

Edgar Filing: PUBLICARD INC - Form 10-Q

PUBLICARD INC  
Form 10-Q  
November 12, 2004

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 SEPTEMBER 30, 2004

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 Identif

ONE ROCKEFELLER PLAZA, 14TH 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  No   
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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No   
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Number of shares of Common Stock outstanding as of November 12, 2004: 24,690,902

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PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED BALANCE SHEETS AS OF  
SEPTEMBER 30, 2004 AND DECEMBER 31, 2003  
(IN THOUSANDS, EXCEPT SHARE DATA)

	SEPTEMBER 30, 2004	DECEMBER 31, 2003
ASSETS		
Current assets:		
Cash, including short-term investments of \$2,102 and \$3,501 in 2004 and 2003, respectively	\$ 2,102	\$ 3,501
Trade receivables, less allowance for doubtful accounts of \$89 and \$115 in 2004 and 2003, respectively	89	115
Inventories	1,000	1,000
Prepaid insurance and other	1,000	1,000
Total current assets	4,191	6,616
Equipment and leasehold improvements, net	1,000	1,000
Goodwill and intangibles	1,000	1,000
Other assets	1,000	1,000
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities:		
Trade accounts payable and overdraft	\$ 1,000	\$ 1,000
Accrued liabilities	1,000	1,000
Total current liabilities	2,000	2,000
Note payable	1,000	1,000
Other non-current liabilities	1,000	1,000
Total liabilities	4,000	4,000
Commitments and contingencies (Note 4)		
Shareholders' deficit:		
Class A Preferred Stock, Second Series, no par value: 1,000 shares authorized; 565 shares issued and outstanding as of September 30, 2004 and December 31, 2003	1,000	1,000

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Common shares, \$0.10 par value: 40,000,000 shares authorized; 24,690,902  
 shares issued and outstanding as of September 30, 2004 and December 31, 2003  
 Additional paid-in capital  
 Accumulated deficit  
 Other comprehensive loss  
 Total shareholders' deficit

1  
 (1  
 ---  
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The accompanying notes to unaudited condensed consolidated financial statements are an integral part of these statements.

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PUBLICARD, INC.  
 AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 FOR THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003  
 (IN THOUSANDS, EXCEPT SHARE DATA)  
 (UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,
	2004	2003	
Revenues	\$ 1,260	\$ 1,417	\$ 3,116
Cost of revenues	530	645	1,416
Gross margin	730	772	1,700
Operating expenses:			
General and administrative	568	676	1,844
Sales and marketing	365	415	1,199
Product development	173	169	522
Amortization of intangibles	10	10	31
	1,116	1,270	3,596
Loss from operations	(386)	(498)	(1,886)
Other income (expenses):			
Interest income	6	3	19
Interest expense	(6)	(3)	(19)
Cost of pensions - non-operating	(132)	(255)	(399)
Loss on pension settlement	(2,739)	--	(2,739)
Gain on insurance recoveries	170	(2)	64
Other income (expenses), net	5	6	--
	(2,696)	(251)	(2,486)

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Net loss	\$ (3,082)	\$ (749)	\$ (4,368)
Basic and diluted loss per common share	\$ (.12)	\$ (.03)	\$ (.12)
Basic and diluted weighted average common shares outstanding	24,690,902	24,534,652	24,690,902

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

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' DEFICIT  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004  
(IN THOUSANDS, EXCEPT SHARE DATA)  
(UNAUDITED)

	Class A Preferred Stock	Common Shares Issued	Amount	Additional Paid-in Capital	Accumulated Deficit
Balance - January 1, 2004	\$ 2,825	24,690,902	\$2,469	\$108,119	\$(113,617)
Comprehensive income (loss):					
Net loss	--	--	--	--	(4,368)
Pension settlement	--	--	--	--	--
Foreign currency translation adjustment	--	--	--	--	--
Comprehensive loss					
Balance - September 30, 2004	\$ 2,825	24,690,902	\$2,469	\$108,119	\$(117,985)

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

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003  
(IN THOUSANDS)  
(UNAUDITED)

	2004
	-----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	\$ (4,3
Adjustments to reconcile net loss to net cash used in operating activities:	
Loss on pension settlement	2,7
Gain on insurance recoveries	(6
Loss on disposal of fixed assets	
Amortization of intangibles	
Depreciation and amortization	
Changes in assets and liabilities:	
Trade receivables	
Inventories	
Prepaid insurance and other current assets	2
Trade accounts payable and overdraft	(2
Accrued liabilities	1,0
Other non-current liabilities	(6
	-----
Net cash used in operating activities	(1,7
	-----
CASH FLOWS FROM INVESTING ACTIVITIES:	
Capital expenditures	(
Proceeds from insurance recoveries	5
Other	
	-----
Net cash provided by investing activities	4
	-----
CASH FLOWS FROM FINANCING ACTIVITIES	
	-----
Effect of exchange rate changes on cash and cash equivalents	
	-----
Net (decrease) increase in cash	(1,2
Cash - beginning of period	3,5
	-----
Cash - end of period	\$ 2,3
	=====
Cash paid for interest	\$
	=====

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

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## PUBLICARD, INC. AND SUBSIDIARY COMPANIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND LIQUIDITY AND GOING CONCERN CONSIDERATIONS

##### 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.

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 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 would 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 solutions for educational and corporate sites. The Company's future plans revolve around a potential acquisition strategy that would focus on businesses in areas outside the high technology sector while continuing to support the expansion of the Infineer business. However, the Company will not be able to implement such plans unless it is successful in obtaining funding, as to which no assurance can be given.

##### LIQUIDITY AND GOING CONCERN CONSIDERATIONS

These unaudited condensed 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 a number of years. 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 \$2.3 million at September 30, 2004. The Company also had a shareholders' deficit of \$4.7 million at September 30, 2004.

The Company sponsored a defined benefit pension plan (the "Plan") that was frozen in 1993. In January 2003, the Company filed a notice with the Pension

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Benefit Guaranty Corporation (the "PBGC") seeking a "distress termination" of the Plan. In September 2004, the PBGC proceeded to terminate the Plan and was appointed as the Plan's trustee. See Note 3 for further information on the Plan termination. As a result of the Plan termination, the Company's 2003 and 2004 funding requirements due to the Plan amounting to \$3.4 million through September 15, 2004 were eliminated. As such, 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 levels through September 30, 2005. However, additional capital will be necessary in order to operate beyond September 30, 2005 and to fund the current business plan and other obligations. While the Company is 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 is not likely to be able to meet its obligations, take advantage of future acquisition opportunities or further develop or enhance its product offering, any of which would have a material adverse effect on its business and results of operations and is likely to lead the Company to seek bankruptcy protection. These conditions raise

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. The independent auditors' reports on the Company's Consolidated Financial Statements for the years ended December 31, 2003 and 2002 contained emphasis paragraphs concerning substantial doubt about the Company's ability to continue as a going concern.

#### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of PublicARD and its wholly-owned subsidiaries. All 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 September 30, 2004 and the results of their operations and cash flows for the three and nine months ended September 30, 2004. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

#### EARNINGS (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is based on net income (loss) 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 and convertible preferred stock at the later of the beginning of the year or date of issuance. For the three and nine months ended September 30, 2004 and 2003, diluted net income (loss) per share was the same as basic net income (loss) per share since the effect of stock

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options and convertible preferred stock were antidilutive.

