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CT HOLDINGS INC  
Form 10QSB  
August 19, 2002

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

FORM 10-QSB

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER: 0-18718

CT HOLDINGS, INC.  
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

DELAWARE  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

75-2432011  
(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

8750 CENTRAL EXPRESSWAY, SUITE 100, DALLAS, TX 75231  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(214) 520-9292  
(ISSUER'S TELEPHONE NUMBER)

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

Class	Outstanding at August 16, 2002
Common Stock, Par value \$.01 per share	57,545,928

Transitional Small Business Disclosure Format Yes  No

CT HOLDINGS, INC.  
FORM 10-QSB  
QUARTERLY PERIOD ENDED JUNE 30, 2002  
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### PART 1 - FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS

#### CT HOLDINGS, INC. BALANCE SHEETS

	June 30, 2002 (unaudited)	December 31, 2001
	-----	-----
ASSETS		
-----		
INVESTMENT IN UNCONSOLIDATED AFFILIATES	\$ 532,000	\$2,735,975
NET LONG-TERM ASSETS OF DISCONTINUED OPERATIONS	-	241,767
	-----	-----
	\$ 532,000	\$2,977,742
	=====	=====
LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY		
-----		
CURRENT LIABILITIES		

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Accounts payable and accrued expenses	\$ 1,278,767	\$ 911,333
Payable to Citadel	30,000	-
Advances and notes payable to related parties	534,395	540,330
Convertible note payable to shareholder	600,000	-
Accrual for legal settlement	766,000	-
Net current liabilities of discontinued operations	-	935,693
	-----	-----
Total current liabilities	3,209,162	2,387,356

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' (DEFICIT) EQUITY

Preferred stock, \$.01 par value per share; 1,000,000 shares authorized; no shares issued at June 30, 2002 and December 31, 2001		
Common stock, \$.01 par value per share; 60,000,000 shares authorized; 57,545,928 and 53,994,221 shares issued at June 30, 2002 and December 31, 2001	575,459	539,943
Additional paid-in capital	56,950,603	56,429,100
Accumulated deficit	(60,203,224)	(53,878,418)
Treasury stock, at cost (4,164,613 shares)	-	(2,500,239)
	-----	-----
Total stockholders' (deficit) equity	(2,677,162)	590,386
	-----	-----
	\$ 532,000	\$ 2,977,742
	=====	=====

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

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CT HOLDINGS, INC.  
UNAUDITED STATEMENTS OF OPERATIONS

	THREE MONTHS ENDED		SIX MONTHS END	
	JUNE 30,		JUNE 30,	
	2002	2001	2002	
	-----	-----	-----	-----
Revenue	\$ -	\$ -	\$ -	\$ -
General and administrative expense	321,858	190,404	775,928	
Common stock issued as compensation	1,347,000	-	1,347,000	
Reversal of legal settlement	-	(1,912,500)	-	(1,912,500)
Accrual for litigation	766,000	-	766,000	
Writedown in investment of affiliate	2,203,975	-	2,203,975	
Equity in loss of unconsolidated affiliate	-	2,099,211	-	2,099,211
Interest expense	35,650	3,372	73,582	
Interest income	-	(9,333)	-	
Other (income) expense	29,951	(6,014)	29,951	
	-----	-----	-----	-----
Loss from continuing operations	(4,704,434)	(365,140)	(5,196,436)	
Costs incurred in connection with spin off of subsidiary	(26,714)	-	(185,431)	
Loss from discontinued operations	(373,357)	(518,971)	(942,939)	(1,835,267)
	-----	-----	-----	-----

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Net loss	\$ (5,104,505)	\$ (884,111)	\$ (6,324,806)	\$ (1,
Net loss per share - basic and diluted				
Continuing operations	\$ (0.08)	\$ (0.01)	\$ (0.10)	\$
Discontinued operations	(0.01)	(0.01)	(0.02)	
	\$ (0.09)	\$ (0.02)	\$ (0.12)	\$
Weighted average shares outstanding				
- basic and diluted	55,087,970	49,708,962	52,569,358	49,

