ION NETWORKS INC
Form SB-2/A
July 12, 2005

Registration No. 333-124274

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

FORM SB-2
AMENDMENT NO. 2
REGISTRATION STATEMENT
UNDER THE SECURITIES ACT OF 1933

ION NETWORKS, INC.
(Name of Small Business Issuer in Its Charter)

DELAWARE	754813	22-2413505
(State or Other Jurisdiction of Incorporation or Organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification Number)

120 CORPORATE BLVD.,
SOUTH PLAINFIELD, NJ 07080
(908) 546-3900
(Address and Telephone Number of Principal Executive Offices and Principal Place of Business)

NORMAN E. CORN
CHIEF EXECUTIVE OFFICER
120 CORPORATE BLVD.,
SOUTH PLAINFIELD, NJ 07080
(908) 546-3900
(Name, Address and Telephone Number of Agent For Service)

Copies to:
JAMES ALTERBAUM
MOSES & SINGER LLP
1301 AVENUE OF THE AMERICAS
NEW YORK, NY 10019
(212) 554-7800

APPROXIMATE DATE OF PROPOSED SALE TO THE PUBLIC: from time to time after the effective date of this Registration Statement.

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. x

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file an amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

PROSPECTUS

Subject to completion, dated July 11, 2005

10,992,514 shares of common stock

ION NETWORKS, INC.

This prospectus covers up to 10,992,514 shares of our common stock held by the selling stockholders identified on pages 30 and 31 of this prospectus, including: (i) 3,373,882 shares issuable upon exercise of warrants, (ii) 2,409,638 shares issuable upon conversion of a convertible debenture, and (iii) 797,230 shares issuable upon conversion of preferred stock. The selling stockholders may sell or otherwise dispose of their shares or interests therein from time to time after the date hereof. The terms on which any sale or disposition may be effected are described under "Plan of Distribution" herein.

We will receive no proceeds from the sale or other disposition of the shares or interests therein by the selling stockholders. However, we will receive proceeds in the amount of $1,601,113 assuming the cash exercise of all of the warrants held by the selling stockholders.

Our common stock is traded on the Over-the-Counter Bulletin Board under the trading symbol "IONN.OB" On July 11, 2005, the last price as reported on the OTC Bulletin Board was $0.16.

The selling stockholders, and any participating broker-dealers may be deemed to be "underwriters" within the meaning of the Securities Act of 1933, and any commissions or discounts given to any such broker-dealer may be regarded as underwriting commissions or discounts under the Securities Act. The selling stockholders have informed us that they do not have any agreement or understanding, directly or indirectly, with any person to distribute their common stock.

Brokers or dealers effecting transactions in the shares should confirm the registration of these securities under the securities laws of the states in which transactions occur or the existence of an exemption from registration.

An investment in shares of our common stock involves a high degree of risk. We urge you to carefully consider the risk factors beginning on page 2.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

July 11, 2005

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PROSPECTUS SUMMARY

This summary highlights selected information contained elsewhere in this prospectus. This summary does not contain all the information that you should consider before investing in the common stock. You should carefully read the entire prospectus, including the “Risk Factors” and the financial statements contained herein, before making an investment decision. In this prospectus, “ION Networks, Inc.” the “Company,”“we,”“us” and “our” refer to ION Networks, Inc

The Company

We are a Delaware corporation founded in 1999 through the combination of two companies -- MicroFrame, a New Jersey Corporation (the predecessor entity to the us, originally founded in 1982), and SolCom Systems Limited, a Scottish corporation located in Livingston, Scotland (originally founded in 1994), and we design, develop, manufacture and sell network and information security and management products to corporations, service providers and government agencies. Our hardware and software suite of products are designed to form a secure auditable portal to protect IT and network infrastructure from internal and external security threats. Our products operate in the IP, data center, telecommunications and transport, and telephony environments and are sold by a direct sales force and indirect channel partners mainly throughout North America and Europe.

Recent Developments

On March 31, 2005, we completed a private placement of 4,411,764 shares of common stock and warrants to purchase an additional 2,205,882 shares of common stock. The total offering price was $750,000. The shares of common stock were issued at $0.17 cents per share and the warrants are exercisable at a price of $0.23 per share subject to certain anti-dilution adjustments. The warrants will expire on expire March 31, 2010. The Company has the right to call the warrants in the event that its common stock trades at a price exceeding $0.69 per share for twenty (20) consecutive trading sessions and certain other conditions are met. The Company also agreed to register for resale the shares of common stock as well as the shares issued upon exercise of the warrants. Further terms relating to this investment are described in the liquidity section of the Management’s Discussion and Analysis section contained in this prospectus.

General

Our executive offices are located at 120 Corporate Blvd., South Plainfield, New Jersey 07080 and our telephone number is (908) 546-3900.

Our corporate web site is www.ION-Networks.com. The information found on our web site is not intended to be part of this prospectus and should not be relied upon by you when making a decision to invest in our common stock.

The Offering

Common Stock Covered Hereby	10,992,514 shares
Common Stock Outstanding Before The Offering	27,050,044 (1)
Common Stock To Be Outstanding After The Offering	33,630,294 shares(2).
Use Of Proceeds	We will receive no proceeds from the sale of common stock by the selling stockholders. We will receive $1,601,113 if all of the warrants for underlying shares included in this prospectus are exercised for cash. We will use these proceeds for general corporate purposes.

(1) Does not include 12,932,499 shares issuable pursuant to currently, outstanding warrants, options and other convertible securities.

(2) Assumes the issuance of all shares that are issuable upon (i) exercise of warrants to purchase 3,373,882 shares, (ii) conversion of preferred stock into 797,230 shares of common stock, and (iii) conversion of a convertible debenture into 2,409,638 shares of common stock.

Summary Financial And Operating Information

The following selected financial information is derived from the financial statements appearing elsewhere in this prospectus and should be read in conjunction with the financial statements, including the notes thereto, appearing elsewhere in this prospectus.

Summary of Operations:	Year Ended December 31, 2004	2003	Three Months Ended March 31, 2005
Revenues	$ 3,616,261	$ 3,342,620	$ 932,431
Cost of sales	1,417,603	1,423,509	244,617
Operating expenses	2,789,638	2,755,333	813,028
Operating loss	(590,980)	(836,222)	(125,214)
Other income	18,309	5,279	13,186
Net loss before income taxes	$ (572,671)	$ (830,943)	$ (112,028)
Income tax benefit/(expense)	322,831	227,151	(272)
Net loss	$ (249,840)	$ (603,792)	$ (112,300)
Net loss per share, basic and diluted	(.01)	(.03)	(.01)

Statement of Financial Position:	As of December 31, 2004	2003	As of March 31, 2005
Cash and cash equivalents	$ 287,437	$ 357,711	$ 549,039
Total assets	$ 1,886,824	$ 2,104,656	$ 2,469,859
Working capital	$ 372,861	$ 287,930	$ 843,591
Stockholders' equity	$ 592,786	$ 797,510	$ 1,215,487

RISK FACTORS

We are vulnerable to technological changes, which may cause our products and services to become obsolete which could materially and negatively impact our cash flow.

Our industry experiences rapid technological changes, changing customer requirements, frequent new product introductions and evolving industry standards that may render existing products and services obsolete. As a result, more advanced products produced by competitors could erode our position in existing markets or other markets that they choose to enter and prevent us from expanding into existing markets or other markets. It is difficult to estimate the life cycles of our products and services, and future success will depend, in part, upon our ability to enhance existing products and services and to develop new products and services on a timely basis. We might experience difficulties that could delay or prevent the successful development, introduction and marketing of new products and services. New products and services and enhancements might not meet the requirements of the marketplace and achieve market acceptance. If these things happen, they would materially and negatively affect cash flow, financial condition and the results of operations.

Hardware and software incorporated in our products may experience bugs or "errors" which could delay the commercial introduction of our products and require time and money to alleviate.

Due to the complex and sophisticated hardware and software that is incorporated in our products, our products have in the past experienced errors or "bugs" both during development and subsequent to commercial introduction. We cannot be certain that all potential problems will be identified, that any bugs that are located can be corrected on a timely basis or at all, or that additional errors will not be located in existing or future products at a later time or when usage increases. Any such errors could delay the commercial introduction of new products, the use of existing or new products, or require modifications in systems that have already been installed. Remedying such errors could be costly and time consuming. Delays in debugging or modifying products could materially and adversely affect our competitive position.

