STRATESEC INC
Form 10-Q
August 16, 2002

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended June 30, 2002

Commission File Number: 1-13427

STRATESEC INCORPORATED

Delaware	22-2817302
State of Incorporation	IRS Employer Identification No.

14360 Sullyfield Circle, Suite B, Chantilly, Virginia 20151
(703) 961-5683

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days.

Yes [X] No [_]

There were 8,401,472 shares of Common Stock, par value $0.01 per share, outstanding at August 7, 2002.

STRATESEC INCORPORATED
QUARTER ENDED JUNE 31, 2002

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PAR T I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

STRATESEC INCORPORATED
BALANCE SHEETS

	(Unaudited) June 30, 2002
Assets	
Current Assets	
Cash and cash equivalents	$ 73,1
Accounts receivable, net of allowance for doubtful accounts of $683,680 in 2002 and $750,000 in 2001	1,701,1
Costs and estimated earnings in excess of billings on uncompleted contracts	253,7
Inventory, net of allowance of $400,000 in 2002 and 2001	203,3
Other current assets	15,1
Total current assets	2,246,4
Property and equipment, net	96,7
Other assets	35,0
Total assets	$ 2,378,2
Liabilities and shareholders' deficit	
Current liabilities	
Accounts payable	$ 1,481,6
Accrued expenses and other	308,9
Income taxes payable	955,9
Bank and other lines of credit	7,742,9

Billings in excess of costs and estimated earnings on uncompleted contracts	52,2
Capital lease obligations	
Total current liabilities	10,541,7
Shareholders' deficit	
Common stock, $0.01 par value per share; authorized 20,000,000 shares; 8,392,550 shares issued and outstanding as of June 30, 2002; and 10,392,550 issued and outstanding as of December 31, 2001	104,0
Treasury stock, 2,009,000 shares as of June 30, 2002 and 9,000 as of December 31, 2001	(212,08
Additional paid-in capital	24,363,7
Accumulated deficit	(32,419,07
Total shareholders deficit	(8,163,45
Total liabilities and shareholders' deficit	$ 2,378,2

The accompanying notes are an integral part of these statements.

STRATESEC INCORPORATED
STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended	
	2002	2001
Revenues	$ 557,814	$ 1,688,322
Cost of revenues	447,850	1,397,257
Gross profit	109,964	291,065
Bad debt expense	975,139	2,200,000
Selling, general and administrative expenses	965,277	1,195,240
	1,940,416	3,395,240
Operating loss	(1,830,452)	(3,104,175)
Interest and financing fees	(416,251)	(191,909)
Interest and other income	-	3,234
	(416,251)	(188,675)

Net loss	$ (2,246,703)	$(3,292,850)
Net loss per share - basic	$ (0.24)	$ (0.32)
Weighted average common shares outstanding - basic	9,676,197	10,279,964

The accompanying notes are an integral part of these statements.

STRATESEC INCORPORATED
STATEMENTS OF CASH FLOWS (UNAUDITED)

	Three Months Ended	
	2002	2001
Cash flows from operating activities:		
Net loss	$(2,246,703)	$(3,292,850)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	163,615	90,284
Provision for bad debts	975,139	2,200,000
Loss on disposition of property and equipment	43,101	-
Changes in operating assets and liabilities		
Accounts receivable	1,685,506	1,118,059
Costs of estimated earnings in excess of billings on uncompleted contracts	(149,435)	(538,314)
Inventory	30,666	233,422
Other current assets	27,210	543,594
Other assets	36,764	5,323
Accounts payable	(305,763)	97,412
Accrued expenses and other	(388,037)	(554,857)
Billings in excess of costs and estimated earnings on uncompleted contracts	(117,739)	-
Net cash used by operating activities	(245,676)	(97,927)
Cash flows from investing activities		
Acquisition of property and equipment	-	-
Cash flows from financing activities		
Proceeds from line of credit	222,386	42,623
Principal payments on capital lease obligations	(6,004)	(25,221)
Net cash provided by financing activities	216,382	17,402
Net increase (decrease) in cash and cash equivalents	(29,294)	(80,525)
Cash and cash equivalents at beginning of period	102,400	892,585
Cash and cash equivalents at end of period	$ 73,106	$ 812,060