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

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CT HOLDINGS, INC.  
UNAUDITED STATEMENTS OF CASH FLOWS

	SIX MONTHS ENDED	
	JUNE 30,	
	2002	2001
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (6,324,806)	\$ (1,538,587)
Less net loss from discontinued operations	942,939	1,028,750
Adjustments to reconcile net loss to net cash used in operating activities:		
Provision for loss on accounts receivable from affiliate	-	40,000
Common stock issued as compensation	1,347,000	-
Beneficial conversion feature of convertible debt recognized as interest expense	51,300	-
Writedown of investment in affiliate	2,203,975	-
Adjustment for participation in debt financing guarantee of affiliate	-	2,099,211
Accrual for legal settlement	766,000	-
Reversal of accrual from legal settlement	-	(1,912,500)
Common stock and options issued in lieu of cash for services	4,148	-
Other non cash expense	29,951	-
Changes in operating assets and liabilities		
Accounts receivable	-	(21,250)
Accounts receivable from affiliate	-	(81,337)
Accounts payable and accrued expenses	530,559	299,772
Payable to affiliate	-	(126,028)
Payable to a related party	30,000	-
NET CASH USED IN OPERATING ACTIVITIES	(418,934)	(211,969)
CASH FLOWS FROM INVESTING ACTIVITIES		
Notes receivable with related parties	-	588,559
Participation in Parago, Inc. guarantee	-	(692,739)

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Notes receivable	-	206,750
	-----	-----
NET CASH PROVIDED BY INVESTING ACTIVITIES	-	102,570
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from convertible note payable to shareholder	600,000	-
Proceeds from advances and notes payable to related parties	526,500	-
Payments on advances and notes payable to related parties	(532,434)	-
Proceeds from sale of common stock	25,000	47,293
Proceeds from notes payable to related party	-	489,983
	-----	-----
NET CASH PROVIDED BY FINANCING ACTIVITIES	619,066	537,275
Net cash provided by continuing operations	200,132	427,876
Net cash used by discontinued operations	(200,132)	(427,876)
	-----	-----
Net change in cash	-	-
Cash and cash equivalents at the beginning of the period	-	-
	-----	-----
Cash and cash equivalents at the end of the period	\$ -	\$ -
	=====	=====
SUPPLEMENTAL CASH FLOW ITEMS		
Stock issued in settlement of accounts payable	\$ 163,125	\$ -

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

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CT HOLDINGS, INC.  
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2002  
(UNAUDITED)

NOTE A - NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

The accompanying unaudited interim consolidated financial statements reflect, in the opinion of management, all adjustments (consisting of normal, recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows of CT Holdings. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States ("GAAP") have been condensed or omitted pursuant to rules and regulations promulgated by the Securities and Exchange Commission (the "SEC" or the "Commission"). These statements should be read together with the audited financial statements and notes thereto for the years ended December 31, 2001 and the ten months ended December 31, 2000, included in CT Holdings' Form 10-KSB for the fiscal year ended December 31, 2001 on file with the Commission. The results of operations for the interim periods shown herein are not necessarily indicative of the results to be expected for any future interim period or for the entire year.

All material intercompany transactions with its consolidated subsidiary through

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the date of the distribution, discussed below, and unconsolidated affiliates have been eliminated pursuant to the applicable accounting principles for consolidation and the equity method of accounting. The balance sheet, results of operations and the cash flows of Citadel Security Software Inc., formerly a wholly owned subsidiary of the Company, are presented as discontinued operations through the date of the Distribution discussed under Citadel Security Software Distribution below. Where appropriate, prior year amounts have been reclassified to conform to the current period presentation.

### NATURE OF BUSINESS

CT Holdings, Inc. (the "Company" or "CT Holdings") provides management expertise including consulting on operations, marketing and strategic planning and a source of capital to early stage technology companies. The Company previously operated under the name Citadel Technology Inc. and was incorporated in Delaware in 1992. At June 30, 2002 the Company held investments in Parago Inc. ("Parago"), River Logic Inc. ("River Logic") and Encore Telecommunications, Inc. ("Encore"). In May 2002, the Company completed the spin-off distribution of Citadel Security Software Inc. ("Citadel"), which was a wholly owned subsidiary, to the shareholders of the Company. The business model is designed to enable the companies with whom the Company acquires or invests to become market leaders in their industries. The strategy over the years has led to the development, acquisition and operation of primarily technology based businesses with compelling valuations and strong business models. The anticipated growth in technology creates strong opportunities to increase shareholder value by investing in early stage ventures well-positioned in their market or holding unique technology. The goal is to realize the value of these investments for the Company's shareholders through a subsequent liquidity event such as a sale, merger, spin-off or initial public offering of the investee companies.