We have difficulty predicting our future operating results or profitability due to the fluctuation in our quarterly and annual revenues.

In the past, we experienced fluctuations in our quarterly and annual revenues and we anticipate that such fluctuations will continue therefore making it difficult for us to predict our future operating results or profitability. Our quarterly and annual operating results may vary significantly depending on a number of factors, including:

- the timing of the introduction or acceptance of new products and services;

- changes in the mix of products and services provided;
- long sales cycles;
- changes in regulations affecting our business;
- increases in the amount of research and development expenditures necessary for new product development and innovation;
- changes in our operating expenses;
- uneven revenue streams;
- volatility in general economic conditions;
- volatility in the network security market; and
- threats of terror and war.

We cannot assure you that our revenues will not vary significantly among quarterly periods or that in future quarterly periods our results of operations will not be below prior results or the expectations of public market analysts and investors. If this occurs, the price of our common stock could significantly decrease. See also “Risks Associated with Our Securities - There is potential for fluctuation in the market price of our securities" page 5.

In the past we have experienced significant losses and negative cash flows from operations. If this trend reoccurs in the future, it could adversely affect our financial condition.

For the quarter ended March 31, 2005 the Company incurred a net loss of $112,300 and cash flows used in operations of $286,015. For the year ended December 31, 2004 and 2003, we experienced net losses of $249,840 and $603,792, respectively, and cash flows provided by (used in) operations of $108,279 and ($376,940), respectively. Based on the results for the quarter ended March 31, 2005 and the years ended December 31, 2004 and 2003, there can be no assurance that our business will become profitable in the future and that additional losses and negative cash flows from operations will not be incurred. If these trends continue in the future, there could be a material adverse affect on our financial condition.

As of March 31, 2005, the Company continues to have a marginal working capital balance, which could inhibit future growth and impact the Company’s financial viability.

Although the Company’s working capital balance increased to $843,591 at March 31, 2005 as compared to $372,861 at December 31, 2004, this balance is still lower than the Company’s optimal requirements. This low working capital balance, while improving, may continue to impact the ability of the Company to attract new customers and employees and could have a material adverse affect upon our business. ION is encouraged by this increase however working capital is still not sufficient to fully mitigate this risk.

We face significant competition and if we do not compete successfully, our results of operations may be adversely affected.

We are subject to significant competition from different sources for our different products and services. We cannot assure you that the market will continue to accept our hardware and software technology or that we will be able to compete successfully in the future. We believe that the main factors affecting competition in the network security business are:

- the products' ability to meet various network security requirements;
- the products' ability to conform to the network and/or computer systems;
- the products' ability to avoid becoming technologically outdated;
- the willingness and the ability of distributors to provide support customization, training and installation; and
- the price.

Although we believe that our present products and services are competitive, we compete with a number of large data networking, network security and network device manufacturers which have financial, research and development, marketing and technical resources far greater than ours. Our competitors may succeed in producing and distributing competitive products more effectively than we can produce and distribute our products, and may also develop new products which compete effectively with our products. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, marketing and other resources than we do. Nothing prevents or hinders these actual or potential competitors from entering our target markets at any time. In addition, our competitors may bundle products competitive to ours with other products that they may sell to our current or potential customers. These customers may accept these bundled products rather than separately purchasing our products. If our current or potential competitors were to use their greater financial, technical and marketing resources in our target markets and if we are unable to compete successfully, our business, financial condition and results of operations may be materially and adversely affected.

We may be unable to protect our proprietary rights, permitting competitors to duplicate our products and services, which could negatively impact our business and operations.

We hold no patents on any of our technology. If we are unable to license any technology or products that we may need in the future, our business and operations may be materially and adversely impacted. We have made a consistent effort to minimize the ability of competitors to duplicate our software technology utilized in our products. However, there remains the possibility of duplication of our products, and competing products have already been introduced. Any such duplication by our competitors could negatively impact our business and operations.

We rely on several key customers for a significant portion of our business, the loss of which would likely significantly decrease our revenues.

Historically, we have been dependent on several large customers each year, but they are not necessarily the same every year. For the year ended December 31, 2004, our most significant customers (stated as an approximate percentage of revenue) were Avaya 38% and MCI 9% compared to the year ended December 31, 2003, of Avaya 18%, Siemens 12%. Qwest 8% and MCI 7%. In general, we cannot predict with certainty, which large customers will continue to order. The loss of any of these large customers, or the failure to attract new large customers would likely significantly decrease our revenues and future prospects, which could materially and adversely affect our business, financial condition and results of operations.

We depend upon key members of our employees and management, the loss of which could have a material adverse effect upon our business, financial condition and results of operations.

Our business is greatly dependent on the efforts of the Chief Executive Officer, Mr. Norman E. Corn, Chief Financial Officer, Mr. Patrick E. Delaney, and Chief Technology Officer, Mr. William Whitney and other key employees, and on our ability to attract key personnel. Other than with respect to Messrs. Corn, Delaney, and Whitney, we do not have employment agreements with our other key employees. Our success depends in large part on the continued services of our key management, sales, engineering, research and development and operational personnel and on our ability to continue to attract, motivate and retain highly qualified employees and independent contractors in those areas. Competition for such personnel is intense and we cannot assure you that we will successfully attract, motivate and retain key personnel. While all of our employees have entered into non-compete agreements, there can be no assurance that any employee will remain with us. Our inability to hire and retain qualified personnel or the loss of the services of our key personnel could have a material adverse effect upon our business, financial condition and results of operations. Currently, we do not maintain "key man" insurance policies with respect to any of our employees.

We rely on several contract manufacturers to supply our products. If our product manufacturers fail to deliver our products, or if we lose these suppliers, we may be unable to deliver our product and our sales and revenues could be negatively impacted.

We rely on three primary contract manufacturers to supply our products: PPI Time Zero, Ituner Networks Corp., and ACE Electronics, Inc. If these manufacturers fail to deliver our products or if we lose these suppliers and are unable to replace them, then we would not be able to deliver our products to our customers. This could negatively impact our sales and revenues and have a material adverse affect on our business, financial condition and results of operations.

Our certificate of incorporation and bylaws contain limitations on the liability of our directors and officers, which may discourage suits against directors and executive officers for breaches of fiduciary duties.

Our Certificate of Incorporation, as amended, and our Bylaws contain provisions limiting the liability of our directors for monetary damages to the fullest extent permissible under Delaware law. This is intended to eliminate the personal liability of a director for monetary damages on an action brought by or in our right for breach of a director's duties to us or to our stockholders except in certain limited circumstances. In addition, our Certificate of Incorporation, as amended, and our Bylaws contain provisions requiring us to indemnify our directors, officers, employees and agents serving at our request, against expenses, judgments (including derivative actions), fines and amounts paid in settlement. This indemnification is limited to actions taken in good faith in the reasonable belief that the conduct was lawful and in, or not opposed to our best interests. The Certificate of Incorporation and the Bylaws provide for the indemnification of directors and officers in connection with civil, criminal, administrative or investigative proceedings when acting in their capacities as agents for us. These provisions may reduce the likelihood of derivative litigation against directors and executive officers and may discourage or deter stockholders or management from suing directors or executive officers for breaches of their fiduciary duties, even though such an action, if successful, might otherwise benefit our stockholders and directors and officers.

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RISKS ASSOCIATED WITH OUR SECURITIES

We do not anticipate the payment of dividends.

We have never declared or paid cash dividends on our common stock. We currently anticipate that we will retain all available funds for use in the operation of our business. Thus, we do not anticipate paying any cash dividends on our common stock in the foreseeable future.

There is potential for fluctuation in the market price of our securities.

Because of the nature of the industry in which we operate, the market price of our securities has been, and can be expected to continue to be, highly volatile. Factors such as announcements by us or others of technological innovations, new commercial products, regulatory approvals or proprietary rights developments, and competitive developments all may have a significant impact on our future business prospects and market price of our securities.

Shares that are eligible for sale in the future may affect the market price of our common stock.