	=========	=========
Supplemental disclosures of cash flow information		
Interest paid	$ -	$ 114,889
	========	=========
In May 2002, certain non-cash assets and liabilities with a fair value of $193,555 were exchanged in a reacquisition of 2 million shares of treasury stock.	$ 193,555	$ -
	==========	=======

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
June 30, 2002
(unaudited)

1. BASIS OF PRESENTATION

The unaudited balance sheet as of June, 2002 and unaudited statement of operations and statement of cash flows for the three and six months ended June 30, 2001 and 2002 are condensed financial statements prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, they omit certain information included in complete financial statements and should be read in conjunction with the financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2001 filed with the Securities and Exchange Commission on March 30, 2002.

In the opinion of the Company, the unaudited financial statements at June 30, 2002 and for the three and six months ended June, 2001 and 2002 include all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for such periods. Results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of results to be expected for the full year.

On November 30, 2000, the Company acquired Security Systems Integration, Inc. (SSI) in a business combination accounted for as a pooling of interests. In the transaction, SSI merged with a wholly owned subsidiary of the Company, which then merged into the Company. The Company exchanged of 1,650,000 in newly-issued shares and 350,000 in treasury shares of its common stock for all of the outstanding stock of SSI.

On May 29, 2002, the Company exchanged certain assets and liabilities with a fair value of $193,555 to reacquire 2 million shares of Stratesec Incorporated.

2. COST AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS AND BILLINGS IN EXCESS OF COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Cost and estimated earnings in excess of billings on uncompleted contracts, as well as the related billings in excess of costs and estimated earnings on uncompleted contracts, represent revenue recognized on long-term fixed-price contracts based on the percentage-of-completion method less the related billings to date. Revenue recognized in excess of billing is included in the asset balance and billings in excess of recognized revenue is included in the liability balance.

3. Computation of Earnings per Share

	For the three months ending		For the six
	6/30/02	6/30/01	6/30/02
Net Loss	$(2,246,703)	$(3,292,850)	$(3,592,767)
Weighted Average Number of Common Shares Outstanding	9,676,197	10,279,964	10,036,831
Net Loss per Share - Basic	$ (0.24)	$ (0.32)	$ (0.36)

4. Taxes payable

The Company presently owes the U.S. government approximately $812 thousand in income taxes which are accrued and appear in the liability section of the Balance Sheet. The Company has not accrued approximately $450 thousand in interest and penalties. The Company believes that given its current circumstances, it is probable that the Company will not have to pay the interest and penalties. The Company has submitted an Offer in Compromise to the Internal Revenue Service to settle the entire debt for $25,000. The Company feels that given its circumstances, it is a reasonable offer and the IRS will accept it.

In addition, the Company owes the State of Virginia approximately $143 thousand in income taxes and $176 thousand in sales tax which are accrued and appear in the liability section of the Balance Sheet. The sales tax arises from sales to the Federal government that are sales tax exempt in the State of Virginia. The Company is presently exploring its options to appealing these taxes and to make an Offer in Compromise, similar to its offer to the Internal Revenue Service.

Should the IRS or the State of Virginia not accept the Company's offer, there would be a material adverse effect on the Company.

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

This discussion and analysis of the Company's financial condition and historical results of operations should be read in conjunction with the condensed financial statements and the related notes included elsewhere in this report.

OVERVIEW

The Company is a single-source provider of comprehensive, technology based security solutions for medium and large commercial and government facilities in the United States and abroad. The Company offers a broad range of services, including: (i) consulting and planning; (ii) engineering and design; (iii) systems integration; and (iv) maintenance and technical support.

