically reviews the carrying value of its minority-owned investments for impairment. This review is based upon projections of anticipated future cash flows and independent market data, if available. While management believes that the current carrying values of such investments has not been impaired, different assumptions could affect the evaluations.

**IMPAIRMENT OF GOODWILL.** The Company periodically evaluates acquired businesses for potential impairment indicators. Judgments regarding the existence of impairment indicators are based on market conditions and operational performance of the acquired businesses. Future events could cause the conclusion that impairment indicators exist and that goodwill associated with acquired businesses is impaired. Any resulting impairment loss could have an adverse impact on the Company's financial condition and results of operations.

**PENSION OBLIGATIONS.** The determination of obligations and expense for pension benefits is dependent on the selection of certain assumptions used by actuaries in calculating such amounts. These assumptions include, among others, the discount rate and the expected rate of return on plan assets. In accordance with generally accepted accounting principles, actual results that differ from assumptions are accumulated and amortized over future periods and therefore, generally affect the recognized expense and recorded obligation in such future periods. While management believes that the assumptions are appropriate, differences in actual experience or significant changes in assumptions may materially affect the pension obligation and future expense.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS No. 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142").

SFAS No. 141 addresses financial accounting and reporting for business combinations. This new statement requires that all business combinations be accounted for using one method (the purchase method), intangible assets be recognized apart from goodwill if they meet certain criteria and disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets

acquired and liabilities assumed by major balance sheet caption. The provisions of this statement apply to all business combinations initiated after June 30, 2001.



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SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. Under this new statement, goodwill and intangible assets that have indefinite useful lives will not be amortized, but rather will be tested at least annually for impairment based on the specific guidance of this statement. In addition, this statement requires disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required. The provisions of this statement are required to be applied starting with fiscal years beginning after December 15, 2001. However, goodwill and intangible assets acquired after June 30, 2001 will be subject immediately to the non-amortization and amortization provisions of this statement. The Company adopted this statement on January 1, 2002. In accordance with this statement, no amortization expense for goodwill will be recorded in current and future periods. Goodwill and other intangibles will be subject to an annual review for impairment or earlier if circumstances or events indicate that impairment has occurred. This may result in future write-downs or the write-off of such assets. Excluding goodwill amortization, the pro forma net loss for the three months ended March 31, 2001, was \$2,849,000, or \$.12 per share.

### FACTORS THAT MAY AFFECT FUTURE RESULTS

WE HAVE A HISTORY OF OPERATING LOSSES AND NEGATIVE CASH FLOW, WE HAVE ONGOING FUNDING OBLIGATIONS AND WE NEED TO RAISE ADDITIONAL CAPITAL THAT MAY NOT BE AVAILABLE TO US. We have incurred losses and experienced negative cash flow from operating activities in the past, and we expect to incur losses and experience negative cash flow from operating activities in the foreseeable future. We incurred losses from continuing operations in 1999, 2000, 2001 and for the three months ended March 31, 2002 of approximately \$16.7 million, \$19.7 million, \$17.2 million and \$1.1 million, respectively. In addition, we experienced negative cash flow from continuing operating activities of \$8.5 million, \$18.7 million, \$12.2 million and \$826,000 in 1999, 2000, 2001 and for the three month ended March 31, 2002, respectively.

We also have continuing obligations to fund payments due under the Consent Decree and an underfunded pension plan. As of March 31, 2002, we were required to make future aggregate payments of \$1.3 million through April 2004 in connection with the Consent Decree. In January 2002, we reached an agreement with the EPA to extend the due date on the remaining unpaid balance. In return, the EPA was granted a security interest in certain assets held in escrow. Consistent with the general practices of environmental enforcement agencies, the Consent Decree does not eliminate our potential liability for remediation of contamination that had not been known at the time of the settlement. In April 2002, we made our required payment of \$450,000.