### REVENUE RECOGNITION AND ACCOUNTS RECEIVABLE.

Revenue from product sales and technology and software license fees is recorded upon shipment if a signed contract exists, the fee is fixed and determinable, the collection of the resulting receivable is probable and the Company has no obligation to install the product or solution. If the Company is responsible for installation, revenue from product sales and license fees is deferred and recognized upon client acceptance or "go live" date. Maintenance and support fees are deferred and recognized as revenue ratably over the contract period. Provisions are recorded for estimated warranty repairs and returns 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 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 assurance that the 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 periodically evaluates the need to record adjustments for impairment of inventory. 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,

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## PUBLICARD, INC. AND SUBSIDIARY COMPANIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

possible alternative uses and the ultimate realization of potentially excess inventory. Inventories as of September 30, 2004 and December 31, 2003 consisted of the following (in thousands):

	2004	2003
	----	----
Raw materials and work-in-process	\$388	\$486
Finished goods	201	149
	----	----
	\$589	\$635
	====	====

### GOODWILL AND INTANGIBLES

Goodwill is the excess of the purchase price and related costs over the value assigned to the net tangible and intangible assets relating to the November 1999 acquisition of Infineer. Through December 31, 2001, goodwill had been amortized over a five year life. Effective January 1, 2002, the Company adopted Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets"



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("SFAS No. 142"). In accordance with the guidelines of this statement, goodwill and indefinite lived intangible assets are no longer amortized but will be assessed for impairment on at least an annual basis. SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives and reviewed for impairment.

The Company determines the fair value of its sole reporting unit primarily using two approaches: a market approach technique and a discounted cash flow valuation technique. The market approach relies primarily on the implied fair value using a multiple of revenues for several entities with comparable operations and economic characteristics. Significant assumptions used in the discounted cash valuation included estimates of future cash flows, future short-term and long-term growth rates and estimated cost of capital for purposes of arriving at a discount factor. The Company performs its annual goodwill impairment test during the fourth quarter absent any interim impairment indicators. The carrying value of goodwill as of September 30, 2004 and December 31, 2003 was \$782,000.

Intangible assets consist of completed technology identified as of the Infineer acquisition date and are amortized over a five-year life. Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the net realizable of the asset. The gross carrying amount and accumulated amortization of intangible assets at September 30, 2004 and December 31, 2003 was as follows (in thousands):

	2004 -----	2003 -----
Gross carrying amount	\$ 1,881	\$ 1,881
Accumulated amortization	(1,871)	(1,841)
	-----	-----
	\$ 10	\$ 40
	=====	=====

Amortization of intangibles was \$30,000 for both the nine months ended September 30, 2004 and 2003. The estimated annual amortization expense for intangibles is \$40,000 for 2004.

### STOCK-BASED COMPENSATION

The Company accounts for employee stock-based compensation cost using the intrinsic value method of accounting prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123") and Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure" ("SFAS No. 148").

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At September 30, 2004, the Company had four fixed stock-based compensation plans. The exercise price of each option granted pursuant to these plans is equal to the market price of the Company's common stock on the date of grant. Accordingly, pursuant to APB No. 25, no compensation cost has been recognized for such grants. Had compensation cost been determined based on the fair value at the grant dates for such awards consistent with the method prescribed by SFAS No. 123, the Company's net (loss) income and (loss) income per share for the three and nine months ended September 30, 2004 and 2003 would have been as follows (in thousands except per share data):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER	
	2004	2003	2004	
Net loss, as reported	\$ (3,082)	\$ (749)	\$ (4,368)	\$
Deduct: Total stock-based compensation expense determined under fair value based method	(35)	(122)	(95)	
Pro forma net loss	\$ (3,117)	\$ (871)	\$ (4,463)	\$
Basic and diluted loss per share:				
As reported	\$ (.12)	\$ (.03)	\$ (.18)	\$
Pro forma	\$ (.13)	\$ (.04)	\$ (.18)	\$

The weighted-average fair value of each stock option included in the preceding pro forma amounts was estimated using the Black-Scholes option-pricing model and is amortized over the vesting period of the underlying options.

### USE OF ESTIMATES

The preparation of these financial statements required the use of certain estimates by management in determining the Company's assets, liabilities, revenues and expenses. Certain of the Company's 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 and valuation of goodwill and intangibles to be critical policies due to the estimation processes involved. While all available information has been considered, actual amounts could differ from those reported.

### FAIR VALUE OF FINANCIAL INSTRUMENTS AND CONCENTRATION OF CREDIT RISK

The carrying amount of financial instruments, including cash and short-term investments, accounts receivable, accounts payable and accrued liabilities, approximates fair value. The fair value of long-term debt is estimated based on current rates which could be offered to the Company for debt of the same remaining maturity. The estimated fair value of the Company's long term debt as of September 30, 2004 was as follows (in thousands):

	CARRYING AMOUNT	FAIR VALUE
Long-term debt	\$ 7,501	\$ 943

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Financial instruments that subject the Company to concentrations of credit risk consist primarily of cash and short-term investments and accounts receivable. The Company maintains all of its cash and short-term investments with high-credit quality financial institutions. The Company's customer base consists of businesses principally in Europe (with a concentration in the United Kingdom) and the United States. For the year ended December 31, 2003, no one customer accounted for more than 10% of revenues. For the nine months ended September 30, 2004, one customer accounted for 10% of revenues. Amounts due from this customer represented approximately 25% of the accounts receivable balance as of September 30, 2004.

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

##### RECENT ACCOUNTING PRONOUNCEMENTS

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". The interpretation addresses the disclosures to be made by a guarantor in its financial statements about its obligations under guarantees. In addition, it also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure provisions became effective December 15, 2002. The adoption of the recognition and measurement provisions did not have a material impact on the Company's Consolidated Financial Statements.

In January 2003, the FASB issued FASB Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). In December 2003, the FASB issued FIN No. 46 (Revised) ("FIN 46-R") to address certain FIN 46 implementation issues. This interpretation clarifies the application of Accounting Research Bulletin ("ARB") No. 51, "Consolidated Financial Statements" for companies that have interests in entities that are Variable Interest Entities ("VIE") as defined under FIN 46. According to this interpretation, if a company has an interest in a VIE and is at risk for a majority of the VIE's expected losses or receives a majority of the VIE's expected gains, it must consolidate the VIE. FIN 46-R also requires additional disclosures by primary beneficiaries and other significant variable interest holders. For entities acquired or created before February 1, 2003, this interpretation is effective no later than the end of the first interim or reporting period ending after March 15, 2004, except for those VIE's that are considered to be special purpose entities, for which the effective date is no later than the end of the first interim or annual reporting period ending after December 15, 2003. For all entities that were acquired subsequent to January 31, 2003, this interpretation is effective as of the first interim or annual period ending after December 31, 2003. The adoption of the provisions of this interpretation did not have a material effect on the Company's Consolidated Financial Statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"). SFAS No. 149 clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". In addition, it

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clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 amends certain other existing pronouncements. SFAS No. 149 is effective on a prospective basis for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement did not have a material impact on the Company's Consolidated Financial Statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity" ("SFAS No. 150"). SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This statement will become effective for financial instruments entered into or modified after May 31, 2003, and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this statement did not have a material impact on the Company's Consolidated Financial Statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("SFAS No. 132 revised") that improves financial statement disclosures for defined benefit plans. The change replaces existing SFAS No. 132 disclosure requirements for pensions and other postretirement benefits and revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement of recognition of those plans required by SFAS No. 87, "Employers' Accounting for Pensions", or SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits." SFAS No. 132 revised retains the disclosure requirements

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

contained in the original SFAS No. 132, but requires additional disclosures about the plan assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. SFAS No. 132 revised is effective for annual and interim periods with fiscal years ending after December 15, 2003. The Company adopted the revised disclosure provisions.