As of July 11, 2005, an aggregate of 6,651,242 of the outstanding shares of our common stock are "restricted securities" as that term is defined in Rule 144 of the Securities Act of 1933 (Rule 144). These restricted shares may be sold pursuant only to an effective registration statement under the securities laws or in compliance with the exemption provisions of Rule 144 or other securities law provisions. In addition, 5,565,629 shares are issuable pursuant to currently exercisable options, 3,373,882 shares are issuable pursuant to currently exercisable warrants, 1,555,570 shares are issuable pursuant to currently convertible preferred stock of 155,557 shares and 2,409,638 shares are issuable pursuant to a convertible debenture. Future sales of substantial amounts of shares in the public market, or the perception that such sales could occur, could negatively affect the price of our common stock.

We may be restricted from issuing new equity securities.

In September 2002, we issued shares of Series A Preferred Stock to several investors. Under the terms of the preferred stock, any issuances of equity securities or securities convertible into or exercisable for equity securities require the prior approval of the holders of a majority of the outstanding shares of Series A Preferred Stock. While two of our directors currently own a significant portion (48.75%) they do not constitute a majority of such preferred stock. While the Company has been successful in obtaining the consent of a majority of the series a preferred stock when the Board of Directors has requested, there can be no assurance that the Company will continue to be able to obtain such consent. If the Company is unable to obtain this approval, the Company would be prevented from issuing equity securities which would preclude the Company from raising equity financing, utilizing equity based compensation plans and from other actions requiring the issuance of equity securities. In addition, the consent of certain of our existing investors (which consent may not be unreasonably withheld or delayed) is required in connection with certain financings involving (subject to certain exclusions) the issuance of securities in which the purchase price, number of securities, exercise price or conversion rate are subject to future adjustment. Failure to obtain such consent could restrict the Company's ability to avail itself of the benefits of such financings.

Our common stock is subject to penny stock regulation that may affect the liquidity for our common stock.

Our common stock is subject to the regulations of the Securities and Exchange Commission relating to the market for penny stocks. These regulations generally require that a disclosure schedule explaining the penny stock market and the risks associated therewith be delivered to purchasers of penny stocks and impose various sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors. The regulations applicable to penny stocks may severely affect the market liquidity for our common stock and could limit your ability to sell your securities in the secondary market.

FORWARD LOOKING STATEMENTS

Statements contained in this prospectus include “forward-looking statements” within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, in particular and without limitation, statements contained herein under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Forward-looking statements involve known and unknown risks, uncertainties and other factors which could cause the Company’s actual results, performance and achievements, whether expressed or implied by such forward-looking statements, not to occur or be realized. These include uncertainties relating to our intellectual property, our expansion plans, and rapid technological changes. Such forward-looking statements generally are based upon the Company’s best estimates of future results, performance or achievement, based upon current conditions and the most recent results of operations. Forward-looking statements may be identified by the use of forward-looking terminology such as “may,”“will,”“expect,”“believe,”“estimate,”“project,”“anticipate,”“continue” or similar terms, variation terms or the negative of those terms. You should carefully consider such risks, uncertainties and other information, disclosures and discussions which contain cautionary statements identifying important factors that could cause actual results to differ materially from those provided in the forward-looking statements. Readers should carefully review the “Risk Factors” section and any other cautionary statements contained in this prospectus and our other public filings. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

USE OF PROCEEDS

We will not receive any portion of the proceeds from the sale or other disposition of common stock or interests therein by the selling stockholders. We may receive proceeds of up to $1,601,113 if all the warrants relating to shares registered hereby are exercised for cash. Management currently anticipates that any such proceeds will be utilized for working capital and other general corporate purposes. We cannot estimate how many, if any, warrants may be exercised as a result of this offering.

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Principal Market And Market Prices

Our common stock has traded in the over-the-counter market on the OTC Electronic Bulletin Board (OTCBB) under the symbol "IONN.OB." The following table sets forth for the indicated periods the high and low bid prices of the common stock for the two fiscal years ended December 31, 2004, 2003, and for the period from January 1, 2005 through July 8, 2005 as reported on the OTCBB. These prices are based on quotations between dealers, and do not reflect retail mark-up, mark-down or commissions, and may not necessarily represent actual transactions.

Fiscal Period	**Year Ended December 31, 2005**		**Year Ended December 31, 2004**		**Year Ended December 31, 2003**	
	High	**Low**	**High**	**Low**	**High**	**Low**
First Quarter	.27	.17	.20	.04	.28	.05
Second Quarter	.19	.09	.14	.05	.11	.05
Third Quarter*	.16	.13	.37	.06	.11	.05
Fourth Quarter	-	-	.44	.19	.11	.04

* Through July 8, 2005

Approximate Number Of Holders Of Our Common Stock

On July 8, 2005, there were approximately 408 stockholders of record of our common stock.

Dividends

We have never declared dividends or paid cash dividends. We intend to retain and use any future earnings for the development and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

ION Networks, Inc ("ION" or the "Company") designs, develops, manufactures and sells security solutions that protect enterprise network administrative interfaces from improper, unauthorized or otherwise undesirable access from external and internal sources. Administrative interfaces are the network access points used by highly trained technical individuals who are charged with the responsibilities of maintaining and supporting the networks and devices employed within the networks such as servers, routers, PBXs and similar network equipment. These technicians may be employees of the enterprise or employed by third parties such as managed service providers, consultants, device vendors or application developers. In all cases, they are considered "trusted insiders" since in order to perform their jobs; permission to enter and work within the network must be granted. The Company's solution, comprised of centralized management and control software, administrative security appliances and soft tokens, are designed to provide secure, auditable access to all administrative interfaces and monitored security once working within the network. Service Providers, Enterprises and Governmental Agencies utilize the ION solution globally in their voice, data and converged environments, to establish and maintain security policies while providing the support and maintenance required of networks and their devices.

The Company is a Delaware corporation founded in 1999 through the combination of two companies - MicroFrame ("MicroFrame"), a New Jersey Corporation (the predecessor entity to the Company, originally founded in 1982), and SolCom Systems Limited ("SolCom"), a Scottish corporation located in Livingston, Scotland (originally founded in 1994). The Scottish corporation was dissolved in 2003. The Company's principal objective was to address the need for security and network management and monitoring solutions, primarily for the PBX-based telecommunications market, resulting in a significant portion of our revenues being generated from sales to various telecommunications companies.

RESULTS OF OPERATIONS

For the three months ended March 31, 2005 compared to the same period in 2004

Net sales for the three month period ended March 31, 2005, was $932,431 compared to net sales of $904,961 for the same period in 2004, an increase of $27,470 or 3.04%. The increase in sales is primarily attributable to billings for hardware, software and professional services from certain government contracts in the three month period ended March 31, 2005 which were not billed in the same period of the prior year.

Cost of sales for the three month period ended March 31, 2005 was $244,617 compared to $387,635 for the same period in 2004. Cost of sales as a percentage of net sales for the three months ended March 31, 2005 decreased to 26.2% from 42.8% for the same period in 2004, resulting therefore in gross margins increasing to 73.8% from 57.2% as compared to the prior year. The decrease in cost of sales and the increase in gross margin in the first quarter of 2005 is due to a positive change in product sales mix and a reduction of amortization expense related to capital software compared to the same period in 2004. During the first quarter of 2005, the Company increased the sales mix of high margin professional services, software, repair and maintenance revenues while reducing the mix of lower margin appliance products compared to the same period last year resulting in a 9.9% gross margin improvement. Amortization expense related to capital software declined from $90,483 or 10% of revenues for the first quarter of 2004 to $30,881 or 3.3% of revenues for the first quarter of 2005.

Research and development expense, net of capitalized software development, for the three month period ended March 31, 2005 was $154,069 compared to $120,269 for the same period in 2004 or an increase of $33,800. The increase is due to headcount additions from 7 to 10 and outside services for development activities related to the Company's new products.

Selling, general and administrative ("SG&A") expenses for the three months ended March 31, 2005 were $656,427 compared to $712,537 for the same period in 2004, a decrease of $56,110. The decline in SG&A expenses is due primarily to reduced overhead items such as, insurance and professional services offset in part by higher payroll related expenses. In addition, there was a charge to SG&A expenses during the three month period ended March 31, 2004 for $58,750 to account for stock compensation for options granted and no such charge in the three month period ended March 31, 2005.

Depreciation expense was $2,532 for the three months ended March 31, 2005 compared to $25,245 in the same period in 2004. The decrease was due primarily to the fact that the Company fully depreciated certain telecommunications and computer equipment during the year ended December 31, 2004 which resulted in a lower asset basis to be depreciated during the three month period ended March 31. 2005, versus the same period in 2004..