We sponsor a defined benefit pension plan, which was frozen in 1993. As of December 31, 2001, the present value of the accrued benefit liabilities of our pension plan exceeded the plan's assets by approximately \$5.5 million. In addition to the \$1.1 million required contribution to the plan in 2002, we are obligated to make continued contributions to the plan in accordance with the rules and regulations prescribed by the Employee Retirement Income Security Act of 1974. Since the plan is significantly underfunded, we expect that the annual contribution requirements beyond 2002 will continue to be significant. Future contribution levels depend in large measure on the mortality rate of plan participants, discount rate and the expected return on the plan assets. In April 2002, we failed to make the required quarterly contribution to the plan due April 15, 2002, in the amount of \$253,000. Pursuant to Federal tax law, interest will begin accruing on the obligation. We will provide notice of our failure to make the required contribution to the Pension Benefit Guaranty Corporation by May 15, 2002 and to the plan participants by June 15, 2002. Should we fail to make the required contributions to the plan for 2002, we could be subject to interest, penalties, liens on assets and ultimately a forced plan termination.

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There is no assurance that we will make the required contributions.

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We will need to raise additional capital that may not be available to us. Although we believe existing cash and short term investments may be sufficient to meet our operating and capital requirements at the currently anticipated level through December 31, 2002, additional working capital will be necessary in order to fund our current business plan and to ensure we are able to fund our pension and environmental obligations. While we are actively considering various funding alternatives, no arrangement to obtain additional funding has been secured or entered into. There can be no assurance that we will be able to obtain additional funding, on acceptable terms or at all. If we cannot raise additional capital to continue at our present level of operations we may not be able to meet our obligations, take advantage of future acquisition opportunities or further develop or enhance our product offering, any of which could have a material adverse effect on our business and results of operations and could lead to our being required to seek bankruptcy protection.

We currently have no capacity for commercial debt financing. Should such capacity become available to us, we may be adversely affected in the future by factors such as higher interest rates, inability to borrow without collateral, and continued operating losses. Borrowings may also involve covenants limiting or restricting our operations or future opportunities.

WE FACE RISKS ASSOCIATED WITH ACQUISITIONS. An important element of our new strategic plan involves the acquisition of businesses in areas outside the technology sectors in which we have recently been engaged, so as to diversify our asset base. Acquisitions would require us to invest financial resources and may have a dilutive effect on our earnings or book value per share of common stock. We cannot assure you that we will consummate any acquisitions in the future, that any financing required for such acquisitions will be available on acceptable terms or at all, or that any past or future acquisitions will not materially adversely affect our results of operations and financial condition.

Our acquisition strategy generally presents a number of significant risks and uncertainties, including the risks that:

- we will not be able to retain the employees or business relationships of the acquired company;
- we will fail to realize any synergies or other cost reduction objectives expected from the acquisition;
- we will not be able to integrate the operations, products, personnel and facilities of acquired companies;
- management's attention will be diverted to pursuing acquisition opportunities and integrating acquired products, technologies or companies and will be distracted from performing its regular responsibilities;
- we will incur or assume liabilities, including liabilities that are unknown or not fully known to us at the time of the acquisition; and
- we will enter markets in which we have no direct prior experience.

We cannot assure you that any of the foregoing will not materialize, which could have an adverse effect on our results of operations and financial condition.

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OUR TECSEC INVESTMENT MAY BE IMPAIRED OR SUBJECT TO A SIGNIFICANT WRITE-DOWN IN THE FUTURE. As of March 31, 2002, the carrying value of our investment in TecSec, a privately held company, was \$5.1 million. This investment has been accounted for at cost and could be subject to write-down in future periods if it is determined that the investment is permanently impaired and not recoverable. If TecSec is not successful in executing its business plan or in obtaining sufficient capital on acceptable terms or at all, our investment in TecSec could be permanently impaired and subject to a significant write-down.

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THE MARKET'S ACCEPTANCE OF OUR PRODUCTS IS UNCERTAIN. Demand for, and market acceptance of, our software solutions and products are subject to a high level of uncertainty due to rapidly changing technology, new product introductions and changes in customer requirements and preferences. The success of our products or any future products depends upon our ability to enhance our existing products and to develop and introduce new products and technologies to meet customer requirements. We face the risk that our current and future products will not achieve market acceptance.