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition", which supersedes SAB No. 101, "Revenue Recognition in Financial Statements". SAB No. 104 rescinds accounting guidance in SAB No. 101 related to multiple-element arrangements, as this guidance has been superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." The adoption of SAB No. 104 did not have a material impact on the Company's Consolidated Financial Statements.

#### NOTE 2 - SEGMENT DATA

The Company's sole operating activities involve the deployment of smart card solutions for educational and corporate sites. As such, the Company reports as a single segment. Sales by geographical areas for the three and nine months ended September 30, 2004 and 2003 are as follows (in thousands):

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	THREE MONTHS ENDED SEPTEMBER 30		NINE MONTHS ENDED SEPTEMBER 30,	
	2004	2003	2004	2003
United States	\$ 197	\$ 258	\$ 368	\$ 812
Europe	1,043	1,062	2,568	2,915
Rest of world	20	97	180	296
	-----	-----	-----	-----
	\$1,260	\$1,417	\$3,116	\$4,023
	=====	=====	=====	=====

The Company has operations in the United States and United Kingdom. Identifiable tangible assets by country as of September 30, 2004 and December 31, 2003 are as follows (in thousands):

	2004	2003
United States	\$ 3,375	\$ 4,542
United Kingdom	1,845	2,035
	-----	-----
	\$ 5,220	\$ 6,577
	=====	=====

NOTE 3 - UNDERFUNDED PENSION PLAN

The Company sponsored a defined benefit pension plan that was frozen in 1993. In January 2003, the Company filed a notice with the PBGC seeking a "distress termination" of the Plan. Pursuant to the Agreement for Appointment of Trustee and Termination of Plan between the PBGC and the Company, effective September 30, 2004, the PBGC proceeded to terminate the Plan and was appointed as the Plan's trustee. As a result, the PBGC has assumed responsibility for paying the obligations to Plan participants. Under the terms of the Settlement Agreement, effective September 23, 2004, between the PBGC and the Company (the "Settlement Agreement"), the Company is liable to the PBGC for the unfunded guaranteed benefit payable by the PBGC to Plan participants in the amount of \$7.5 million. The Company satisfied this liability by issuing a non-interest bearing note (the "Note"), dated September 23, 2004, payable to the PBGC with a face amount of \$7.5 million. A loss on the termination of the Plan of \$2.7 million was recorded in the third quarter of 2004.

Pursuant to the Security Agreement and Pledge Agreement, both dated September 23, 2004, the Note is secured by (a) all presently owned or hereafter acquired real or personal property and rights to property of the Company and (b) the common and preferred stock of Infineer and TecSec Incorporated ("TecSec") owned by the

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Company. Infineer is a wholly-owned subsidiary of the Company. The Company has an approximately 5% ownership interest in TecSec, on a fully diluted basis.

The Note matures on September 23, 2011. The first payment will be equal to \$1.0 million and will become due 30 days after the Company has received a total of \$4.0 million in Net Recoveries (as defined below). Thereafter, on each anniversary of the first payment, the Company is required to pay the PBGC an amount equal to 25% of the Net Recoveries in excess of \$4.0 million (less the sum of all prior payments made in accordance with this sentence in prior years). Net Recoveries, as defined in the Settlement Agreement, is the net cash proceeds received by the Company with respect to transactions consummated after March 31, 2003 from (a) the sale of the Company's interest in Infineer and TecSec and real property in Louisiana and (b) any recoveries from the Company's historic insurance program. As of September 30, 2004, Net Recoveries was approximately \$3.2 million.

In the event of default by the Company under the Settlement Agreement, the PBGC may declare the outstanding amount of the Note to be immediately due and payable, proceed with foreclosure of the liens granted in favor of the PBGC and exercise any other rights available under applicable law.

Cost of retirement benefits - non-operating of \$396,000 and \$697,000 for the nine months ended September 30, 2004 and 2003, respectively, includes the net periodic pension cost and other Plan related expenses. The components of the net periodic pension cost for the nine months ended September 30, 2004 and 2003 were as follows (in thousands):

	2004	2003
	-----	-----
Interest cost	\$ 348	\$ 398
Expected return on plan assets	(87)	(122)
Amortization of transition obligation	-	220
Amortization of net (gain) loss	83	64
	-----	-----
Net periodic pension cost	\$ 344	\$ 560
	=====	=====

The unrecognized transition obligation was zero at December 31, 2003 and, accordingly, there was no further amortization expense related to this component of net periodic pension cost in 2004. As a result of the termination of the Plan, net periodic pension cost will be zero prospectively.

#### NOTE 4 - COMMITMENTS AND CONTINGENCIES

##### LEGAL

On May 28, 2002, a lawsuit was filed against the Company in the Superior Court of the State of California, in the County of Los Angeles by Leonard M. Ross and affiliated entities alleging, among other things, misrepresentation and securities fraud. The lawsuit names the Company and four of its current and former executive officers and directors as the defendants. The plaintiffs seek monetary and punitive damages for alleged actions made by the defendants in order to induce the plaintiff to purchase, hold or refrain from selling PublicARD common stock. The plaintiffs allege that the defendants made a series of material misrepresentations, misleading statements, omissions and concealments, specifically and directly to the plaintiffs concerning the nature, existence and status of contracts with certain purchasers, the nature and existence of investments in the Company by third parties, the nature and existence of business relationships and investments by the Company. The Company believes it has meritorious defenses to the allegations and intends to defend vigorously.

In November 2002, the Company and the individual defendants served with the

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action filed a demurrer seeking the dismissal of six of the plaintiffs' nine purported causes of action. In January 2003, the court ruled in favor of the demurrer and dismissed the entire complaint. The plaintiffs were granted the right to replead and subsequently filed an amended complaint in February 2003. The Company and individual defendants filed a second demurrer in March 2003. In June 2003, the court ruled in favor of the demurrer and dismissed, without

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### PUBLICARD, INC. AND SUBSIDIARY COMPANIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

leave to amend, six of the eleven purported causes of action in the amended complaint. The lawsuit is in the early stages. Discovery has just commenced and no trial date has been set. Consequently, at this time it is not reasonably possible to estimate the damages, or range of damages, if any, that the Company might incur in connection with this action. However, if the outcome of this lawsuit is unfavorable to the Company, it could have a material adverse effect on the Company's operations, cash flow and financial position.

The Company incurred approximately \$200,000 in defense costs in 2002. No additional costs have been incurred in 2004 and 2003. Notice of the commencement of this action has been given to the Company's directors and officers liability insurance carriers. The Company's directors and officers liability insurance carriers are funding the additional costs of defending this action, subject to the carriers' reservation of rights.

Various other legal proceedings are pending against the Company. The Company considers all such other proceedings to be ordinary litigation incident to the character of its businesses. 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.

#### INSURANCE RECOVERIES

In February and March 2003, the Company entered into two binding settlements with various historical insurers that resolve certain claims (including certain future claims) under policies of insurance issued to the Company by those insurers. As a result of the settlements, after allowance for associated expenses and offsetting adjustments, the Company received net proceeds of approximately \$1.0 million in February 2003 and an additional \$682,000 in April 2003. The Company recognized a gain from these settlements of \$1.7 million in the first quarter of 2003.

In February 2004, the Company entered into a binding agreement to assign to a third party certain insurance claims against a group of historic insurers. In July 2004, the assignment was supplemented to include several additional insurers. The claims involve several historic general liability policies of insurance issued to the Company. As a result of the assignment, after allowance for associated expenses and offsetting adjustments, the Company received net proceeds of approximately \$477,000 in May 2004 and an additional \$170,000 in October 2004. The Company recognized a gain of \$477,000 in the first quarter of 2004 and an additional gain of \$170,000 in the third quarter of 2004.