Net loss for the three months ended March 31, 2005 was $112,300 compared to $322,808 for the three months ended March 31, 2004. The reduced loss of $210,508 is primarily due the higher gross margins earned from the product mix, and reduced operating expenses.

FINANCIAL CONDITION AND CAPITAL RESOURCES

The Company's working capital balance as of March 31, 2005 was $843,591 compared to $372,861 at December 31, 2004. The increase was due primarily to cash realized from the sale of 4,411,764 shares of common stock and warrants to purchase an additional 2,205,882 shares of common stock for $750,000 on March 31, 2005.

Net cash used by operating activities during the three months ended March 31, 2005 was $286,015 compared to net cash provided during the same period in 2004 of $189,463 or a difference of $475,478. This difference was due primarily to increases in inventory, accounts receivable, deferred income and decreases in non-cash items such as stock based compensation, depreciation and amortization.

Net cash used in investing activities during the three months ended March 31, 2005 was $187,007 compared to net cash used during the same period in 2004 of $42,950. This increase of $144,057 was primarily due to increased capitalized software expenditures from $37,905 the three months ended March 31, 2004 to $176,321 for the same period in 2005.

Net cash provided by financing activities during the three months ended March 31, 2005 was $734,624 compared to net cash used during the same period in 2004 of $23,554, or an increase of $758,178. The increase was due primarily to cash realized from the sale of 4,411,764 shares of common stock and warrants to purchase an additional 2,205,882 shares of common stock for $750,000 (less approximately $15,000 for expenses related to the transaction) by the Company on March 31, 2005.

During 2004, the Company's financial condition improved particularly with the operating results in the last half of 2004 where the Company posted two successive quarters of earnings and over $1.0 million in revenue for each quarter. The Company generated $108,279 in cash provided by operating activities in 2004 compared to $376,940 used in 2003. Also, in 2004 the Company increased its investments in new products to be rolled-out in 2005 and still was able to improve the overall annual usage of cash and cash equivalents, with the net decrease to $70,274 from a net decrease of $507,973 in 2003. The Company continues to have a delicate cash position and while the future viability of the organization has significantly improved, it is necessary for it to continue to strictly manage expenditures and to increase product revenues despite the cash infusion of $750,000 on March 31, 2005 from the sale of 4,411,765 shares of common stock.

Results Of Operations

The Year Ended December 31, 2004 Compared to the Year Ended December 31, 2003

Revenues for the year ended December 31, 2004 were $3,616,261 as compared to $3,342,620 for the year ended December 31, 2003, an increase of approximately 8% or $273,641. This increase is attributable mainly to the growth in the number of units sold for the year 2004 compared to 2003 offset in part by a slight reduction in maintenance revenues. This reversal in the trend for the Company of declining year over year revenues was caused primarily by the growth of the ION's Original Equipment Manufacturing (OEM) business caused by a general rebound in the telecommunications sector of the economy. The Company's OEM revenues increased from $638,000 in 2003 to $1,372,000 in 2004. This change was due primarily to the increase in unit sales of higher margin 5500 model appliances from 79 to 335 units offset in part by a decline in sales of older product models i.e., 3100 from 515 to 440.

Gross margin for the year ended December 31, 2004 was $2,198,658 or 60.8% of revenue compared to $1,919,111 or 57.4% for the year ended December 31, 2003. Despite an 8% increase in revenues during the year ended 2004 compared to 2003, cost of sales remained flat resulting in reducing cost of sales as a percentage of revenue from 42.6% in 2003 to 39.2% in 2004. The increase in gross margin was due to a decline in amortization expense related to capital software from $531,136 or15.8% of revenue in 2003 to $352,160 or 9.7% in 2004 offset in part by a slight decline in prices during 2004 when compared to 2003.

Research and development expenses, net of capitalized software development, increased to $598,012 for the year ended December 31, 2004 from $503,146 for the year ended December 31, 2003, an increase of 18.8%. This increase for research and development expenditures was primarily due to the higher expenses related to the conversion of certain products to a Linux based platform from a proprietary software platform and the preliminary outside consulting services related to new product development.

Selling, general and administrative expenses decreased 5.6% from $2,452,031 for the year ended December 31, 2003 to $2,314,834 for the year ended December 31, 2004. This decline in expense was due primarily to certain cost containment programs implemented by management particularly for insurances, professional services and the full year impact of the move in 2003 of the Company's headquarters to a more efficient facility.

Depreciation was $57,325 for the year ended December 31, 2004 compared to $205,558 for the year ended December 31, 2003, a decrease of $148,233 or approximately 72.1%. The primary reason for this reduction in 2004 as compared to 2003 was that the Company did not purchase depreciable fixed assets at a rate equal to prior periods due to a shift of the Company's reduction in staff and outsourcing of certain manufacturing processes.

The Company acquired a corporation business tax benefit certificate pursuant to New Jersey law, which relates to the surrendering of unused net operating losses. For the year ended December 31, 2004 and for the year ended December 31, 2003, the Company received a benefit of $322,831 and $227,151, respectively.

During the year ended December 31, 2004 the Company recognized benefits from restructuring in the amount of $180,533 compared to $405,402 for the year ended December 31, 2003.

The Company had a loss of $249,840 for the year ended December 31, 2004 compared to a loss of $603,792 for the year ended December 31, 2003 or an improvement of $353,952.

Financial Condition And Capital Resources

The Company's working capital balance as of December 31, 2004 was $372,861 compared to $287,930 as of December 31, 2003.

Net cash provided by operating activities during the year ended December 31, 2004 was $108,279, compared to net cash used in operating activities of $376,940 during the year ended December 31, 2003. The $485,219 improvement in cash provided from operations was primarily a result of the decrease in net losses of $353,952 for the year ended December 31, 2004 compared to the year ended December 31, 2003.

Net cash used in investing activities during the year ended December 31, 2004 was $321,963, compared to net cash used of $59,167 in year ended December 31, 2003. The increase of $262,796 of the net cash used in investing activities during the year ended December 31, 2004, was due to a slight increase of capitalized software expenditures in 2004 of $310,223 compared to $214,996 in 2003 and that in the prior year there were offsets against capital spending for the release of restricted cash of $125,700 and sale of certain assets of $30,129.

Net cash provided by financing activities during the year ended December 31, 2004 was $143,410, compared to $85,135 used in the year ended December 31, 2003. Financing activities during the year ended December 31, 2004 include the sale of a $200,000 convertible debenture to Mr. Steven Deixler in August 2004 (see item 5 - Recent Sales of unregistered securities) and exercise of $11,250 of employee stock options. During 2003 there were no financings.

On March 31, 2005, the Company entered into a investment agreement with the New York based institutional investment firm Special Situations Fund III, LP and several related funds (the "SSF Funds"), pursuant to which Ion completed a private placement of 4,411,765 shares of common stock and warrants to purchase an additional 2,205,882 shares of common stock. The total offering price was $750,000. This cash infusion should permit the Company to complete engineering, build initial inventory stocks and expend some marketing funds on the launch of its two new product offerings and have some cash remaining for general corporate purposes.

Critical Accounting Policies

Use of Estimates -

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

The significant estimates include the allowance for doubtful accounts, allowance for inventory obsolescence, capitalized software including estimates of future gross revenues, and the related amortization lives, deferred tax asset valuation allowance and depreciation and amortization lives.

Allowance for Doubtful Accounts Receivable -

Accounts receivable are reduced by an allowance to estimate the amount that will actually be collected from our customers. If the financial condition of our customers were to materially deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory, net -

Inventory is stated at the lower of cost (average cost) or market. Reserves for slow moving and obsolete inventories are provided based on historical experience and current product demand. If our estimate of future demand is not correct or if our customers place significant order cancellations, inventory reserves could increase from our estimate. We may also receive orders for inventory that has been fully or partially reserved. To the extent that the sale of reserved inventory has a material impact on our financial results, we will appropriately disclose such effects. Our inventory carrying costs are not material; thus we may not physically dispose of reserved inventory immediately.