Our future revenues and earnings depend in large part on the success of these products, and if the benefits are not perceived sufficient or if alternative technologies are more widely accepted, the demand for our solutions may not grow and our business and operating results would be materially and adversely affected.

WE DEPEND ON A RELATIVELY SMALL NUMBER OF CUSTOMERS FOR A MAJORITY OF OUR REVENUES. We rely on a limited number of customers in our business. We expect to continue to depend upon a relatively small number of customers for a majority of the revenues in our business. For the year ended December 31, 2001, one customer represented approximately 17% of the Company's sales and 17% of the accounts receivable balance as of December 31, 2001. For the three months ended March 31, 2002, no customer represented more than 10% of sales or 10% of the accounts receivable balance as of March 31, 2002.

We generally do not enter into long-term supply commitments with our customers. Instead, we bid on a project basis and have supply contracts in place for each project. Significant reductions in sales to any of our largest customers would have a material adverse effect on our business. In addition, we generate significant accounts receivable and inventory balances in connection with providing products to our customers. A customer's inability to pay for our products could have a material adverse effect on our results of operations.

OUR FUTURE SUCCESS DEPENDS ON OUR ABILITY TO KEEP PACE WITH TECHNOLOGICAL CHANGES AND INTRODUCE NEW PRODUCTS IN A TIMELY MANNER. The rate of technological change currently affecting the smart card market is particularly rapid compared to other industries. Our ability to anticipate these trends and adapt to new technologies is critical to our success. Because new product development commitments must be made well in advance of actual sales, new product decisions must anticipate future demand as well as the speed and direction of technological change. Our ability to remain competitive will depend upon our ability to develop in a timely and cost effective manner new and enhanced products at competitive prices. New product introductions or enhancements by our competitors could cause a decline in sales or loss of market acceptance of our existing products and lower profit margins.

Our success in developing, introducing and selling new and enhanced products depends upon a variety of factors, including:

- product selections;

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- timely and efficient completion of product design and development;
- timely and efficient implementation of manufacturing processes;
- effective sales, service and marketing;
- price; and
- product performance in the field.

Our ability to develop new products also depends upon the success of our research and development efforts. We may need to devote additional resources to our research and development efforts in the future. We cannot assure you that funds will be available for these expenditures or that these funds will lead to the development of viable products.

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THE HIGHLY COMPETITIVE MARKETS IN WHICH WE OPERATE COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS AND OPERATING RESULTS. The markets in which we operate are intensely competitive and characterized by rapidly changing technology. We compete against numerous companies, many of which have greater resources than we do, and we believe that competition is likely to intensify.

We believe that the principal competitive factors affecting us are:

- the extent to which products support industry standards and are capable of being operated or integrated with other products;
- technical features and level of security;
- strength of distribution channels;
- price;
- product reputation, reliability, quality, performance and customer support;
- product features such as adaptability, functionality and ease of use; and
- competitor reputation, positioning and resources.

We cannot assure you that competitive pressures will not have a material adverse effect on our business and operating results. Many of our current and potential competitors have longer operating histories and significantly greater financial, technical, sales, customer support, marketing and other resources, as well as greater name recognition and a larger installed base of their products and technologies than our company. Additionally, there can be no assurance that new competitors will not enter our markets. Increased competition would likely result in price reductions, reduced margins and loss of market share, any of which would have a material adverse effect on our business and operating results.

Our primary competition currently comes from companies offering closed environment solutions, including small value electronic cash systems and database management solutions, such as Girovend, MARS, Diebold, CyberMark and Schlumberger.

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Many of our current and potential competitors have broader customer relationships that could be leveraged, including relationships with many of our customers. These companies also have more established customer support and professional services organizations than we do. In addition, a number of companies with significantly greater resources than we have could attempt to increase their presence by acquiring or forming strategic alliances with our competitors, resulting in increased competition.