The following plan addresses management's approach to improving the financial condition of the Company.

Sales remained slow through the first half of 2002, averaging slightly under $200,000 per month. This was below the $300,000 to $500,000 per month that the Company expected. The reduction was due to a slower restart than anticipated in the Company's Texas office and continued delays in contract awards. Due to the continued lack of significant business from the Texas office, on July 31, 2002 the Company decided to discontinue installation operations in Texas. The Company maintains its Texas office to continue consulting work with a small senior staff.

The Company has shifted the focus of its Virginia office to concentrate totally on U.S. Government business. The Company is actively searching for experienced Government sales personnel to aggressively pursue the expected significant increase in Federal security projects during the next Government fiscal year. Should the Company not gain significant additional work from its Virginia office, the Company may decide to cease security installation business in the Virginia area.

The Company is aggressively pursuing business while simultaneously looking at paring costs to our current level of business. These cost cuts look at the level of personnel needed to work current and anticipated jobs. The Company has continued its initiatives to reduce its overhead expenses to reduce its breakeven point to match the reduced sales volume. The Company looks to be cash flow neutral by the 4th quarter of 2002.
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As of August 1, there are $2.4 million in projects on which the Company has been informed that it is the vendor of choice, and there are $4.9 million more in high probability proposals outstanding. The Company has contracts on $1.6 million of the $2.4 million, and has been verbally notified on the other $0.78 million of projects. The Company believes that all of the remaining $0.78 million will be awarded to the Company over the next 60 days if capital spending by its customers resumes.

In order to lower costs and focus on the Company's primary business of physical security consulting, design, and installation, the Company has narrowed its focus to representing or providing software security products and services to a very select set of products.

Critical Accounting Policies and Estimates

The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which requires the Company to make certain estimates and assumptions. A summary of significant accounting policies is disclosed in Note 1 to the financial statements which are included in the Company's annual report on Form 10-KSB for the year ended December 31, 2001. The following section is a summary of certain aspects of those accounting policies that may require subjective or complex judgments and are most important to the portrayal of Company's financial condition and results of operations. The Company believes that there is a low probability that the use of different estimates or assumptions in making these judgments would result in materially different amounts being reported in the financial statements.

Revenue Recognition

The Company derives its revenue principally from long-term contracts, which are generally on a fixed-price basis. Revenue on fixed-price contracts includes direct costs and allocated indirect costs incurred plus recognized profit. Revenue is recognized under fixed-price contracts on the percentage-of-completion basis. The percentage of completion of individual contracts includes management's best estimate of the amounts expected to be realized on the contracts. It is at least reasonably possible that the amounts the Company will ultimately realize could differ materially in the near term from the amounts estimated in arriving at the earned revenue and costs and estimated earnings in excess of billings on uncompleted contracts.

Contract costs include all direct material, direct labor and direct subcontract costs. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability, including those arising from contract revisions and final contract settlements, may result in revisions to costs and income and are recognized in the period in which the revisions occur.

The asset "costs and estimated earnings in excess of billings on uncompleted contracts" represents revenue recognized in excess of amounts billed to clients. The liability "billings in excess of costs and estimated earnings on uncompleted contracts" represents billings in excess of revenue recognized.

RESULTS OF OPERATIONS

The following describes the Company's results of operations for the three and six-month periods ended June 30, 2002 and 2001, as required by the SEC's regulations. The Company believes, however, that information for sequential quarterly periods is more meaningful in light of recent trends in its business and has also has included such information in the tables and discussion that follows.