Capitalized Software -

The Company capitalizes computer software development costs in accordance with the provisions of Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"). SFAS No. 86 requires that the Company capitalize computer software development costs upon the establishment of the technological feasibility of a product, to the extent that such costs are expected to be recovered through future sales of the product. Management is required to use professional judgment in determining whether development costs meet the criteria for immediate expense or capitalization. These costs are amortized to Cost of sales by the greater of the amount computed using (i) the ratio that current gross revenues from the sales of software bear to the total of current and anticipated future gross revenues from the sales of that software, or (ii) the straight-line method over the estimated useful life of the product. As a result, the carrying amount of the capitalized software costs may be reduced materially in the near term.

We record impairment losses on capitalized software and other long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. While we believe that our estimates of future cash flows are reasonable, different assumptions regarding such cash flows could materially affect our estimates.

Description of Business

Overview

ION Networks, Inc and subsidiary ("ION" or the "Company") designs, develops, manufactures and sells security solutions that protect enterprise network administrative interfaces from improper, unauthorized or otherwise undesirable access from external and internal sources. Administrative interfaces are the network access points used by highly trained technical individuals who are charged with the responsibilities of maintaining and supporting the networks and devices employed within the networks such as servers, routers, PBXs and similar types of equipment. These technicians may be employees of the enterprise or employed by third parties such as managed service providers, consultants, device vendors or application developers. In all cases, they are considered “trusted insiders” since in order to perform their jobs; permission to enter and work within the network must be granted. The Company’s solution, comprised of centralized management and control software, administrative security appliances and soft tokens, are designed to provide secure, auditable access to all administrative interfaces and monitored security once working within the network. Service Providers, Enterprises and Governmental Agencies utilize the ION solution globally in their voice, data and converged environments, to establish and maintain security policies while providing the support and maintenance required of networks and their devices.

As network complexity continues to rise, particularly with the growing movement toward IP (internet protocol) based networks (converged environments,) security implications for both enterprises and their service providers are growing even more rapidly. The significant growth in outsourcing of network and device support and maintenance functions has required an increasing level of ‘trust’ between enterprise and service provider as well as heightened the level of competition between managed service providers. New compliance and privacy legislation and regulations are having an equally broad impact. Management and control requirements have escalated with the advent of Sarbanes-Oxley and the numerous privacy laws recently enacted such as Gramm-Leach-Bliley, HIPPA, California SB 1386, etc.

Service providers are struggling to maintain expertise throughout their geographic footprint. They are faced with an expanding deployment of enterprise security strategies and an inability to implement security solutions independently. On the other side, enterprises have become more cost conscious, working to extend the life of their legacy devices and aggregate network connections through the Internet. With all this movement, there is little consistency or standards regarding security and service delivery as the number of trusted insiders increases dramatically. The implications are enormous, particularly when understanding that the average cost of a network breach, reported by the 2003 CSI/FBI Security Survey, is $56,000 when it occurs from external sources (through the perimeter of the network) and in excess of $2.5 million when it is caused by an “insider.” There are many effective and popular ‘security solutions’ that address the perimeter, such as Firewalls, Intrusion Detection Systems, Virtual Private Networks and anti-virus software, providing protection from the typical hacker as well as end users. However, little attention has been paid to securing administrative interfaces where either maliciously or inadvertently, information and data can be easily compromised or destroyed. This is the arena in which ION focuses.

ION’s solution provides customers with secure access as well as forensic security within their owned and managed networks. It is a robust solution that is highly scalable, reliable, simple to use and cost effective. The solution also provides monitoring and alarming of the environment such as temperature and contact closures, forensics and buffering, and security logging of all activities down to the keystroke level. Due to the fact it is vendor agnostic, broad connectivity to virtually all network devices is guaranteed. The combination of ION's single sign-on centralized management and control software, PRIISMS, our administrative security appliances and our two factor authentication tokens, mitigates the impact of potential network breaches. These breaches would likely cause financial losses to the enterprise due to lost revenue and lost intellectual property; plummeting customer satisfaction, and corporate embarrassment with most consumers attuned to security issues and where reputations cannot be quickly rebuilt; extensive physical and environmental damage as well as data corruption; and the difficult and costly tasks of detection and recovery. ION's solutions are used in small, remote branch locations, medium to large local and global networks as well as data centers, ranging from a few to thousands of devices.

Though the Company's focus is providing hardware and software solutions, ION also offers support and maintenance programs. Services revenue is typically generated from systems engineering and maintenance services in conjunction with the sale of our solutions.

ION's solutions are distributed via three channels: (i) a direct sales force, (ii) indirect channels such as service providers and original equipment manufacturers (OEM) and (iii) resellers both domestically and internationally. In addition to these distribution channels, the Company segments its target markets by (i) enterprises, (ii) service providers and (iii) governmental agencies. Each market segment has unique characteristics and provides significant opportunities for future growth.

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ION Networks, Inc. is a Delaware corporation founded in 1999 through the combination of two companies, MicroFrame, Inc. (originally founded in 1982), a New Jersey corporation and SolCom Systems Limited (originally founded in 1994), a Scottish corporation located in Livingston, Scotland. The Scottish corporation was dissolved in 2003. In 1999, the Company expanded through the purchase of certain assets of LeeMAH DataCom Security Corporation. The Company currently has over 300 customers located in 35 countries and more than 50,000 appliances and devices currently in use. References in this document to "we," "our," "us," and "the Company" refer to ION Networks, Inc. Our principal executive offices are located at 120 Corporate Blvd. South Plainfield, New Jersey 07080, and our telephone number is (908) 546-3900.

Market Background

The Exposure

Accelerated growth of market factors such as increasing network complexity and expansion of network management outsourcing has resulted in a far greater need for security of network administrative interfaces. These interfaces are used for network and device management, maintenance and repair, as well as updates and changes. The administrative ‘sessions’ are active in all types of networks including voice networks, data networks and networks supporting critical infrastructure such as electronic distribution. To perform these functions effectively and efficiently, both local and remote access is required.

The “Inside” Threat is Real

Enterprises and service providers alike must consider the human element in performing network support and maintenance. In addition to the outsourcing of many IT functions, employee turnover at both the enterprise and service provider plays a key role in secure access and network security. Today, the ‘insider’ is everywhere, even outside. The technical environment poses additional challenges. Remote access is necessary to maintain any semblance of cost controls and access is quite simple. The risk of a security breach has never been higher. The ‘trusted’ community is large, knowledgeable and potentially motivated. Inconsistent, ineffective, and non-existent security practices exist in far too many places. An inadvertent breach is as costly as a malicious attack. According to The National Strategy to Secure Cyberspace (part of The President’s Critical Infrastructure Protection Board,) “approximately 70 percent of all cyber attacks on enterprise systems are believed to be perpetrated by trusted insiders.” The former Director of Security Strategies of The Hurwitz Group stated, “For every in-house attack reported, there could be as many as 50 that go either unreported or undetected.” Newspapers, magazines and government publications are littered with articles about security breaches such as the US Department of Justice press release on November 26, 2001 where, “former (network hardware vendor) accountants sentenced for unauthorized access to computer systems to illegally issue almost $8 Million in company stock to themselves” and the US Department of Justice press release on December 18, 2003, where a “Milford man pleads guilty to intrusion and theft of data costs company $5.8 Million.”

To Make Matters Worse . . .

Federal regulations are stringent and increasing while new legislation from States has already begun. Fines for mismanagement have been greatly increased. Penalties, formerly just at the corporate level are now targeted at individuals as well. Executives are now personally responsible and liable for fines, incarceration and professional sanctions. Fragile customer trust is fueling negative publicity while legal costs are rising. In an effort to combat these realities, organizations have learned that compliance is not simple. Regulations are sweeping, yet vague. Implications are felt across all departments and ignorance is no longer an accepted excuse. ION’s solutions help mitigate these risks.

The Market is Growing

IDC and Janney Montgomery Scott Research estimated the worldwide Network Security Market at over $25 Billion in 2004 with a compound annual growth rate of greater than 27%. The US Network Security Market was estimated at approximately $7 Billion in 2004 with 2006 estimates at about $10 Billion by Datamonitor. In addition, a 2003 survey by PricewaterhouseCoopers and CIO magazine showed a 62% increase in security spending with the top strategic initiatives being: blocking unauthorized access and enhancing network security. We believe enterprises, service providers and government agencies are recognizing, in constantly increasing numbers, the vulnerabilities associated with the lack of secure network access and internal network security and the markets for ION's solutions will continue to grow at higher rates than in the past.