OUR LONG PRODUCT SALES CYCLES SUBJECT US TO RISK. Our products fall into two categories; those that are standardized and ready to install and use and those that require significant development efforts to implement within the purchasers' own systems. Those products requiring significant development efforts tend to be newly developed technologies and software applications that can represent major investments for customers. We rely on potential customers' internal review processes and systems requirements. The implementation of some of our products involves deliveries of small quantities for pilot programs and significant testing by the customers before firm orders are received for production volumes, or lengthy beta testing of software solutions. For these more complex products, the sales process may take one year or longer, during which time we may expend significant financial, technical and management resources, without any certainty of a sale.

WE MAY BE LIMITED IN OUR USE OF OUR FEDERAL NET OPERATING LOSS CARRYFORWARDS. As of December 31, 2001, we had federal net operating loss carryforwards, subject to review by the Internal Revenue Service, totaling approximately \$86.0 million for federal income tax purposes, approximately \$25.0 million of which will expire at the end of 2002. We do not expect to earn any significant taxable income in the next several years, and may not do so until much later. A federal net operating loss can generally be carried back two or three years and then forward fifteen or twenty years (depending on the year in which the loss was

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incurred), and used to offset taxable income earned by a company (and thus reduce its income tax liability).

Section 382 of the Internal Revenue Code provides that when a company undergoes an "ownership change," that company's use of its net operating losses is limited in each subsequent year. An "ownership change" occurs when, as of any testing date, the sum of the increases in ownership of each shareholder that owns five percent or more of the value of a company's stock as compared to that shareholder's lowest percentage ownership during the preceding three-year period exceeds fifty percentage points. For purposes of this rule, certain shareholders who own less than five percent of a company's stock are aggregated and treated as a single five-percent shareholder. We may issue a substantial number of shares of our stock in connection with public and private offerings, acquisitions and other transactions in the future. In addition, the exercise of outstanding warrants and options to purchase shares of our common stock may require us to issue additional shares of our common stock. The issuance of a significant number of shares of stock could result in an "ownership change." If we were to experience such an "ownership change," we estimate that virtually all of our available federal net operating loss carryforwards could not be used to reduce our taxable income.

The extent of the actual future use of our federal net operating loss carryforwards is subject to inherent uncertainty because it depends on the amount of otherwise taxable income we may earn. We cannot give any assurance that we will have sufficient taxable income in future years to use any of our federal net operating loss carryforwards before they would otherwise expire.

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OUR PROPRIETARY TECHNOLOGY IS DIFFICULT TO PROTECT AND MAY INFRINGE ON THE INTELLECTUAL PROPERTY RIGHTS OF THIRD PARTIES. Our success depends significantly upon our proprietary technology. We rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality agreements and contractual provisions to protect our proprietary rights. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. We cannot assure you that any of our applications will be approved, that any new patents will be issued, that we will develop proprietary products or technologies that are patentable, that any issued patent will provide us with any competitive advantages or will not be challenged by third parties. Furthermore, we cannot assure you that the patents of others will not have a material adverse effect on our business and operating results.

If our technology or products is determined to infringe upon the rights of others, and we were unable to obtain licenses to use the technology, we could be required to cease using the technology and stop selling the products. We may not be able to obtain a license in a timely manner on acceptable terms or at all. Any of these events would have a material adverse effect on our financial condition and results of operations.

Patent disputes are common in technology related industries. We cannot assure you that we will have the financial resources to enforce or defend a patent infringement or proprietary rights action. As the number of products and competitors in the smart card market grows, the likelihood of infringement claims also increases. Any claim or litigation may be time consuming and costly, cause product shipment delays or require us to redesign our products or enter into royalty or licensing agreements. Any of these events would have a material adverse effect on our business and operating results. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to use our proprietary information and software. In addition, the laws of some foreign countries do not protect proprietary and intellectual property rights as effectively as do the laws of the United States. Our means of protecting our proprietary and intellectual property rights may not be adequate. There is a risk that our competitors will independently develop similar technology, duplicate our products or design around patents or other intellectual property rights.