The Company is also in discussions with other insurance markets regarding the status of certain policies of insurance. It cannot be determined whether any additional amounts may be recovered from these other insurers nor can the timing

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of any such additional recoveries be determined.

LEASES

The Company leases certain office space, vehicles and office equipment under operating leases that expire over the next five years. Minimum payments for operating leases, having initial or remaining non-cancelable terms in excess of one year, aggregates approximately \$921,000.

NOTE 5- COMPREHENSIVE LOSS

Comprehensive (loss) income for the Company includes foreign currency translation adjustments, as well as the net (loss) income reported in the Company's Condensed Consolidated Statements of Operations. Comprehensive (loss) income for the three and nine months ended September 30, 2004 and 2003 was as follows (in thousands):

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PUBLICARD, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2004	2003	2004	2003
	-----	-----	-----	-----
Net loss	\$ (3,082)	\$ (749)	\$ (4,368)	\$ (6,000)
Pension termination	2,649	--	2,649	--
Foreign currency translation adjustments	(2)	--	(4)	--
	-----	-----	-----	-----
Comprehensive loss	\$ (435)	\$ (749)	\$ (1,723)	\$ (6,000)
	=====	=====	=====	=====

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

"Management's Discussion and Analysis of Financial Condition and Results of Operations" and other sections of this Form 10-Q contain forward-looking statements, including (without limitation) statements concerning possible or assumed future results of operations of PublicARD preceded by, followed by or that include forward-looking words or phrases, including "believes," "expects," "anticipates," "estimates," "may," "should," "would," "could," "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 the possible consequences of events described under such statements made under "Factors That May Affect Future



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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.

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 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 would 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 solutions for educational and corporate sites. The Company's future plans revolve around a potential acquisition strategy that would focus on businesses in areas outside the high technology sector while continuing to support the expansion of the Infineer business. However, the Company will not be able to implement such plans unless it is successful in obtaining additional funding, as to which no assurance can be given.

PubliCARD's financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the Unaudited Condensed 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 Company's failure to obtain funding or inability to continue as a going concern.

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### RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2003

REVENUES. Revenues are generated from product sales, technology and software license fees, installation and maintenance contracts. Consolidated revenues decreased to \$1.3 million in 2004 compared to \$1.4 million for 2003. Foreign currency changes had the effect of increasing revenues by 10%. Excluding the

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impact of foreign currency changes, sales in 2004 decreased by 21% driven by a decline in shipments to distribution partners located outside of the United Kingdom.

**GROSS MARGIN.** Cost of revenues consists primarily of material, personnel costs and overhead. Gross margin, as a percentage of net sales, was 58% in 2004 and 54% in 2003.

**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 \$365,000 in 2004 compared to \$415,000 in 2003. The 2003 results included \$25,000 in employee termination expense.

**PRODUCT DEVELOPMENT EXPENSES.** Product development expenses include costs associated with the development of new products and enhancements to existing products. Product development expenses consist primarily of personnel and travel costs and contract engineering services. Product development expenses amounted to \$173,000 in 2004 compared to \$169,000 in 2003.

**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 were \$568,000 in 2004 compared to \$676,000 in 2003. The decrease in expenses is mainly attributable to a decline in legal, insurance and other corporate costs.

**AMORTIZATION OF INTANGIBLES.** In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), effective January 1, 2002, goodwill is no longer amortized. 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. Amortization of intangibles relates to the continuing amortization of definite life intangibles. Amortization expense was \$10,000 in both 2004 and 2003.

**COST OF PENSIONS - NON-OPERATING.** Cost of pensions, which represents amounts related to discontinued product lines and related plant closings in prior years, principally relates to pension expense associated with the Company's frozen defined benefit pension plan. The original unrecognized transition obligation was fully amortized at December 31, 2003. As such, beginning in 2004 there will be no further amortization expense related to this component of net periodic pension cost. Cost of pensions therefore declined from \$255,000 in 2003 to \$132,000 in 2004. As a result of the pension settlement (see below), cost of pensions - non-operating will be zero prospectively.

**LOSS ON PENSION SETTLEMENT.** The Company sponsored a defined benefit pension plan that was frozen in 1993. In January 2003, the Company filed a notice with the PBGC seeking a "distress termination" of the Plan. Pursuant to the Agreement for Appointment of Trustee and Termination of Plan between the PBGC and the Company effective September 30, 2004, the PBGC proceeded to terminate the Plan and was appointed as the Plan's trustee. As a result, the PBGC has assumed responsibility for paying the obligations to Plan participants. Under the terms of the Settlement Agreement, the Company is liable to the PBGC for the unfunded guaranteed benefit payable by the PBGC to Plan participants in the amount of \$7.5 million. The Company satisfied this liability by issuing a non-interest bearing Note payable to the PBGC with a face amount of \$7.5 million. A loss on the termination of the Plan of \$2.7 million was recorded in the third quarter of 2004.

Pursuant to the Security Agreement and Pledge Agreement, both dated September 23, 2004, the Note is secured by (a) all presently owned or hereafter

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acquired real or personal property and rights to property of the

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Company and (b) the common and preferred stock of Infineer and TecSec Incorporated ("TecSec") owned by the Company. Infineer is a wholly-owned subsidiary of the Company. The Company has an approximately 5% ownership interest in TecSec, on a fully diluted basis.

The Note matures on September 23, 2011. The first payment will be equal to \$1.0 million and will become due 30 days after the Company has received a total of \$4.0 million in Net Recoveries (as defined below). Thereafter, on each anniversary of the first payment, the Company is required to pay the PBGC an amount equal to 25% of the Net Recoveries in excess of \$4.0 million (less the sum of all prior payments made in accordance with this sentence in prior years). Net Recoveries, as defined in the Settlement Agreement, is the net cash proceeds received by the Company with respect to transactions consummated after March 31, 2003 from (a) the sale of the Company's interest in Infineer and TecSec and real property in Louisiana and (b) any recoveries from the Company's historic insurance program. As of September 30, 2004, Net Recoveries was approximately \$3.2 million.

In the event of default by the Company under the Settlement Agreement, the PBGC may declare the outstanding amount of the Note to be immediately due and payable, proceed with foreclosure of the liens granted in favor of the PBGC and exercise any other rights available under applicable law.

**GAIN ON INSURANCE RECOVERIES.** In February 2004, the Company entered into a binding agreement to assign to a third party certain insurance claims against a group of historic insurers. In July 2004, the assignment was supplemented to include several additional insurers. The claims involve several historic general liability policies of insurance issued to the Company. As a result of the assignment, after allowance for associated expenses and offsetting adjustments, the Company received net proceeds of approximately \$477,000 in May 2004 and an additional \$170,000 in October 2004. The Company recognized a gain of \$477,000 in the first quarter of 2004 and an additional gain of \$170,000 in the third quarter of 2004.

**NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2003**

**REVENUES.** Consolidated revenues decreased by 23% to \$3.1 million in 2004 compared to \$4.0 million for 2003. Foreign currency changes had the effect of increasing revenues by 8%. Excluding the impact of foreign currency changes, sales in 2004 decreased by 31%. Sales in each of the Company's three geographic areas suffered declines versus 2003. The revenue decline in Europe, principally in the United Kingdom, was caused by a decrease in new business booked through catering accounts. Also, shipments to distribution partners located in the U.S. declined by \$444,000 in 2004 as compared to 2003. The 2003 revenues included \$270,000 of sales to a customer in the U.S. relating to a magnetic stripe product that was phased-out.