The ION Networks Solution

At the core of enterprise networks is proprietary data and information. It is typically accessed by its end user population through the perimeter of the network to applications that massage and organize the data and information. In order to gain access, users have to go through firewalls, intrusion detection systems, anti-virus software and other tools. The overall enterprise contains many different networks such as a Data Network with routers and switches, a Voice Network with PBXs and voicemail, an IT Network with servers and network attached storage, and middleware such as databases and applications. In order to maintain and support the various enterprise networks and their devices, internal network support staff along with equipment vendors, managed service providers, IT consultants, etc., must have access. ION's integrated solution includes PRIISMS, which provides controlled centralized access and administrative management access; a family of administrative security appliances, which provide local security for remote access sessions and include encryption, strong authentication and environmental monitoring; and 3DES soft tokens with two factor authentication, which can be used from a Windows PC, Palm or Blackberry.

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The Value Equation

The value of ION's solution can be viewed through the eyes of the Company's Enterprise customers, Service Provider customers, and in many cases, both. A sample of elements that provide value to both include:

- Scalable across thousands of distributed locations and tens of thousands of protected endpoints. The modular hardware design and robust software allow the solution to be easily expanded.
- Reduces knowledge of inner workings of networks by masking routes to equipment preventing endpoints from being accessed independently.
- Provides audit and forensic data through the real-time monitoring of administrative sessions, instantly identifying incorrect network administration as well as a tool for fault diagnostics.
- Provides alarms for network and device outages, vulnerabilities and environmental events through polling to accelerate fault identification and resolution while allowing immediate response to an impending breach.
- Provides high availability with both in-band and out-of-band secure access

A few elements of the value equation that address enterprise concerns include:

- Regulatory compliance support by encrypting, recording and reporting all device management activities, controlling access to information and maintaining privacy.
- Reduces internal and external threats since access to information is approved or denied at a central point and monitoring of user activity and endpoints is accomplished in real-time.
- Provides a mechanism to implement and maintain enterprise-wide security policies
- Provides investment protection with full security and monitoring for legacy devices

A few of the value elements that address the many challenges facing service providers include:

- Increased margins through more efficient management and a central point of control
- Reduced costs since less headcount and fewer 'truck rolls' are required
- Enhanced ability to meet their customers' security policies and service level agreements
- Differentiated and expanded service offerings
- Reduced downstream liability due to increased audit controls
- Lower cost of ownership by providing multiple functions in a single solution along with ease of device management.

ION Networks Products and Services

ION Networks provides a complete network and information security solution that provides secure access to enterprise networks through administrative interfaces as well as secure access to devices within the network. The specific devices the technical users may access and work upon, as well as what actions may be performed on those devices, can be controlled from a central point using ION's PRIISMS software. Once authorization is granted and user authentication completed, the users' activities can be monitored and tracked, down to the keystroke level. Should the technical user attempt to perform an action without permission, an alarm can be broadcast, preventing a breach before it occurs. Additionally, the environment and devices may be monitored with specific alarms that are sent due to water, heat or other damaging factors, including disconnecting of lines or devices or doors left ajar. The ION security solution is based on centralized security policy management and distributed security policy enforcement. It consists of ION's Administrative Security Gateway, PRIISMS for centralized management and control, and ION's Administrative Security Appliances for distributed secure access and monitoring. ION also provides training, consulting and support services to our customers and partners.

ION PRIISMS - Administrative Security Gateway

Through its web-based user interface, PRIISMS provides connectivity to a vast array of managed endpoints from nearly every vendor covering a variety of platforms. This administrative security gateway enables authenticated administrators and technicians to configure, troubleshoot and manage geographically dispersed network devices from a central operations center within a secure environment. PRIISMS also provides centralized, 24x7 surveillance and provisioning across the entire suite of ION Administrative Security Appliances.

Key Capabilities include:

- n Single Sign-On Environment for Local and Remote Access.
  - s Multi-factor authentication via ION soft tokens or 3rd party vendor hard tokens
  - s Support for in-band and out-of-band connectivity
  - s Control of all device access information
  - s Masking of IP addresses and phone numbers
  - s Point and click access to all authorized devices
- n Secure Environment for all Administrative Access
  - s Instant VPN tunneling for automatic encrypted sessions
  - s HTTPS or SSH connections for all users
- n Centralized Administration for large Device Networks
  - s User management of access to each device
  - s Centralizes alarm notification, logging and consolidation
  - s Device polling
  - s Real-time, forensic monitoring and control of user sessions to the keystroke level
- n Scalable, Web-Based Architecture
  - s Easily manage large (5000+) device communities
  - s Easily handle great number of concurrent users

ION Administrative Security Appliances

ION appliances provide a connection point for secure, authorized access, and also act as a barrier to access by unauthorized systems and individuals. ION appliances integrate secure connectivity, monitoring, alarming and event logging of administrator level users into a single appliance, providing simplified and cost effective protection against unintentional or malicious security threats. ION's suite of appliances support 2, 4, 16 or 28 serial ports, 1 or 2 modems, up to 2 Ethernet ports, multifactor authentication, and environmental sensor inputs including up to 144 contact closures, 2 relay connectors, 2 temperature sensor inputs and 1 analog input. In addition, the majority of ION appliances include support for encrypted sessions and a firewall.

Key Capabilities include:

- n Connectivity
  - s Serial and Ethernet Connectivity
  - s Built-in VPN, Router, Firewall capability
- n Security
  - s Appliance logs
  - s Logging of All Sessions - Distribution over Dial-up, Ethernet or via PRIISMS
  - s PBX, VM, Router Monitoring (ASCII, PING)
  - s Control of external devices for Device Reboot (intelligent power controller)
- n Monitoring and Alarming
  - s Environment
    - n Hi Temperature, Low Temperature
    - n Water, Humidity
    - n Contact Closures - Monitor UPS, Doors, Motion
  - s Relays - Remotely Open Doors, Turn on Fan, Turn on Alarm or Flashing Light
  - s Access - Notification of Login Success, Failure
  - s Cables - Notification of Device Disconnect or Failure
  - s Multiple Delivery Methods, Locations (SNMP, SMTP, Pager, ASCII)

n Buffering / Forensics

s Session Buffering
s Host Port Buffering
s Core Dump

ION Soft Tokens

ION soft tokens are simple to use. Each user may be assigned a ‘disposable’ ION soft token via email or the web which can be loaded onto a Windows®, RIM® Blackberry™ or PalmOS® device. Each time the user requests connectivity to PRIISMS or an appliance, they are challenged to enter additional criteria generated by the token that will positively identify them. ION soft tokens utilize strong 3DES encryption and can be quickly activated and deactivated through PRIISMS.

Wide Range of Protected Infrastructure Devices

ION network and information security solutions protect a growing variety of infrastructure devices provided by leading IT and telecommunications network and system vendors, including vendors of:

- Access Servers
- Routers
- VoIP Platforms
- Call Management Systems
- Carrier Grade Multi-Service Switches
- Cellular Switches
- CSU/DSUs
- Databases
- Integrated Access Devices
- LAN Switches
- Mail Servers
- Messaging Servers
- Multi-Service Switches
- Optical Switches
- PBXs (Switched & IP)
- Power Protection Systems (UPS)
- Application Servers
- SONET Switches
- SS7 Switches
- DSLAMs
- Storage Area Networks
- Terminal Servers
- UNIX Servers
- Wireless Switches

Having narrowed our focus over the last year, the Company's goal is to concentrate on providing secure administrative access to enterprise networks while delivering a full security solution to our target markets. Our emphasis will be on the value provided to Service Providers, Enterprises and Government agencies rather than simply our technology. Key items of value include:

n Scalability across thousands of distributed locations and tens of thousands protected endpoints
  s Modular hardware design and robust centralized management and control software
  s Easily expandable solutions
n Reduction in the knowledge of the inner workings of networks
  s Routes to devices and information are masked
  s Endpoints cannot be independently accessed
n Provision of audit and forensic data and real-time monitoring of administrative sessions
  s Identifying incorrect network administration
  s Providing a tool for fault diagnosis
n Providing alarms to devices and environmental elements through polling
  s Mechanism for fault identification and resolution
  s Provide for immediate response to an impending breach
n Enabling compliance with current legislation
  s Providing control over access to information
  s Maintaining privacy
n Reduction of internal and external threats
  s Approval or denial, at a central point, of access to information
  s Monitoring user activities and endpoints in real-time
n Reduction of costly administrative activities
  s Providing a single sign-on, central point of administration
  s Eliminating time and costs associated with password changes
  s Significantly reducing the requirement for on-site support
n Continuing to be completely vendor agnostic

- Providing high availability through secure in-band and out-of-band access

Our goal is to become recognized by our target markets as an industry leader and the standard by which secure access and network security solutions are measured. Key elements of our strategy include:

Increase Percent of Value Delivered through Software. Continuing upon the direction of providing most of our new and enhanced value through our software technology, changing the hardware / software mix of the ION solution and enabling the Company to deliver greater value more rapidly.