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THE NATURE OF OUR PRODUCTS SUBJECTS US TO PRODUCT LIABILITY RISKS. Our customers may rely on certain of our current products and products in development to prevent unauthorized access to digital content for financial transactions, computer networks, and real property. A malfunction of or design defect in certain of our products could result in tort or warranty claims. Although we attempt to reduce the risk of exposure from such claims through warranty disclaimers and liability limitation clauses in our sales agreements and by maintaining product liability insurance, we cannot assure you that these measures will be effective in limiting our liability for any damages. Any liability for damages resulting from security breaches could be substantial and could have a material adverse effect on our business and operating results. In addition, a well-publicized actual or perceived security breach involving our conditional access or security products could adversely affect the market's perception of our products in general, regardless of whether any breach is attributable to our products. This could result in a decline in demand for our products, which would have a material adverse effect on our business and operating results.

WE MAY HAVE DIFFICULTY RETAINING OR RECRUITING PROFESSIONALS FOR OUR BUSINESS. Our future success and performance is dependent on the continued

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services and performance of our senior management and other key personnel. If we fail to meet our operating and financial objectives this may make it more difficult to retain and reward our senior management and key personnel. The loss of the services of any of our executive officers or other key employees could materially adversely affect our business.

Our business requires experienced software programmers, creative designers and application developers, and our success depends on identifying, hiring, training and retaining such experienced, knowledgeable professionals. If a significant number of our current employees or any of our senior technical personnel resign, or for other reasons are no longer employed by us, we may be unable to complete or retain existing projects or bid for new projects of similar scope and revenues. In addition, former employees may compete with us in the future.

Even if we retain our current employees, our management must continually recruit talented professionals in order for our business to grow. Furthermore, there is significant competition for employees with the skills required to perform the services we offer. We cannot assure you that we will be able to attract a sufficient number of qualified employees in the future to sustain and grow our business, or that we will be successful in motivating and retaining the employees we are able to attract. If we cannot attract, motivate and retain qualified professionals, our business, financial condition and results of operations will suffer.

OUR INTERNATIONAL OPERATIONS SUBJECT US TO RISK ASSOCIATED WITH OPERATING IN FOREIGN MARKETS, INCLUDING FLUCTUATIONS IN CURRENCY EXCHANGE RATES, WHICH COULD ADVERSELY AFFECT OUR OPERATIONS AND FINANCIAL CONDITION. Sales outside the U. S. represented approximately 76% of total sales for the three months ended March 31, 2002. Because we derive a substantial portion of our business outside the United States, we are subject to certain risks associated with operating in foreign markets including the following:

- tariffs and other trade barriers;
- difficulties in staffing and managing foreign operations;
- currency exchange risks;
- export controls related to encryption technology;
- unexpected changes in regulatory requirements;
- changes in economic and political conditions;
- potentially adverse tax consequences; and
- burdens of complying with a variety of foreign laws.

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Any of the foregoing could adversely impact the success of our international operations. We cannot assure you that such factors will not have a material adverse effect on our future international sales and, consequently, on our business, operating results and financial condition. In addition, fluctuations in exchange rates could have a material adverse effect on our business, operating results and financial condition. To date, we have not engaged in currency hedging.

WE ARE SUBJECT TO GOVERNMENT REGULATION. Federal, state and local regulations impose various environmental controls on the discharge of chemicals

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and gases, which have been used in our past assembly processes and may be used in future processes. Moreover, changes in such environmental rules and regulations may require us to invest in capital equipment and implement compliance programs in the future. Any failure by us to comply with environmental rules and regulations, including the discharge of hazardous substances, would subject us to liabilities and would materially adversely affect our operations.

OUR ARTICLES OF INCORPORATION AND BY-LAWS, CERTAIN CHANGE OF CONTROL AGREEMENTS, OUR RIGHTS PLAN AND PROVISIONS OF PENNSYLVANIA LAW COULD DETER TAKEOVER ATTEMPTS.