In January 2002, Citadel filed a registration statement and in March and April 2002 filed amendments to the registration statement with the SEC related to the spin off Citadel from CT Holdings as a separate public company in a pro rata dividend distribution of the common stock of Citadel to CT Holdings' shareholders. (See the Citadel Security Software Distribution below.) The distribution of the Citadel shares occurred on May 17, 2002 with 14,387,244 shares of Citadel common stock distributed to CT Holdings shareholders. While Citadel operates its security software business as a stand-alone company, the assets, liabilities, revenue and expense, previously consolidated with the financial statements of the Company are presented in these financial statements as discontinued operations through May 17, 2002, the date of the distribution.

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CT HOLDINGS, INC.  
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2002  
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Citadel develops, markets and licenses a line of desktop and network security software products that address security inside the firewall, a growing segment within the software industry. Citadel's security software products are generally licensed for perpetual use on standalone personal computers or on single or multiple networks, across single or multiple customer computing sites. Citadel's software products, Hercules, Secure PC and NetOFF, provide the flexibility and scalability that security administrators require for automating the remediation of security vulnerabilities and for managing security policies within their computing environments. These security software tools operate inside the firewall and are designed to secure computers and networks against unauthorized configuration changes, unapproved software installations, insecure

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and other causes of security vulnerabilities in computing systems.

Parago was formed in 1999 as an application service provider ("ASP") and Internet based business process outsourcer that provides an online suite of offerings designed to increase sales, reduce costs, retain customers and increase client profitability. These services include online promotional management, online rebate processing, proactive email, online surveys, and customer data warehousing, analysis and reporting. Parago's comprehensive integrated suite of outsourced customer care solutions are marketed across multiple industry lines.

During 2001 the Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional private equity financing by Parago begun in December 2001 and completed in February 2002 in which the Company chose not to participate. The Company's investment in Parago had been accounted for using the equity method through December 12, 2001, the date of the first closing of the financing. Subsequent to this financing, the Company's investment has been accounted for using the cost method.

In May 2000, CT Holdings acquired a minority interest in River Logic, Inc. a software developer of enterprise optimization technologies and decision support applications. River Logic creates strategic-level, process modeling tools and approaches for helping senior business managers theorize, evaluate, and understand the impact of strategic business decisions on the overall profitability of their organizations. Using a technology developed by River Logic known as COR Technology, a rapid-application development system, developers at River Logic create applications that enable industry professionals to model complex enterprises and explore financial relationships on a desktop computer or laptop. Embedded analytics allow end-users to understand the financial implications of critical business decisions easily by manipulating graphical icons that model their enterprise. The Company holds approximately 12% of River Logic and accounts for its investment in River Logic using the cost method.

The Company also holds a small minority investment in Encore Telecommunications Inc. following the restructure of a loan the Company made to an entity whose assets were acquired by Encore.

### CITADEL SECURITY SOFTWARE DISTRIBUTION

In November 2001, the board of directors of CT Holdings approved the spin-off of Citadel through the declaration of a pro rata dividend distribution to the holders of record of the outstanding shares of CT Holdings common stock (the "Distribution"). The Distribution consisted of one (1) share of Citadel common stock for every four (4) shares of CT Holdings (the "Distribution Ratio") held by CT Holdings shareholders as of May 6, 2002 (the "Record Date"). Following the Distribution on May 17, 2002 (the "Distribution Date"), Citadel became an independent company and CT Holdings retains no ownership interest in Citadel. The Distribution is intended to be a tax free distribution for U.S. federal tax purposes. On the Distribution Date, CT Holdings and Citadel entered into a series of agreements including a distribution agreement, a transition services agreement, an indemnity agreement and a tax disaffiliation agreement which provide for, among other things, the principal corporate transactions required to effect the Distribution, to provide for an orderly transition to the status of two independent companies and to define the continuing relationship between Citadel and CT Holdings after the Distribution. The net effect of the Distribution was the recording of the transfer of approximately \$1.4 million in net liabilities from CT Holdings to Citadel with a resulting increase in paid-in capital.