Expand, Update Product Line, Develop New Products, and Reduce Manufacturing Costs. The Company is pursuing a strategy of leveraging the open source development community and intends to expand our current offerings at both the entry and top end of our product offerings. The Company also intends to better align its solutions with its target markets, recognizing the different value equations for each. By reducing manufacturing costs we will be able to maintain margins while addressing the price pressures of the market.

Establish the ION Networks Brand. We believe that strong brand recognition in our target markets is important to our long-term success. We intend to continue to strengthen our brand names through increased corporate marketing, a newly refreshed web site, direct mailings to customers in all our target markets and public relations. The positioning of our solutions and the value they provide will contribute both our direct and more importantly, our indirect sales efforts.

Expand Indirect Channels. Our strategy is to build and expand our base of indirect channel partners domestically and internationally through new marketing programs and by leveraging current relationships.

Expand Strategic Original Equipment Manufacturer Relationships. By entering into original equipment manufacturer ("OEM") arrangements to sell our products, we intend to leverage our sales capabilities and expand penetration of our target markets.

Customers

During the year ended December 31, 2004, 54 customers generated $3,616,261 in revenue from hardware, software, services, maintenance and repairs. Historically, our largest customers have been service providers primarily in the United States and in Europe. See also “Risk Factors - We rely on several key customers for a significant portion of our business, the loss of which would likely significantly decrease our revenues" on page 4. While ION has begun to penetrate the corporate market and, in particular, the financial services sector, the majority of revenues continue to come from our traditional customer base.

ION customers can be categorized based on three target markets: Enterprises, Service Providers and Governmental Agencies:

Enterprises. The Enterprise target market consists of non-governmental organizations that use their network infrastructure as a platform to provide their own goods or services. There are many sectors in the enterprise market, including, but not limited to, banking, financial services, insurance, energy, manufacturing, retailers, pharmaceuticals, healthcare, technology and transportation.

Service Providers. The service provider target market consists of businesses that use their network infrastructure to provide services to their customers and provide managed services to enterprises, supporting their networks and devices. It also includes resellers of solutions such as ION’s, who provide complementary services to their customer base.

Governmental Agencies. The Government target market consists of domestic and foreign governmental agencies that provide internal services to their constituencies. Particular emphasis is placed on agencies within the Department of Defense and the Department of Energy.

Sales and Marketing

Our marketing programs are intended to promote ION Networks and brand awareness to build our reputation as a supplier of highly scalable, robust, reliable, easy-to-use and cost-effective secure access and network security solutions. During the year ended December 31, 2004, the Company did not have the financial resources to adequately promote and strengthen our brand. ION attempted to repair damaged customer relationships by frequent, direct executive communications with customers. The relative effectiveness of this customer retention program has been demonstrated by improved operating results in 2004. We intend to expand and strengthen our customer and channel relationships through additional marketing programs and staff, as well as increased promotional activities as resources become available.

While we believe ION solutions are suited for both direct sale to customers and indirect channels where it is not economically efficient for us to sell directly to end user organizations, we are focusing on the opportunity to leverage the sales forces of our service provider customers and resellers.

Direct Sales. On December 31, 2004, the Company's sales and marketing headcount stood at 4. For the year ended December 31, 2004, approximately 15% of ION’s revenue came from direct sales.

Indirect Sales/Channel Partners. We also market and sell our solutions via indirect channels through Service providers and reseller partners in the United States and in Europe. Indirect sales accounted for approximately 47% of our total revenue for the year ended December 31, 2004. Our VAR partnerships are non-exclusive.

Original Equipment Manufacturers (OEMs). We enter into select original equipment manufacturer relationships in order to take advantage of well-established companies that sell into our target markets. We believe these relationships expand our overall market penetration. The terms of our agreements with these customers vary by contract, but have typically been for three year terms. For the year ended December 31, 2004, our original equipment manufacturer revenue accounted for approximately 38% of total revenue.

Geographic Distribution. We divide our sales organization regionally into three territories: (1) the United States and Canada, (2) Europe, the Middle East and Africa, and (3) other locations.

For the year ended December 31, 2004, approximately 80% of ION's sales were in the United States and Canada and 20% Europe, the Middle East, Africa and other locations. (Refer to Note 12 in the Company's Consolidated Financial Statements.)

Technical Services

We offer our customers a range of support services that includes technical support either by phone or electronically, product maintenance and repair, custom development and professional support services. Our technical services staff, including quality assurance, is located at our corporate headquarters in South Plainfield, New Jersey.

Competition

The market for secure network access and security solutions is worldwide, highly competitive, and growing rapidly. Competitors can be generally categorized as either: (i) vendors who provide high performance, security point products, or (ii) suppliers of network management appliances that provide limited security features. Many of these individual solutions require additional products in order to implement a comprehensive network access and security solution. Current and potential competitors in our markets include, but are not limited to the following companies, all of which sell worldwide or have a presence in most of the major markets for such products:

- Alarm and Buffer Box vendors such as: Data Track, Teltronics, OmniTronics;
- Network vendors such as: Cisco, Juniper;
- Terminal Server vendors such as: MRV, Cyclades, Digi;
- Secure Modem vendors such as: US Robotics, Multitech.

Many competitors have generally targeted large organizations' perimeter security needs with VPN, firewall and intrusion detection systems that range in price from under one thousand to hundreds of thousands of dollars. These offerings may increase competitive pressure on some of our solutions, resulting in both lower prices and gross margins. Many of our current or potential competitors have greater name recognition, larger customer bases and significantly greater financial, technical, marketing and other resources than ION. Nothing prevents or hinders these actual or potential competitors from entering our target markets at any time. In addition, our competitors may bundle products competitive to ours with other products that they may sell to our current or potential customers. These customers may accept these bundled products rather than separately purchasing our products. If these companies were to use their greater financial, technical and marketing resources in our target markets, it could adversely affect our business. See also “Risk Factors - We face significant competition and if we do not compete successfully, our results of operations may be adversely affected" on page 3.

Sources And Availability Of Materials

The Company designs its security appliances utilizing readily available parts manufactured by multiple suppliers and relies on and intends to continue to rely on these suppliers. Our principal suppliers are Arrow Electronics, Inc., PPI Time Zero, Ituner Networks Corp., AVNET, Inc. and ACE Electronics, Inc.. The Company has been and expects to continue to be able to obtain the parts required to manufacture its products without any significant interruption or sudden price increase, although there can be no assurance that it will be able to continue to do so.

The Company sometimes utilizes a component available from only one supplier. If a supplier were to cease to supply this component, the Company would most likely have to redesign a feature of the affected device. In these situations, the Company maintains a greater supply of the component on hand in order to allow the time necessary to effect a redesign or alternative course of action should the need arise.

Dependence On Particular Customers

Historically, the Company has been dependent on several large customers each year, but they are not necessarily the same every year. In general, the Company cannot predict with certainty, which large customers will continue to order our products. The loss of any of these large customers, or the failure to attract new large customers, could have a material adverse effect on the Company's business.

Intellectual Property, Licenses And Labor Contracts

The Company holds no patents on its technology. Although it licenses some of its technology from third parties, the Company does not consider any of these licenses to be critical to its operation.

The Company has made a consistent effort to minimize the ability of competitors to duplicate the software technology utilized in its solutions. However, the possibility of duplication of its products remains, and competing products have already been introduced.

Governmental Approvals And Effect Of Governmental Regulation

The Company's solutions may be exported to any country in the world except those countries restricted by the anti-terrorism controls imposed by the Department of Commerce. These anti-terrorism controls prohibit the Company from exporting some of its solutions to Cuba, Libya, Iran, Iraq, North Korea, Sudan and Syria without a license. As with all U.S. origin items, the Company's solutions are also subject to the Bureau of Export Administration's ten general prohibitions that restrict exports to certain countries, organizations, and persons.