**GROSS MARGIN.** Gross margin, as a percentage of net sales, increased slightly to 55% in 2004 compared to 53% in 2003.

**SALES AND MARKETING EXPENSES.** Sales and marketing expenses were \$1.2 million in 2004 compared to \$1.4 million in 2003. The decrease is primarily attributable to a \$150,000 reduction in salaries, employee business expense and employee termination expense resulting from headcount reductions. Also, the 2004 expenses reflect a reimbursement of \$47,000 of marketing costs under a grant with a

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government agency in Northern Ireland.

**PRODUCT DEVELOPMENT EXPENSES.** Product development expenses amounted to \$522,000 in 2004 compared to \$414,000 in 2003. The 2003 expenses included a \$73,000 reimbursement of certain development costs under a grant with a government agency in Northern Ireland. This reimbursement coupled with a \$44,000 increase in wages and third party engineering costs primarily accounted for the increase in product development expense.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses for the nine months ended September 30, 2004 decreased to \$1.8 million from \$2.1 million for 2003. The decrease in expenses is mainly attributable to a decline in legal, consulting, public reporting costs, insurance and other corporate costs.

**AMORTIZATION OF GOODWILL AND INTANGIBLES.** Amortization expense associated with definite lived intangible assets was \$30,000 in both 2004 and 2003.

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**COST OF PENSIONS - NON-OPERATING.** Cost of pensions declined from \$697,000 in 2003 to \$396,000 in 2004. The decrease is primarily attributable to the cessation of the amortization of the transition obligation component of net period pension expense effective December 31, 2003.

**LOSS ON PENSION SETTLEMENT.** A loss on the termination of the Plan of \$2.7 million was recorded in the third quarter of 2004. See the discussion above for further information.

**GAIN ON INSURANCE RECOVERIES.** In February and March 2003, the Company entered into two binding settlements with various historical insurers that resolve certain claims (including certain future claims) under policies of insurance issued to the Company by those insurers. As a result of the settlements, after allowance for associated expenses and offsetting adjustments, the Company received net proceeds of approximately \$1.0 million in February 2003 and an additional \$682,000 in April 2003. The Company recognized a gain from these settlements of \$1.7 million in the first quarter of 2003. As discussed above, the 2004 results include a gain of \$647,000 relating to the assignment to a third party of certain insurance claims against a group of historic insurers.

### LIQUIDITY

The Company has financed its operations over the last several years primarily through funds received from the sale of a non-core businesses in 2000 and insurance recoveries in 2003 and 2004. For the nine months ended September 30, 2004, cash, including short-term investments, decreased by \$1.2 million to \$2.3 million as of September 30, 2004.

Operating activities utilized cash of \$1.7 million in 2004 and principally consisted of the net loss of \$4.4 million plus a gain on insurance recoveries of \$647,000 offset by a loss on the pension settlement of \$2.7 million, depreciation and amortization of \$124,000 and a reduction in assets and liabilities of \$426,000.

Investing activities for the nine months ended September 30, 2004 principally consisted of cash received from insurance recoveries of \$531,000 offset by capital expenditures of \$49,000.

The Company has experienced negative cash flow from operating activities in the past and expects to experience negative cash flow in 2004 and beyond. In addition to funding operating and capital requirements and corporate overhead,

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future uses of cash include the following:

- o The Company sponsors a defined benefit pension plan, which was frozen in 1993. In January 2003, the Company filed a notice with the PBGC seeking a "distress termination" of the Plan. Pursuant to the Agreement for Appointment of Trustee and Termination of Plan between the PBGC and the Company effective September 30, 2004, the PBGC proceeded to terminate the Plan and was appointed as the Plan's trustee. As a result, the PBGC has assumed responsibility for paying the obligations to Plan participants. Under the terms of the Settlement Agreement effective September 23, 2004 between the PBGC and the Company, the Company is liable to the PBGC for the unfunded guaranteed benefit payable by the PBGC to Plan participants in the amount of \$7.5 million. The Company satisfied this liability by issuing a non-interest bearing note dated September 23, 2004 payable to the PBGC with a face amount of \$7.5 million.

Pursuant to the Security Agreement and Pledge Agreement, both dated September 23, 2004, the Note is secured by (a) all presently owned or hereafter acquired real or personal property and rights to property of the Company and (b) the common and preferred stock of Infineer and TecSec owned by the Company. Infineer is a wholly-owned subsidiary of the Company. The Company has an approximately 5% ownership interest in TecSec, on a fully diluted basis.

The Note matures on September 23, 2011. The first payment will be equal to \$1.0 million and will become due 30 days after the Company has received a total of \$4.0 million in Net Recoveries. Thereafter, on each anniversary of the first payment, the Company is required to pay the PBGC an

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amount equal to 25% of the Net Recoveries in excess of \$4.0 million (less the sum of all prior payments made in accordance with this sentence in prior years). As of September 30, 2004, Net Recoveries was approximately \$3.2 million.

In the event of default by the Company under the Settlement Agreement, the PBGC may declare the outstanding amount of the Note to be immediately due and payable, proceed with foreclosure of the liens granted in favor of the PBGC and exercise any other rights available under applicable law.

- o On May 28, 2002, a lawsuit was filed against the Company in the Superior Court of the State of California, in the County of Los Angeles by Leonard M. Ross and affiliated entities alleging, among other things, misrepresentation and securities fraud. The lawsuit names the Company and four of its current and former executive officers and directors as the defendants. The plaintiffs seek monetary and punitive damages for alleged actions made by the defendants in order to induce the plaintiff to purchase, hold or refrain from selling PublicARD common stock. The plaintiffs allege that the defendants made a series of material misrepresentations, misleading statements, omissions and concealments, specifically and directly to the plaintiffs concerning the nature, existence and status of contracts with certain purchasers, the nature and existence of investments in the Company by third parties, the nature and existence of business relationships and investments by the Company. The Company believes it has meritorious defenses to the allegations and intends to defend vigorously.

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In November 2002, the Company and the individual defendants served with the action filed a demurrer seeking the dismissal of six of the plaintiffs' nine purported causes of action. In January 2003, the court ruled in favor of the demurrer and dismissed the entire complaint. The plaintiffs were granted the right to replead and subsequently filed an amended complaint in February 2003. The Company and individual defendants filed a second demurrer in March 2003. In June 2003, the court ruled in favor of the demurrer and dismissed, without leave to amend, six of the eleven purported causes of action in the amended complaint. The lawsuit is in the early stages. Discovery has just commenced and no trial date has been set. Consequently, at this time it is not reasonably possible to estimate the damages, or range of damages, if any, that the Company might incur in connection with this action. However, if the outcome of this lawsuit is unfavorable to the Company, it could have a material adverse effect on the Company's operations, cash flow and financial position.

- o The Company leases certain office space, vehicles and office equipment under operating leases that expire over the next five years. Minimum future payments for operating leases having initial or remaining non-cancelable terms in excess of one year aggregates approximately \$921,000.

The Company will need to raise additional capital that may not be available to it. As a result of the Plan termination discussed above, the Company's 2003 and 2004 funding requirements due to the Plan amounting to \$3.4 million through September 15, 2004 were eliminated. As such, 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 levels through September 30, 2005. However, additional capital will be necessary in order to operate beyond September 30, 2005 and to fund the current business plan and other obligations. While the Company is 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 is not likely to be able to meet its obligations, take advantage of future acquisition opportunities or further develop or enhance its product offering, any of which would 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 collateral, and continued operating losses. Borrowings may also involve covenants limiting or restricting its operations or future opportunities.