THREE AND SIX MONTHS ENDED JUNE 30, 2002 COMPARED WITH THREE AND SIX MONTHS ENDED JUNE 30, 2001

Quarter Ended	6/30/02	3/31/02	12/31/01
Revenue	$ 557,814	$646,922	$1,232,554
Revenue decrease as a percentage as compared to the previous quarter	14%	48%	28%

Revenue decreased for both the three and six month periods ended June 30, 2002 as compared to the prior year. Revenues from the last three consecutive quarters has decreased but at a decreasing rate 28%, 48%, and 14% for the quarters ending December 31, 2001, March 31, 2002 and June 30, 2002 respectively. The Company has continued to suffer from the adverse economic conditions and the lack of capital spending in the commercial sector. The Government sector revenue from existing customers also declined dramatically and no new Government customers have been added since the 1st quarter 2002.

Quarter Ended	6/30/02	3/31/02	12/31/01

Revenue	$557,814	$646,922	$ 1,232,554
Cost of Revenue	447,850	583,831	1,735,449
Gross Profit	$109,964	$ 63,091	$(502,895)
Gross Profit %	20%	10%	(41)%

Cost of revenue decreased for the three and six months ended June 30, 2002 as compared to the periods ended June 30, 2001, primarily due to the decrease in revenue. Gross margin for the six month period ended June 30, 2002 as compared to June 30, 2001 decreased from 34% in 2001 to 15% in 2002. This was due to aggressive bidding to win contracts and excess labor cost to complete several contracts.

Gross Margins for the three month periods ended June 30, 2002 and 2001 were approximately the same at 20% verses 18%, respectively. Gross margin percentages for the quarters ended December 31 and September 30, 2001 are (41)% and 40%, respectively. When the 3rd and 4th quarters are combined, there is a gross profit margin of 6%. For these periods the gross margins were 6%, 10%, and 20%, respectively. The Company believes gross margin percentages will continue to increase toward our historical gross margin of 30%.

Quarter Ended	6/30/02	3/31/02	12/31/01
Bad debt expense	$ 975,139	$ -	$1,878,922
Selling, General, and Administrative expenses	$965,277	$1,070,842	$1,035,394
Interest expense	$416,251	$338,313	$797,238
Net Loss	$2,246,703	$1,346,064	$3,925,189
Net cash used in operations	$245,676	$1,310,420	$2,312,530
Net borrowings	$222,386	$1,195,050	$2,311,292

Bad debt expense decreased for the three and six months ended June 30, 2002 as compared to the three and six month periods June 30, 2001. The bad debt expense in the second quarter 2002 reflects the total reserve of all WorldCom Inc. receivables due to the Chapter 11 filing in July 2002 of WorldCom Inc. In addition, reserves were added to reflect difficulties in collecting from a set of customers with whom the Company no longer does business.

Selling, general and administrative expenses decreased by 28.4% from $1.5 million in the 3rd quarter 2001 to $1.0 million in the 2nd quarter 2002 due to the Company's continued efforts to reduce overhead expenses and its break-even point.

Interest expense and financing fees increased significantly in both the year over year comparisons and quarter to quarter with the exception of the 4th quarter 2001 which included a large back interest accrual due to a higher rater effective July 1, 2001. The increase was due to the increased use of line of credit and increase rate of interest.

Net loss decreased for the second quarter 2002 as compared to 2001. The increase in the net loss for the 2nd quarter 2002 as compared to the 1st quarter is due to the increase in bad debts. The 1st half 2002 net loss is greater than the same period in 2001 due to a significant reduction in gross profit. The 1st half 2002 net loss is significantly less then the 2nd half of 2001 due primarily to a reduction in selling, general, and administrative expenses.

LIQUIDITY AND CAPITAL RESOURCES

The Company's principal capital requirements are increased working capital needed to support the rebuild of the Company. The Company currently is funding its working capital requirements with cash generated by operations and a receivables factoring facility with a financial institution. The Company is seeking additional financing to reduce outstanding aged accounts payable and to provide the working capital to fund the sales projected for 2002. If it is unable to obtain additional financing, its ability to obtain new business and increase revenue may be limited and its ability to continue as a going concern is in doubt.