As required by law or demanded by customer contract, the Company obtains approval of its solutions by Underwriters' Laboratories. Additionally, because many of the products interface with telecommunications networks, the Company's products are subject to several key Federal Communications Commission ("FCC") rules requiring FCC approval.

Part 68 of the FCC rules contains the majority of the technical requirements with which telephone systems must comply in order to qualify for FCC registration for interconnection to the public telephone network. Part 68 registration requires telecommunication equipment interfacing with the public telephone network to comply with certain interference parameters and other technical specifications. FCC Part 68 registration for ION's products has been granted, and the Company intends to apply for FCC Part 68 registration for all of its new and future products.

Part 15 of the FCC rules requires equipment classified as containing a Class A computing device to meet certain radio and television interference requirements, especially as they relate to operation of such equipment in a residential area. Certain of ION's products are subject to and comply with Part 15.

The European Community has developed a similar set of requirements for its members and the Company has begun the compliance process for its products in Europe. Additionally, ION has certified certain of its products to the NEBS (Network Equipment Business Specification) level of certification. This is a certification that was developed by Bellcore (now Telcordia Technologies) and is required by many of ION's telecommunications customers.

Research And Development Activities

As of December 31, 2004, the Company had 5 R&D staff members devoting part of their time to research and development activities. We believe the effort of these employees will be minimally sufficient to allow the Company to keep up with technology advances for the foreseeable future. However, the Company intends to increase staff during 2005, as resources become available, in order to more rapidly introduce new and enhanced products. In 2004, the Company incurred a charge of $598,012 for R&D activities.

The current R&D staff was primarily responsible for the successful completion and delivery of the most recent ISOS software releases and enhancing PRIISMS functionality. They also enhanced the code base to meet major customer requirements and significantly reduced the number of product issues affecting our customers. In addition, the quality assurance function was reestablished and has designed a new QA lab for product testing.

Employees

As of December 31, 2004, the Company had 23 employees, 21 full-time employees and 2 part-time employees. This headcount includes 9 technical and production, 7 sales, marketing and support, and 7 financial, administrative and executive capacities. None of the Company's employees are represented by labor unions. The Company considers it has generally satisfactory relations with its employees.

DESCRIPTION OF PROPERTY

The Company entered into a lease on August 1, 2003 for approximately 7,000 square feet for its principal executive offices at 120 Corporate Blvd., South Plainfield, New Jersey. The base rent is $4,505 per month effective October 2003 through July 2006. The Company is also obligated to make additional payments to the landlord relating to certain taxes and operating expenses.

The Company abandoned the lease space at 48834 Kato Road, Fremont, California in the Bedford Fremont Business Center. This lease commenced on June 1, 1999 and is for a term of 60 months with monthly rent payable by the Company to the landlord as follows: $7,360 per month for the first 12 months of the term; $7,590 per month for months 13-24; $7,820 per month for months 25-36; $8,050 per month for months 37-48; and $8,280 per month for months 49-60. The Company entered into an abandonment agreement with the landlord in March of 2003. As a result, the Company recorded a one-time charge to Restructuring of $123,510 in the quarter ended March 31, 2003. This amount represents the total lease payments from December 2002 to May 2004 offset by landlords stated sub-lease rental payments. The Company has not occupied the space since approximately March 2003. In 2004, Management revaluated the current status of the ongoing negotiations and reversed its prior reserve amount by approximately $63,716. Management believes that the final settlement amount should not exceed the reserved amount of $60,000 at December 31, 2004. However, the Company and Landlord have no settlement agreement in place at this time.

LEGAL PROCEEDINGS

While the Company is occasionally involved in various claims and legal actions in the ordinary course of business. The Company is not currently involved in any legal proceedings.

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

Directors and Executive Officers

The directors and executive officers of the Company are as follows:

Name	Age	Position Held with the Company
Norman E. Corn	58	Chief Executive Officer
Patrick E. Delaney	51	Chief Financial Officer
William Whitney	50	Chief Technology Officer and Vice President of Research and Development
Stephen M. Deixler	69	Chairman of the Board of Directors
Harry F. Immerman	61	Director
Frank S. Russo	62	Director

NORMAN E. CORN has served as Chief Executive Officer since August 15, 2003. Prior to joining ION, from 2000 until 2003, Mr. Corn was Executive Vice President of Liquent, Inc., a Pennsylvania-based software company that provides electronic publishing solutions, focused on the life sciences industry. Mr. Corn has also served from 1994 to 2000 as CEO of TCG Software, Inc., an offshore software services organization providing custom development to large corporate enterprises in the US. Mr. Corn has led other companies, including Axiom Systems Group, The Cobre Group, Inc., The Office Works, Inc. and Longview Results, Inc., having spent the early part of his career in sales, marketing and executive positions in AT&T and IBM.

PATRICK E. DELANEY has served as Chief Financial Officer since September 15, 2003. Prior to joining ION, from 2000 until 2003, Mr. Delaney was the President of Taracon, Inc. a privately owned independent consulting firm that provides management consulting for early and mid-stage technology and financial services companies. Mr. Delaney also served as Chief Financial Officer for two publicly traded telecommunications providers, Pointe Communications Corporation from 1993 to 2000 and Advanced Telecommunications Corporation from 1986 to 1993. Mr. Delaney has served other companies in executive capacities including RealCom Communications, Argo Communications and ACF Industries.

WILLIAM WHITNEY has served as Vice President of Research and Development since March 2002 and Chief Technology Officer since October 1, 2002. Prior to joining ION, from April 2000 to February 2002, Mr. Whitney served as the Vice President of Development and Chief Technology Officer for Outercurve Technologies, a provider of wireless application development and deployment solutions. Previously from, May 1998 to March 2002, Mr. Whitney served as President of CTO Systems.

STEPHEN M. DEIXLER has been Chairman of the Board of Directors since May 1982 and served as Chief Executive Officer of the Company from April 1996 to May 1997. He was President of the Company from May 1982 to June 1985 and served as Treasurer of the Company from its formation in 1982 until September 1993. During the period since March 2003 to September 2003, Mr. Deixler has served as the interim Chief Financial Officer of the Company. He also serves as Chairman of the Board of Trilogy Leasing Co., LLC and President of Resource Planning Inc. Mr. Deixler was the Chairman of Princeton Credit Corporation until April 1995 and Chief Financial Officer of Multipoint Communications, LLC until November 2002.

HARRY F. IMMERMAN joined the ION Network Board of Directors in October, 2004. Mr. Immerman retired from PricewaterhouseCoopers LLP (“PwC”) in July, 2003, having worked at the firm since July, 1966. He became a partner in the firm on October 1, 1973. During his career with PwC, he served in several management and client service positions. Mr. Immerman served as the Global Tax Leader for the Pharmaceutical Industry Sector from 1999 to 2003, the National Director of Industry Programs from 1996 to 1999 and as the Partner-in-Charge of the New York Metro Region and New York office tax department from 1983 to 1993. From 1983 to 1995, he also was a member of the Firm Council, the partner group responsible for management oversight and governance. Throughout his career with PwC, Mr., Immerman served as the client service tax partner on large multinational companies with a focus on pharmaceutical and telecommunication enterprises.

FRANK S. RUSSO has served as a director of the Company since November 2000. Mr. Russo was with AT&T Corporation from September 1980 to September 2000 and most recently served as its Corporate Strategy and Business Development Vice President. While at AT&T Solutions, Mr. Russo held a number of other positions including that of General Manager, Network Management Services from which he helped architect and launch AT&T's entry into the global network outsourcing and professional services business. Mr. Russo retired from AT&T in 2000. Prior to joining AT&T, Mr. Russo was employed by IBM Corporation in a variety of system engineering, sales and sales management positions. Mr. Russo served on the Board of Directors of Oak Industries, Inc., a manufacturer of highly engineered components, from January 1999 to February 2000, and currently serves on the Board of Directors of Advance-com, a private e-commerce company headquartered in Boston, Massachusetts.

EXECUTIVE COMPENSATION

The following table sets forth the compensation earned, whether paid or deferred, by the Company's Chief Executive Officer and its other two most highly compensated executive officers during the year ended December 31, 2004 (the "Named Executive Officers") for services rendered in all capacities to the Company.

	Annual Compensation	Long-Term Compensation