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CT HOLDINGS, INC.  
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
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## LIQUIDITY

The Company has incurred recurring operating losses and has a significant working capital deficiency at June 30, 2002 of \$3.2 million and a stockholders' deficit of \$2.7 million. Cash used in operations was approximately \$419,000 during the six months ended June 30, 2002. The Company had no cash balance at June 30, 2002. Immediate funding needs of the business are expected to be provided by financings through advances, short-term notes payable and additional investments from related parties.

The Company has been and continues to be dependent upon outside financing to perform its business development activities, make investments in new technology companies and to fund operations. During the six months ended June 30, 2002, related parties provided substantially all of this financing. The financings during the six months ended June 30, 2002 included proceeds of \$600,000 from the issuance of a convertible note to a shareholder described further in Note C and advances and proceeds of notes payable from the Company's CEO, directors and other related parties. Future cash may come from the realization of the value of our investments in Parago, River Logic and Encore, although there can be no assurance that any value will ever be realized from these investments.

The Company's strategy of continuing to support and expand its business development activities will not generate positive cash flow in the foreseeable future. The complete implementation of this element of our strategy requires the Company to obtain additional capital. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from the Company's investments in unconsolidated affiliates. The Company estimates it will need to raise \$1.5 million to \$3.8 million to settle liabilities and support its incubator and business development activities through the next twelve months. Historically, the Company has obtained short-term bridge funding from its Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available or if available with terms that the Company would be willing to accept.

The Company has made investments in entities that it believes may provide liquidity to the Company in the long term. The Company believes that its investment in Parago has been successful with Parago having had no revenue at the time of the Company's initial \$50,000 equity investment, growing revenue to approximately \$26 million during the year ended December 31, 2001. As expected in an early stage company, Parago has not been profitable and has experienced cash flow deficiencies as it implements its business plan. During 2001 the Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional equity financing raised by Parago in December 2001 in which the Company chose not to participate. The Company believes, however, that its investment of 20,000 common shares of Parago (following a 1-for-1000 reverse stock split) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of common stock) may ultimately provide an appropriate return.

Similarly, the Company believes its investment in River Logic has also been successful. Since the Company's initial investment, River Logic has made progress in executing its strategy through its development and introduction of new products and establishment of new customer relationships. In addition, during April, 2001 River Logic obtained a strategic investment from the Intel 64 Fund, Cardinal Investments, eMed Ventures, and Mercury Ventures. Similar to the



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investments in Parago, the Company recognized that this investment would be initially illiquid. However during the three months ended June 30, 2002 general economic conditions worsened, stock market valuations declined from the values at December 31, 2001 and raising capital at previous historical valuations became difficult. Management considered all the facts and circumstances of River Logic's business, marketplace and cost of new capital and based on an this consideration determined that the fair market value of the Company's investment in River Logic had declined to approximately \$500,000 and accordingly wrote down the investment by \$2,203,975. The investment in River Logic is accounted for using the cost method of accounting for investments in common stock therefore no proportionate share of equity in income or loss is recorded.

The Company's minority position in Encore is immaterial and is not expected to provide liquidity to the Company in the foreseeable future.

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CT HOLDINGS, INC.  
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2002  
(UNAUDITED)

While the Company is pleased with the performance of its investee companies to date, there can be no assurance that the Company will ever achieve liquidity for its investments. In addition there can be no assurance that management's plans will be successful or what other actions may become necessary. Until the Company is able to create liquidity from its investments through sale to a strategic investor, an initial public offering or some other liquidity transaction, the Company will continue to require working capital to fund its own operating expenses. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's business and operations and result in charges that could be material to the Company's business and results of operations.

### USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimates.

### EQUITY INVESTMENTS IN AFFILIATED COMPANIES

At June 30, 2002 the Company held investments in three affiliated companies, Parago, River Logic, and Encore. The Company used the cost method of accounting for these investments and presents its investments in affiliated companies on its balance sheets as Investment in Unconsolidated Affiliates.