As a result of a failure to meet certain continuing listing requirements of 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. On March 19, 2003, the Company received a Nasdaq Staff Determination letter indicating that the Company failed to comply with the minimum bid price requirement for continued listing on the SmallCap Market and that the Company's common stock was therefore subject to delisting. The Board of the Company decided not to appeal the delisting determination. Effective March 28, 2003, the Company's common stock no longer traded on the Nasdaq SmallCap Market. On March 28, 2003 the Company's common stock began trading on the OTC

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Bulletin Board. As a result of the delisting, the liquidity of the common stock may 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 common stockholders.

If the Company's liquidity does not improve, it may be unable to continue as a going concern and is likely to seek bankruptcy protection. Such an event may result in the Company's common and preferred stock being negatively affected or becoming worthless. The auditors' reports on the Company's Consolidated Financial Statements for the years ended December 31, 2003 and 2002 contained an emphasis paragraph concerning substantial doubt about the Company's ability to continue as a going concern.

### CONTRACTUAL OBLIGATIONS

The following is a summary of the Company's commitments as of September 30, 2004 (in thousands):

	TOTAL	PAYMENTS DUE BY PERIOD			
		LESS THAN 1 YEAR	1 TO 3 YEARS	3 TO 5 YEARS	MORE THAN 5 YEARS
	-----	-----	-----	-----	-----
Operating lease obligations	\$ 921	\$ 339	\$ 500	\$ 82	\$ --
Other long-term liabilities:					
Note payable to PBGC	7,501	--	--	--	7,501
Other long-term obligations	410	30	312	60	8
	-----	-----	-----	-----	-----
Total	\$8,832	\$ 369	\$ 812	\$ 142	\$7,509
	=====	=====	=====	=====	=====

### CRITICAL ACCOUNTING POLICIES

The Company's significant accounting policies are more fully described in the Notes to the Company's Unaudited Condensed Consolidated Financial Statements included herein and the Notes to the Consolidated Financial Statements included in the Company's Form 10-K for the year ended December 31, 2003. 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 and valuation of goodwill and intangibles to be critical policies due to the estimation processes involved.

**REVENUE RECOGNITION AND ACCOUNTS RECEIVABLE.** Revenue from product sales and technology and software license fees is recorded upon shipment if a signed contract exists, the fee is fixed and determinable, the collection of the resulting receivable is probable and the Company has no obligation to install the product or solution. If the Company is responsible for installation, revenue from product sales and license fees is deferred and recognized upon client acceptance or "go live" date. Maintenance and support fees are deferred and recognized as revenue ratably over the contract period. Provisions are recorded for estimated warranty repairs and returns at the time the

products are shipped. In the event changes in conditions cause management to determine that revenue recognition criteria are not met for certain future 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 assurance that the 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 periodically evaluates the need to record adjustments for impairment of inventory. 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.

IMPAIRMENT OF GOODWILL AND INTANGIBLES. Effective January 1, 2002, the Company adopted SFAS No. 142. In accordance with the guidelines of this statement, goodwill and indefinite lived intangible assets are no longer amortized but will be assessed for impairment on at least an annual basis. SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives and reviewed for impairment. The Company determined the fair value of its sole reporting unit primarily using two approaches: a market approach technique and a discounted cash flow valuation technique. The market approach relied primarily on the implied fair value using a multiple of revenues for several entities with comparable operations and economic characteristics. Significant assumptions used in the discounted cash valuation included estimates of future cash flows, future short-term and long-term growth rates and estimated cost of capital for purposes of arriving at a discount factor.

Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the net realizable of the asset.

#### RECENT ACCOUNTING PRONOUNCEMENTS

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". The interpretation addresses the disclosures to be made by a guarantor in its financial statements about its obligations under guarantees. In addition, it also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that



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guarantee. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure provisions became effective December 15, 2002. The adoption of the recognition and measurement provisions did not have a material impact on the Company's Consolidated Financial Statements.

In January 2003, the FASB issued FASB FIN No. 46, "Consolidation of Variable Interest Entities". In December 2003, the FASB issued FIN No. 46 (Revised) to address certain FIN 46 implementation issues. This interpretation clarifies the application of ARB No. 51, "Consolidated Financial Statements", for companies that have interests in entities that are Variable Interest Entities as defined under FIN 46. According to this interpretation, if a company has an interest in a VIE and is at risk for a majority of the VIE's expected losses or receives a majority of the VIE's expected gains, it must consolidate the VIE. FIN 46-R also requires additional disclosures by primary beneficiaries and other significant variable interest holders. For entities acquired or

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created before February 1, 2003, this interpretation is effective no later than the end of the first interim or reporting period ending after March 15, 2004, except for those VIEs that are considered to be special purpose entities, for which the effective date is no later than the end of the first interim or annual reporting period ending after December 15, 2003. For all entities that were acquired subsequent to January 31, 2003, this interpretation is effective as of the first interim or annual period ending after December 31, 2003. The adoption of the provisions of this interpretation did not have a material effect on the Company's Consolidated Financial Statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". SFAS No. 149 clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". In addition, it clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 amends certain other existing pronouncements. SFAS No. 149 is effective on a prospective basis for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement did not have a material impact on the Company's Consolidated Financial Statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity". SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This statement will become effective for financial instruments entered into or modified after May 31, 2003, and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this statement did not have a material impact on the Company's Consolidated Financial Statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits" that improves financial statement disclosures for defined benefit plans. The change replaces existing SFAS No. 132 disclosure requirements for pensions and other postretirement benefits and revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement of

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recognition of those plans required by SFAS No. 87, "Employers' Accounting for Pensions", or SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits." SFAS No. 132 revised retains the disclosure requirements contained in the original SFAS No. 132, but requires additional disclosures about the plan assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. SFAS No. 132 revised is effective for annual and interim periods with fiscal years ending after December 15, 2003. The Company adopted the revised disclosure provisions.

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104, Revenue Recognition, which supersedes SAB No. 101, Revenue Recognition in Financial Statements. SAB No. 104 rescinds accounting guidance in SAB No. 101 related to multiple-element arrangements, as this guidance has been superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." The adoption of SAB No. 104 did not have a material impact on the Company's Consolidated Financial Statements.

### 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, ALL OF WHICH COULD LEAD US TO SEEK BANKRUPTCY PROTECTION. 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 2001, 2002, 2003 and the nine months ended September 30, 2004 of approximately \$17.2 million, \$8.3 million, \$1.6 million and \$4.4 million, respectively. In addition, we experienced negative cash flow from operating activities of \$12.7 million, \$5.1 million, \$2.2 million and \$1.7

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million in 2001, 2002, 2003 and the nine months ended September 30, 2004 respectively, and have a shareholders' deficit of \$4.7 million as of September 30, 2004.

We sponsor a defined benefit pension plan which was frozen in 1993. In January 2003, we filed a notice with the PBGC seeking a "distress termination" of the Plan. Pursuant to the Agreement for Appointment of Trustee and Termination of Plan between the PBGC and us effective September 30, 2004, the PBGC proceeded to terminate the Plan and was appointed as the Plan's trustee. As a result, the PBGC has assumed responsibility for paying the obligations to Plan participants. Under the terms of the Settlement Agreement effective September 23, 2004 between the PBGC and us, we are liable to the PBGC for the unfunded guaranteed benefit payable by the PBGC to Plan participants in the amount of \$7.5 million. We satisfied this liability by issuing a non-interest bearing note dated September 23, 2004 payable to the PBGC with a face amount of \$7.5 million.