The Company's lender E.S. Bankest is a finance company which has the financial capacity to fund the all the Company's financing needs. Bankest has shown a great deal of flexibility in working with the Company's in meeting the Company's continuing working capital needs. However, Bankest has made no firm commitment to continue to fund the Company and there can be no assurance that Bankest will continue to fund the working capital needs of the Company.
The Company is currently in merger negotiations with a privately held, profitable information security company. There is no definitive agreement at this time with this company and there can be no assurance an agreement will be reached. Forward-Looking Statements

This Form 10-QSB includes certain statements that may be deemed to be "forward-looking statements" within the meaning of Section 27A of the Securities Act. All statements, other than statements of historical fact, included in this Form 10-KSB that address activities, events, or developments that the Company expects, projects, believes, or anticipates will or may occur in the future, including matters having to do with existing or future contracts, the Company's ability to fund its operations and repay debt, business strategies, expansion and growth of operations and other such matters, are forward-looking statements. These statements are based on certain assumptions and analyses made by our management in light of its experience and its perception of historical trends, current conditions, expected future developments, and other factors it believes are appropriate in the circumstances. These statements are subject to a number of assumptions, risks and uncertainties, including general economic and business conditions, the business opportunities (or lack thereof) that may be presented to and pursued by the Company, the Company's performance on its current contracts and its success in obtaining new contracts, the Company's ability to attract and retain qualified employees, and other factors, many of which are beyond the Company's control. You are cautioned that these forward-looking statements are not guarantees of future performance and those actual results or developments may differ materially from those projected in such statements.

PART II. OTHER INFORMATION
ITEM 5. Other Information

Delisting of Securities from American Stock Exchange

Stratesec, Incorporated received notice on July 18, 2002, from the American Stock Exchange staff that the Company no longer complies with the Exchange's continued listing guidelines due to recurring losses and stockholders' equity and that its securities are, therefore, subject to being delisted from the Exchange. The Company fails to meet the following listing standards as established by the American Stock Exchange:

- o Stockholders' equity is less than $2 million and it has sustained losses from continuing operations and/or net losses in two of its three most recent fiscal years.
- o Stockholders' equity is less than $4 million and it has sustained losses from continuing operations and/or net losses in three of its four most recent fiscal years.
- o The opinion of the Company's prior auditors, Argy, Wiltse and Robinson, LLP, that the Company's recurring losses from operations and net capital deficiencies raises substantial doubt about the Company's ability to continue as a going concern.

Stratesec has appealed the determination and has requested a hearing before the Committee of the Exchange. There can be no assurance that the Company's request for continued listing will be granted. Stratesec is currently in merger negotiations with a privately held, profitable information security company. If the merger is consummated Stratesec believes it will comply with AMEX listing requirements. There is no definitive agreement at this time with this company and there can be no assurance an agreement will be reached.

Should the Company be delisted by the American Stock Exchange, the Company believes it is eligible to trade on the BBX, OTC Bulletin Board (OTCBB). The Company believes that the exchange on which the Company's shares are traded does not affect the market value or intrinsic value of the Company's business.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

10. Material Contracts
   - 10.1 Revised Line of Credit Agreement with E.S. Bankest, signed 6/15/02
   - 10.2 Agreement to exchange assets and liabilities for 2 million shares of Stratesec Incorporated.

11. Calculation of Net Income per Share

99. Other exhibits
   - Certifications of filing by officers

b. Reports on Form 8-K.

The forms 8-K listed below are hereby incorporated by reference.

- o May 31, 2002
- o July 19, 2002

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.

STRATESEC INCORPORATED

/s/ BARRY MCDANIEL

Barry McDaniel
President and Chief Executive Officer

/s/ RICHARD ROOMBERG

Richard Roomberg
Executive Vice President, Chief Operating Officer,
and Chief Financial Officer

August 14, 2002