Affiliates in which the Company's direct or indirect ownership is more than 50% of the outstanding securities or those where the Company has effective control are generally accounted for under the consolidation method of accounting. Under this method, an affiliate's accounts are consolidated within the Company's financial statements. Participation of other unrelated stockholders in the earnings or losses of a consolidated affiliate would be reflected as a minority interest in consolidated financial statements. Minority interest adjusts the Company's consolidated net results of operations to reflect only the Company's proportionate share of the earnings or losses of the consolidated affiliate company. All significant intercompany accounts and transactions are eliminated

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in consolidation. The Company had no affiliated companies qualified for the consolidation method of accounting at June 30, 2002.

Affiliated companies whose results are not consolidated, but over whom the Company exercises significant influence, are generally accounted for under the equity method of accounting. Whether or not the Company exercises significant influence with respect to an affiliated company depends on an evaluation of several factors including, among others, representation on the affiliated company's board of directors and percentage ownership level, which is generally a 20% to 50% interest in the securities of the affiliated company, including holdings in common, preferred and other convertible instruments in the affiliated company where the Company has voting rights.

Under the equity method of accounting, an affiliated company's accounts are not reflected within the Company's financial statements; however, the Company's proportionate share of the earnings or losses of the affiliated company is reflected in our statements of operations. All significant intercompany accounts and transactions are eliminated prior to such recognition. If the carrying value of the Company's net investment falls below zero, the Company discontinues the recognition of its proportionate share of net income or loss in its statement of operations until the carrying value of the net investment rises above zero. In the event the Company's ownership percentage exceeds 20%, and the Company's proportionate share of cumulative net income causes the carrying value of the Company's investment to rise above zero, the Company will resume applying the equity method or the consolidation method as applicable.

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CT HOLDINGS, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2002

(UNAUDITED)

Equity investments in affiliated companies not accounted for under either the consolidation or the equity method of accounting are accounted for under the cost method of accounting. This method is generally applied when the ownership percentage is below 20% of the affiliate's outstanding securities. Under this method, the carrying value of the investment is recorded at the lower of cost or fair market value and the Company's share of the earnings or losses of these companies is not included in the statements of operations.

### IMPAIRMENT OF LONG-LIVED ASSETS

In accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and exceeds its fair value. If conditions indicate an asset might be impaired, the Company estimates the future cash flows expected to result from the use of the asset and its eventual disposition. The impairment would be measured by the amount by which the asset exceeds its fair value typically represented by the future discounted cash flow associated with the asset.

### STOCK-BASED COMPENSATION

The Company has elected to account for stock-based compensation to employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25") and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the

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date of the grant over the amount an employee must pay to acquire the stock.

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance is complete or the date on which it is probable that performance will occur.

### NET LOSS PER COMMON SHARE

Basic loss per common share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Basic loss per share excludes any dilutive effects of options. Stock options and warrants to purchase shares of common stock have been excluded from the computation of diluted loss per share, as the effect would be anti-dilutive.

### NOTE B - DISCONTINUED OPERATIONS

On May 17, 2002 the Company completed the spin off distribution of Citadel Security Software Inc. and as a result the balance sheet and statement of operations for Citadel are presented as discontinued operations through May 17, 2002. The unaudited results of operations for the period January 1, 2002 through May 17, 2002 and the six months ended June 30, 2001 for Citadel are as follows:

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CT HOLDINGS, INC.  
 NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2002  
 (UNAUDITED)

	Period January 1, 2002 Through May 17, 2002	Six Months Ended June 30, 2001
	-----	-----
Revenue	\$ 130,519	\$ 181,418
Costs of revenue		
Shipping, supplies and other	3,045	2,457
Software amortization	17,511	363,738
	-----	-----
Total costs of revenue	20,556	366,195
Operating expenses		
Selling, general and administrative expense	949,541	788,346
Product development expense	83,303	-
Depreciation expense	20,058	55,627
	-----	-----
Total operating expenses	1,052,902	843,973

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Operating loss	(942,939)	(1,028,750)
Provision for income taxes	-	-
Net loss	\$ (942,939)	\$ (1,028,750)

At December 31, 2001 the net current liabilities and the net long-term assets of Citadel were as follows:

	December 31, 2001
CURRENT ASSETS	
Cash and cash equivalents	\$ 75,030
Accounts receivable, net	24,222
Prepaid expenses	72,702
Total current assets	171,954
Current liabilities	
Accounts payable and accrued expenses	862,262
Payroll tax obligations	245,385
Deferred revenue	-
Total current liabilities	1,107,647
Net current liabilities of discontinued operations	\$ 935,693
Property and equipment, net	
Capitalized software development costs, net	43,006
Other assets	174,110
Net long-term assets of discontinued operations	\$ 241,767

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CT HOLDINGS, INC.  
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
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NOTE C - RELATED PARTY TRANSACTIONS

During the six months ended June 30, 2002 the Company borrowed \$600,000 from a stockholder. The non interest bearing note matures on April 1, 2003 and is convertible into 2,700,000 shares of CT Holdings common stock plus 675,000 shares of Citadel common stock at a conversion price below the fair market value of the stock at the dates of issuance of the proceeds to the Company. Pursuant to EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" interest expense of \$51,300 representing the beneficial conversion feature associated with the principal outstanding at June 30, 2002 has been recorded during the six months

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ended June 30, 2002 with an offset to paid-in-capital.

During the six months ended June 30, 2002 an entity related to an employee of the Company advanced \$239,000 and the Company repaid \$190,000 of the advances. At June 30, 2002 the Company had an 8% note payable due June 30, 2002 for the remaining \$49,000 outstanding and is currently in default.

Pursuant to the terms of the transition services agreement with Citadel, the Company has agreed to pay Citadel a monthly fee of \$20,000 per month for the services of its CEO, CFO and accounting and information management staff, as well as office rent and indirect overhead expenses. The Company has recorded \$120,000 of expense related to this agreement. In addition the Company has a liability recorded for \$30,000 for amounts payable to Citadel at June 30, 2002.

The Company held a \$250,000, 8% note payable to a director that was due April 30, 2002 and is currently in default. In May 2002 the director exercised stock options for 2,250,000 shares of the Company's common stock with an aggregate exercise price of \$450,000 and entered into a note receivable secured by the shares and recorded stock compensation expense of \$450,000 to fully reserve this receivable. The shares of common stock issued pursuant to the exercise of the stock options are unregistered shares subject to the requirements of Rule 144. See additional disclosure in Note E.

At December 31, 2001 the Company had a liability recorded of approximately \$290,000 for cash advances received from its CEO. During the six months ended June 30, 2002 the Company received \$267,500 of additional advances from the CEO, repaid \$322,500 of the total advances and offset \$8,934 of the CEO's business expenses against the net amount due the CEO. The remaining amount due the CEO of approximately \$226,000 was converted into a 5% note payable due July 1, 2002 and is currently in default and accruing interest at 18%. In addition, stock options for 3,000,000 shares of the Company's common stock were exercised for an aggregate exercise price of \$600,000 in exchange for a note. The note receivable was reserved and \$600,000 was recorded as stock compensation expense. The shares of common stock received pursuant to the exercise of the stock options are unregistered shares subject to the requirements of Rule 144. See additional disclosure in Note E.

During the three and six months ended June 30, 2002 the Company incurred \$72,675 and \$126,669, respectively, of legal fees to an attorney who is a former employee and a relative of the Company's CEO. Part of these fees were settled through the issuance of 250,000 shares of common a stock with a fair value at the time of issuance of \$62,500 and the remainder is an outstanding liability at June 30, 2002. The shares of common stock issued to the attorney are unregistered shares subject to the requirements of Rule 144. During the six months ended June 30, 2001 approximately \$36,000 of legal fees were expensed and outstanding at June 30, 2001 to this attorney.

Another shareholder received 250,000 shares of the Company's common stock for consulting with the Company in the first quarter of 2002. These services were valued at \$62,500. In addition the Company incurred fees of \$36,250 related to services performed by a consultant in the first quarter of 2002 prior to becoming employed as the Company's Chief Financial Officer. Of this amount \$11,250 was settled through the issuance of 25,000 shares of common stock of the Company and the remainder of \$25,000 in cash of which \$15,000 remains outstanding at June 30, 2002. The shares of common stock issued to the shareholder and the CFO are unregistered shares subject to the requirements of Rule 144. See additional disclosure in Note E.