Blank check preferred stock. Our board of directors has the authority to issue preferred stock and to fix the rights, preferences, privileges and restrictions, including voting rights, of these shares without any further vote or action by the holders of our common stock. The rights of the holders of any preferred stock that may be issued in the future may adversely affect the rights of the holders of our common stock. The issuance of preferred stock could make it more difficult for a third party to acquire a majority of our outstanding voting stock, thereby delaying, deferring or preventing a change of control. Such preferred stock may have other rights, including economic rights, senior to our common stock, and as a result, the issuance of the preferred stock could limit the price that investors might be willing to pay in the future for shares of our common stock and could have a material adverse effect on the market value of our common stock.

Rights plan. Our rights plan entitles the registered holders of rights to purchase shares of our class A preferred stock upon the occurrence of certain events, and may have the effect of delaying, deferring or preventing a change of control.

Change of control agreements. We are a party to change of control agreements, which provide for payments to certain of our directors and executive officers under certain circumstances following a change of control. Since the change of control agreements require large cash payments to be made by any person effecting a change of control, these agreements may discourage takeover attempts.

The change of control agreements provide that, if the services of any person party to a change of control agreement are terminated within three years following a change of control, that individual will be entitled to receive, in a lump sum within 10 days of the termination date, a payment equal to 2.99 times that individual's average annual compensation for the shorter of the five years preceding the change of control and the period the individual received compensation from us for personal services. Assuming a change of control were to occur at the present time, payments in the following amounts would be required: Mr. Harry I. Freund of \$934,000 and Mr. Jay S. Goldsmith of \$934,000. If any such payment, either alone or together with others made in connection with the individual's termination, is considered to be an excess parachute payment under the Internal Revenue Code, the individual will be entitled to receive an additional payment in an amount which, when added to the initial payment, would result in a net benefit to the individual, after giving effect to excise taxes imposed by Section 4999 of the Internal Revenue Code and income taxes on such additional payment, equal to the initial payment before such additional payment and we would not be able to deduct these initial or additional payments for income tax purposes.

Pennsylvania law. We are a Pennsylvania corporation. Anti-takeover provisions of Pennsylvania law could make it difficult for a third party to



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acquire control of us, even if such change of control would be beneficial to our shareholders.

OUR STOCK PRICE IS EXTREMELY VOLATILE. The stock market has recently experienced significant price and volume fluctuations unrelated to the operating performance of particular companies. The market price of our common stock has been highly volatile and is likely to continue to be volatile. The future trading price for our common stock will depend on a number of factors, including:

- continued listing of our common stock on the National Market or SmallCap Market (see "Our stock may be delisted from the Nasdaq System" below);
- the volume of activity for our common stock is minimal and therefore a large number of shares placed for sale or purchase could increase its volatility;
- our ability to effectively manage our business, including our ability to raise capital;
- variations in our annual or quarterly financial results or those of our competitors;
- general economic conditions, in particular, the technology service sector;
- expected or announced relationships with other companies;
- announcements of technological advances innovations or new products by us or our competitors;
- patents or other proprietary rights or patent litigation; and
- product liability or warranty litigation.

We cannot be certain that the market price of our common stock will not experience significant fluctuations in the future, including fluctuations that are adverse and unrelated to our performance.

OUR STOCK MAY BE DELISTED FROM THE NASDAQ SYSTEM. On February 14, 2002, we received notice from The Nasdaq Stock Market ("Nasdaq") that our common stock had failed to maintain a minimum closing bid price of \$1.00 over the last 30 consecutive trading days as required by Nasdaq Marketplace rules. We received a second notice on February 27, 2002, that our common stock also failed to maintain a market value of public float of \$5 million. The Nasdaq had previously suspended the minimum bid price and market value of public float requirements in response to market conditions following the September 11 terrorists attacks. The Nasdaq reinstated these requirements effective January 2, 2002.