Pursuant to the Security Agreement and Pledge Agreement, both dated September 23, 2004, the Note is secured by (a) all of our presently owned or hereafter acquired real or personal property and rights to property of and (b) the common and preferred stock of Infineer and TecSec we own. Infineer is a wholly-owned subsidiary of ours. We have an approximately 5% ownership interest in TecSec, on a fully diluted basis.

The Note matures on September 23, 2011. The first payment will be equal to \$1.0 million and will become due 30 days after we have received a total of \$4.0

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million in Net Recoveries (as defined below). Thereafter, on each anniversary of the first payment, we are required to pay the PBGC an amount equal to 25% of the Net Recoveries in excess of \$4.0 million (less the sum of all prior payments made in accordance with this sentence in prior years). As of September 30, 2004, Net Recoveries was approximately \$3.2 million.

In the event of our default under the Settlement Agreement, the PBGC may declare the outstanding amount of the Note to be immediately due and payable, proceed with foreclosure of the liens granted in favor of the PBGC and exercise any other rights available under applicable law.

We and certain current and former officers are defendants in a lawsuit alleging, among other things, misrepresentation and securities fraud. We believe that we have meritorious defenses to the allegations and intend to defend ourselves vigorously. The cost of defending against this action could be significant, and if the Company is not successful in defending itself, the Company may be required to pay the plaintiff's damages, which could have a material adverse effect on the Company's business and operations. See "We are unable to predict the extent to which the resolution of lawsuits pending against us could adversely affect our business". In addition, we have future non-cancelable operating lease obligations for office space, vehicles and office equipment aggregating \$921,000.

We will need to raise additional capital that may not be available to us. As a result of the Plan termination discussed above, our 2003 and 2004 funding requirements due to the Plan amounting to \$3.4 million through September 15, 2004 were eliminated. As such, we believe that existing cash and short term investments may be sufficient to meet our operating and capital requirements at the currently anticipated levels through September 30, 2005. However, additional capital will be necessary in order to operate beyond September 30, 2005 and to fund the current business plan and other 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 us to seek bankruptcy protection. The auditors' reports on the Company's Consolidated Financial Statements for the years ended December 31, 2001, 2002 and 2003 contained an emphasis paragraph concerning substantial doubt about the Company's ability to continue as a going concern.

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.

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OUR STOCK WAS DELISTED FROM THE NASDAQ SYSTEM. On February 14, 2002, we received a 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 the Nasdaq National Market 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.

In accordance with the Nasdaq rules, we were required to regain compliance with the National Market minimum bid price requirement and with the market value of public float requirement by May 2002. Since our common stock continued to

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trade significantly below \$1.00, 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 stock listing was transferred to the SmallCap Market effective May 2, 2002. The SmallCap Market also has a minimum bid price requirement of \$1.00. We qualified for an extended grace period to comply with the SmallCap Market's \$1.00 minimum bid price requirement, which extended the delisting determination by Nasdaq until February 10, 2003.

On March 19, 2003, we received a Nasdaq Staff Determination letter indicating that we failed to comply with the minimum bid price requirement for continued listing on the SmallCap Market and that our common stock was therefore subject to delisting. Our board of directors decided not to appeal the delisting determination. Effective March 28, 2003, our common stock no longer traded on the SmallCap Market. On March 28, 2003, our common stock began trading on the OTC Bulletin Board.

As a result of the delisting, the liquidity of our common stock may be materially adversely affected. This could impair our ability to raise capital in the future. 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 us to seek bankruptcy protection.

WE ARE UNABLE TO PREDICT THE EXTENT TO WHICH THE RESOLUTION OF LAWSUITS PENDING AGAINST US COULD ADVERSELY AFFECT OUR BUSINESS. On May 28, 2002, a lawsuit was filed against us in the Superior Court of the State of California, in the County of Los Angeles by Leonard M. Ross and affiliated entities alleging, among other things misrepresentation and securities fraud. The lawsuit names four of our current and former executive officers and directors and us as the defendants. The plaintiffs seek monetary and punitive damages for alleged actions made by the defendants in order to induce the plaintiff to purchase, hold or refrain from selling our common stock. The plaintiffs allege that the defendants made a series of material misrepresentations, misleading statements, omissions and concealments, specifically and directly to the plaintiffs concerning the nature, existence and status of contracts with certain purchasers, the nature and existence of investments in us by third parties, the nature and existence of business relationships and investments by us. We believe we have meritorious defenses to the allegations and intend to defend vigorously.

In November 2002, we and the individual defendants served with the action filed a demurrer seeking the dismissal of six of the plaintiffs' nine purported causes of action. In January 2003, the court ruled in favor of the demurrer and dismissed the entire complaint. The plaintiffs were granted the right to replead and subsequently filed an amended complaint in February 2003. We and the individual defendants filed a second demurrer in March 2003. In June 2003, the court ruled in favor of the demurrer and dismissed, without leave to amend, six of the eleven purported causes of action in the amended complaint. The lawsuit is in the early stages. Discovery has just commenced and no trial date has been set. Consequently, at this time it is not reasonably possible to estimate the damages, or range of damages, if any, that we might incur in connection with this action. However, if the outcome of this lawsuit is unfavorable to us, it could have a material adverse effect on our operations, cash flow and financial position.

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We incurred approximately \$200,000 in defense costs in 2002. No additional costs have been incurred in 2004 and 2003. Notice of the commencement of this action has been given to our directors and officers liability insurance carriers. Our directors and officers liability insurance carriers are funding the additional costs of defending this action, subject to the carriers' reservation of rights.

WE FACE RISKS ASSOCIATED WITH ACQUISITIONS. An important element of our 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. However, we will only be able to engage in future acquisitions if we are successful in obtaining additional funding, as to which no assurance can be given. 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:

- o we will not be able to retain the employees or business relationships of the acquired company;
- o we will fail to realize any synergies or other cost reduction objectives expected from the acquisition;
- o we will not be able to integrate the operations, products, personnel and facilities of acquired companies;
- o 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;
- o we will incur or assume liabilities, including liabilities that are unknown or not fully known to us at the time of the acquisition; and
- o 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.

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, 2003, no one customer accounted for more than 10% of our revenues. For the nine months ended September 30, 2004, one customer accounted for 10% of revenues. Amounts due from this customer represented approximately 25% of the accounts receivable balance

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as of September 30, 2004.

We generally do not enter into long-term supply commitments with our customers. Instead, we bid on a project basis. 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

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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:

- o product selections;
- o timely and efficient completion of product design and development;
- o timely and efficient implementation of manufacturing processes;
- o effective sales, service and marketing;
- o price; and
- o 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.

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:

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

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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 could 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 Moneybox (Girovend), MARS, Cunninghams, Uniware, Diebold and Schlumberger.

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

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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 are subject to 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, 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, 2003, we had federal net operating loss carryforwards, subject to review by the Internal Revenue Service, totaling approximately \$66.8 million for federal income tax purposes. The federal net operating loss carryforwards begin to expire in 2005. We do not expect to earn any significant taxable income in the next several years, and may not do so until much later, if ever. A federal net operating loss can generally be carried back two, three or five years and then forward fifteen or twenty years (depending on the year in which the loss was 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

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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, although no assurance can be given that any such offering, acquisition or other transaction will be effected. In addition, the exercise of outstanding 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 would be effectively unavailable 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.

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.

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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.