In connection with an acquisition by Parago in 1999 the Company agreed to exchange up to 500,000 shares of the Company's common stock for shares of Parago common stock at the option of the stockholders of the company acquired by Parago. In May 2002 the Company exchanged 139,806 shares of the Company's common

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stock for 1,240 shares of common stock of Parago as a result of this conversion feature. The fair market value of the stock issued in these transactions of \$34,952 was recorded as other expenses. All the shares of common stock issued in these transactions are unregistered shares subject to the requirements of Rule 144.

Pursuant to subscription agreements between Parago and some of its stockholders, the Company may be required at the option of such stockholders, to issue up to 414,000 shares of the Company's common stock. In May 2002 one such stockholder was issued 16,000 restricted shares of common stock of the Company.

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### NOTE D - COMMITMENTS AND CONTINGENCIES

In August 1998, Janssen-Meyers Associates L.P. (JMA) filed a lawsuit against the Company arising out of an alleged 1995 contract with the Company's predecessor (Old Citadel). The suit alleged that Old Citadel breached a letter of intent dated September 1995 and/or a Placement Agency Agreement dated November 1995 between JMA and Old Citadel. As its damages, JMA claimed that it was entitled to, among other things, the cash value of warrants to purchase 1.8 million shares of CT Holdings common stock at an exercise price of \$0.89 per share, valued during May 1996. According to JMA's valuation of those warrants, potential damages were alleged to exceed \$40 million. The Company vigorously disputes that it breached either the letter of intent or the Placement Agency Agreement or that it is liable to JMA. The lawsuit was styled Janssen-Meyers Associates, L.P. v. Citadel Technology, Inc., and was filed in the Supreme Court of the State of New York, County of New York. The Company removed the case to federal court in the Southern District of New York.

Following mediation in July 2000, the Company entered into a settlement term sheet, to attempt to resolve the disputes between it and JMA, pursuant to which the Company and JMA agreed in principle to settle the lawsuit for an aggregate of \$3 million, in a combination of \$1.5 million in cash and 300,000 shares of the Company's common stock with a guaranteed value of \$5 per share as of January, April and October 2001 (with respect to 100,000 of the shares for each period). The settlement was subject to execution of definitive settlement documents and approval of the boards of directors of both parties. As a result, the Company recorded approximately \$1,912,500 (\$1.5 million in cash and 300,000 shares of the Company's Common Stock at the market price of \$1.375 per share) as a nonrecurring charge related to the settlement of the litigation in the ten months ended December 31, 2000.

However, the Company and JMA were unable to negotiate the final definitive settlement agreement. The case was dismissed in August 2000 without any resolution of this issue. On March 27, 2001, JMA attempted to reopen this matter, but the Court hearing the JMA lawsuit issued a Summary Order denying JMA's motion to enforce the settlement term sheet and confirmed the prior dismissal of the lawsuit. The Court further ruled that JMA would either have to bring an action on the proposed settlement or move to re-open the dismissed case. The Court stated that it did not express any view with respect to the merits of the settlement that brought about the dismissal of the case. There was no activity on the case from March 2001 through August 2001. On August 27, 2001 JMA refiled its lawsuit with a federal court in New York, and the Company filed its motion to dismiss the case because the plaintiffs lacked the required

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diversity jurisdiction to pursue the claims in federal court. On October 31, 2001 the case was dismissed in federal court. In December 2001, the plaintiffs refiled the lawsuit in the state court seeking to enforce the proposed settlement term sheet. The case was filed in Supreme Court of New York, that state's trial court, in a case styled Roan Meyers v. CT Holdings. Given these events, including the dismissal of the lawsuit and the failure of the plaintiffs to refile a lawsuit for more than one year after the date of the dismissal, the Company, in the year ended December 31, 2001, reversed the nonrecurring charge that the Company had previously recorded related to the settlement of the lawsuit. There was no change to the status of this lawsuit during the six months ended June 30, 2002.

In June 2000, CT Holdings was served with a lawsuit filed in state court in Houston, Texas by Michael and Patricia Ferguson for breach of contract, tortious interference and negligence. Specifically, the Fergusons claim that they were damaged when they attempted to exercise warrants during a time when CT Holdings' related registration statement could not be used and asserted damages between \$300,000 and \$1,500,000. CT Holdings believes that the claims asserted by the Fergusons are without merit and will vigorously defend the claims. The trial in the case was heard in late April and early May 2002 and the Company received the court's decision in July 2002. The trial court awarded the Fergusons approximately \$766,000 in damages, interest and legal fees. CT Holdings intends to appeal the decision of the trial court. As a result of the judgment during the quarter ended June 30, 2002, the Company has recorded approximately \$766,000 as a nonrecurring charge related to the litigation pending appeal.