In accordance with the Nasdaq rules, we were provided 90 calendar days, or until May 15, 2002, to regain compliance with the minimum bid price requirement and until May 28, 2002 to regain compliance with the market value of public float requirement. If at any time before May 15, 2002, the closing bid price of our common stock was at least \$1.00 for a minimum of 10 consecutive trading days, Nasdaq would determine if we were in compliance. However, if we were unable to demonstrate compliance on or before May 15, 2002, Nasdaq would provide written notification that our securities would be delisted. At that time, we may appeal the decision to a Nasdaq Listing Qualification Panel.

In April 2002, we filed an application to transfer the listing of our common stock to the SmallCap Market. The application was approved and our common

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stock listing was transferred to the Nasdaq SmallCap market effective May 2, 2002. We will now be afforded an additional 90-day grace period to comply with the \$1.00 minimum bid price requirement, which will extend the delisting determination until August 14, 2002. We may also be eligible for an additional 180-day grace period provided that we meet certain SmallCap Market initial listing criteria. If we should meet the minimum bid price requirement for 30 consecutive trading days and maintain compliance with all other National Market listing requirements, we may be eligible to transfer our listing back to the National Market.

If we are unable to meet the SmallCap Market minimum maintenance requirements, we would be

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subject to delisting from the Nasdaq system. In that event, after receiving notification that our securities would be delisted, we may appeal the delisting determination.

We cannot assure you (i) that we will remedy the identified deficiencies and continue to meet other National Market quantitative or qualitative listing criteria, (ii) that we will continue to meet the SmallCap Market continued maintenance requirements, (iii) that any appeal in the event of non-compliance of our common stock will be successful or (iv) that our common stock will not be delisted.

Should our common stock be delisted, the liquidity of our common stock would be adversely affected. This could impair our ability to raise capital in the future. If we are not successful in raising additional capital when required in sufficient amounts and on terms acceptable to us or at all, we may be required to scale back the scope of our business plan, which would have a material adverse effect on our financial condition and results of operations, and be unable to fund our pension and environmental obligations.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Foreign currency exchange rate risk

We conduct operations in the United Kingdom and sell products in several different countries. Therefore, our operating results may be impacted by the fluctuating exchange rates of foreign currencies, especially the British pound, in relation to the U.S. dollar. We do not currently engage in hedging activities with respect to our foreign currency exposure. We continually monitor our exposure to currency fluctuations and may use financial hedging techniques when appropriate to minimize the effect of these fluctuations. Even so, exchange rate fluctuations may still have a material adverse effect on our business and operating results.

#### Market Risk

We are exposed to market risk primarily through short-term investments. Our investment policy calls for investment in short-term, low risk instruments. As of March 31, 2002, short-term investments (principally U.S. Treasury bills) were \$3.5 million. Due to the nature of these investments, any decrease in rates would not have a material impact on our financial condition or results of operations.

#### Investment Risk

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As of March 31, 2002, the value of our investment in TecSec, a privately held company, was \$5.1 million. This investment has been accounted for at cost and could be subject to write-down in future periods if it is determined that the investment is permanently impaired and not recoverable. TecSec is currently evaluating alternative sources of financing to meet ongoing capital and operating needs. If TecSec is not successful in obtaining sufficient capital on acceptable terms or at all, our investment in TecSec could be permanently impaired and subject to a significant write-down.

### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

##### GENERAL LITIGATION

Various legal proceedings are pending against the Company. The Company considers all such proceedings to be ordinary litigation incident to the character of its business. Certain claims are covered by liability insurance. The Company believes that the resolution of those claims to the extent not covered by insurance will not, individually or in the aggregate, have a material adverse effect on the financial position or results of operations of the Company.

#### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

None.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PUBLICARD, INC.  
(Registrant)

Date: May 3, 2002

/s/ Antonio L. DeLise  
Antonio L. DeLise, President,  
Chief Operating Officer, Chief  
Financial Officer

Date: May 3, 2002

/s/ Robert J. Caldaroni  
Robert J. Caldaroni,  
Vice President and Controller

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