We believe that establishing, maintaining and enhancing the Infineer brand



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name is essential to our business. We filed an application for a United States trademark registration and an application for service mark registration of our name and logo. We are aware of third parties that use marks or names that contain similar sounding words or variations of the "infi" prefix. In July 2002, we received a claim from a third party challenging the use of the Infineer name. We have reached an agreement in principle with this third party, subject to negotiation of definitive documentation, and believe this particular challenge should be resolved. As a result of this claim and other challenges which may occur in the future, we may incur significant expenses, pay substantial damages and be prevented from using the Infineer name. Use of a similar name by third parties may also cause confusion to our clients and confusion in the market, which could decrease the value of our brand and harm our reputation. We cannot assure you that our business would not be adversely affected if we are required to change our name or if confusion in the market did occur.

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 could 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 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 and hardware engineers, 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

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results of operations will suffer.

OUR INTERNATIONAL OPERATIONS SUBJECT US TO RISKS ASSOCIATED WITH OPERATING IN FOREIGN MARKETS, INCLUDING FLUCTUATIONS IN CURRENCY EXCHANGE RATES, WHICH COULD ADVERSELY AFFECT OUR OPERATIONS AND FINANCIAL CONDITION. Our operations are located in the United Kingdom and sales to customers outside the U.S. represented approximately 82% and 88% of total sales for the year ended December 31, 2003 and nine months ended September 30, 2004, respectively. 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:

- o tariffs and other trade barriers;
- o difficulties in staffing and managing foreign operations;
- o currency exchange risks;
- o export controls related to encryption technology;
- o unexpected changes in regulatory requirements;
- o changes in economic and political conditions;
- o seasonal reductions in business activities in the countries where our customers are located;
- o longer payment cycles and greater difficulty in accounts receivable collection;
- o potentially adverse tax consequences; and
- o burdens of complying with a variety of foreign laws.

Any of the foregoing could adversely impact the success of our operations. We cannot assure you that such factors will not have a material adverse effect on our future 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.

CHANGES WE MAY NEED OR BE REQUIRED TO MAKE IN OUR INSURANCE COVERAGE MAY EXPOSE US TO INCREASED LIABILITIES AND MAY INTERFERE WITH OUR ABILITY TO RETAIN OR ATTRACT QUALIFIED OFFICERS AND DIRECTORS. We renew or replace various insurance policies on an annual basis, including those that cover directors and officers liability. Given the current climate of rapidly increasing insurance premiums and erosions of coverage, we may need or be required to reduce our coverage and increase our deductibles in order to afford the premiums. To the extent we reduce our coverage and increase our deductibles, our exposure and the exposure of our directors and officers for liabilities that either become excluded from coverage or underinsured will increase. As a result, we may lose or may experience difficulty in attracting qualified directors and officers.

WE ARE SUBJECT TO GOVERNMENT REGULATION. Federal, state and local regulations impose various environmental controls on the discharge of chemicals 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, could subject us to liabilities and could materially adversely affect our operations.

RECENTLY ENACTED AND PROPOSED REGULATORY CHANGES WILL CAUSE US TO INCUR INCREASED COSTS. Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002, will increase our expenses as we evaluate the implications of new rules and devote resources to respond to the new requirements. In particular, we expect to incur significant additional administrative expense as we implement Section 404 of the Sarbanes-Oxley Act, which requires management to report on, and our independent registered public

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accounting firm to attest to, our internal controls. The compliance of these new rules could also result in continued diversion of management's time and attention, which could prove to be disruptive to business operations. Further, we may lose or may experience difficulty in attracting qualified directors and officers.

There can be no assurance that we will timely complete the management certification and auditor attestation requirements of Section 404 of Sarbanes-Oxley Act. Possible consequences of failure to complete such actions

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include sanction or investigation by regulatory authorities, such as the Securities and Exchange Commission. Any such action could harm our stock price and also have a material adverse effect on our cash flow and financial position.

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 would be made of approximately \$738,000 to each of Mr. Harry I. Freund and Mr. Jay S. Goldsmith. 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

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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 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:

- o delisting of our common stock from the Nasdaq SmallCap Market effective March 28, 2003 (see "Our stock has been delisted from the Nasdaq System" above);
- o 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;
- o our ability to effectively manage our business, including our ability to raise capital;
- o variations in our annual or quarterly financial results or those of our competitors;

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- o general economic conditions, in particular, the technology service sector;
- o expected or announced relationships with other companies;
- o announcements of technological advances innovations or new products by us or our competitors;
- o patents or other proprietary rights or patent litigation; and
- o 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.

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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.

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### Market Risk

We are exposed to market risk primarily through short-term investments and an overdraft facility. Our investment policy calls for investment in short-term, low risk instruments. As of September 30, 2004, short-term investments (principally U.S. Treasury bills and money-market accounts) were \$2.1 million and borrowing under the overdraft facility amounted to \$344,000. Due to the nature of the short-term investments and the amount of the overdraft facility, any change in rates would not have a material impact on our financial condition or results of operations.

### ITEM 4. CONTROLS AND PROCEDURES

With the participation of management, the Company's chief executive officer and chief financial officer has evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, the chief executive officer and chief financial officer has concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

There has not been any change in the Company's internal controls over financial reporting during the period to which this report relates that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On May 28, 2002, a lawsuit was filed against the Company in the Superior Court of the State of California, in the County of Los Angeles by Leonard M. Ross and affiliated entities alleging, among other things, misrepresentation and securities fraud. The lawsuit names the Company and four of its current and former executive officers and directors as the defendants. The plaintiffs seek monetary and punitive damages for alleged actions made by the defendants in order to induce the plaintiff to purchase, hold or refrain from selling PublicARD common stock. The plaintiffs allege that the defendants made a series of material misrepresentations, misleading statements, omissions and concealments, specifically and directly to the plaintiffs concerning the nature, existence and status of contracts with certain purchasers, the nature and existence of investments in the Company by third parties, the nature and existence of business relationships and investments by the Company. The Company believes it has meritorious defenses to the allegations and intends to defend vigorously.

In November 2002, the Company and the individual defendants served with the action filed a demurrer seeking the dismissal of six of the plaintiffs' nine purported causes of action. In January 2003, the court ruled in favor of the demurrer and dismissed the entire complaint. The plaintiffs were granted the right to replead and subsequently filed an amended complaint in February 2003.

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The Company and individual defendants filed a second demurrer in March 2003. In June 2003, the court ruled in favor of the demurrer and dismissed, without leave to amend, six of the eleven purported causes of action in the amended complaint. The lawsuit is in the early stages. Discovery has just commenced and no trial date has been set. Consequently, at this time it is not reasonably possible to estimate the damages, or range of damages, if any, that the Company might incur in connection with this action. However, if the outcome of this lawsuit is unfavorable to the Company, it could have a material adverse effect on the Company's operations, cash flow and financial position.

The Company incurred approximately \$200,000 in defense costs in 2002. No additional costs have been incurred in 2004 and 2003. Notice of the commencement of this action has been given to the Company's directors and officers liability insurance carriers. The Company's directors and officers liability insurance carriers are funding the additional costs of defending this action, subject to the carriers' reservation of rights.

Various other legal proceedings are pending against the Company. The Company considers all such other 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 these claims to the extent not covered by insurance will not, individually or in the aggregate, have a material adverse effect on the consolidated financial position or consolidated results of operations of the Company.

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

#### (a) Exhibits

- 31.1 Certification of the Chief Executive Officer and Chief Financial Officer filed herewith pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer and Chief Financial Officer filed herewith pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

#### (b) Report on Form 8-K

Form 8-K dated August 13, 2004, reporting of the Registrant's results of operations for the second quarter of 2004.

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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: November 12, 2004

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