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In June 2000, Tech Data Corporation filed suit against CT Holdings, alleging a breach of a Software Distribution Agreement ("the Agreement") with CT Holdings. The lawsuit is styled Tech Data Corporation v. Citadel Technology, Inc. (now known as CT Holdings), and was filed in Dallas County Court at Law No. 2. Because CT Holdings was not properly served, Tech Data obtained a default judgment for \$101,049. When CT Holdings discovered the default judgment, it filed and won a motion to set aside this judgment. In June 2001, Tech Data properly served CT Holdings. CT Holdings answered and demanded binding arbitration pursuant to the agreement. The parties filed a Joint Motion to Arbitrate in December 2001. The judge granted this motion, and CT Holdings expects that this matter will be referred to binding arbitration in the fourth quarter of 2002. The Company has recorded a liability of \$101,049 at December 31, 2001 and 2000 related to this lawsuit. As part of the Distribution, Citadel assumed responsibility for this lawsuit, although there can be no assurance that we will be released from the lawsuit.

At this time, the Company is unable to predict the ultimate outcome of some of these suits, the costs associated with defending the claims and pursuing counterclaims, and monetary compensation awarded, if any. The Company has, when appropriate, recorded its current estimate of the amounts necessary to settle the litigation.

The Company is also involved in other litigation, however the Company does not believe the outcome of such litigation will be material to the Company's financial condition or results of operations.

The Company may become involved in litigation on various matters which are

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routine in conducting its business. The Company believes that none of these actions, individually or in the aggregate, will have a material adverse effect on its financial position or results of operations, though any adverse decision in these cases or the costs of defending or settling such claims could have a material adverse effect on the Company's operations.

### NOTE E - CERTAIN TRANSACTIONS

During the quarter ended June 30, 2002 the Company issued 1,397,500 shares of common stock to employees and directors of the Company pursuant to the exercise of stock options. The aggregate exercise price of these stock options was approximately \$297,000 all of which has been recorded as stock compensation expense. The shares of common stock issued pursuant to the exercise of the stock options are unregistered shares subject to the requirements of Rule 144.

In May 2002, prior to the record date of the Distribution, the Company entered into negotiations to settle approximately \$860,000 of operating liabilities in exchange for 1,662,500 shares of common stock of the Company. As of June 30, 2002 a gain of approximately \$9,000 on the extinguishment of approximately \$163,000 of these liabilities was recorded in other income on the statement of operations as a result of issuing 612,500 shares of common stock including 100,000 shares for services provided by an independent consultant, 25,000 shares to a consultant for services performed prior to employment as the Company's Chief Financial Officer, 250,000 shares to a shareholder for consulting services, and 250,000 shares to an attorney who is also related to the Company's CEO, for the performance of professional services to the Company. For the purposes of calculating the gain the fair value of the Company's common stock was determined as the closing price (\$.25) on May 1, 2002, the day before the Citadel ex-dividend date, the last day the Company's common stock was traded and quoted with the value of the distribution dividend included in the value of the Company's stock. At June 30, 2002 approximately \$697,000 of operating

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liabilities were under negotiation for settlement with shares of the Company's common stock including all dividends and distributions. Approximately 1,050,000 shares of common stock, plus 262,500 shares of common stock of Citadel Security Software, Inc. are reserved for issuance upon final settlement of these liabilities. The Company believes that the negotiations will ultimately be concluded with the issuance of the shares in full settlement of these liabilities however there can be no assurance that such settlement will be finalized or on terms favorable to the Company. If such shares are finally issued to settle the associated liabilities a gain of approximately \$400,000 will be recognized.

During the six months ended June 30, 2002 a shareholder advanced \$20,000 to the Company and entered into an 8% note due June 30, 2002. At June 30, 2002 the outstanding balance of this note was \$9,000 and is currently in default.

During May 2002 the Company sold 100,000 unregistered shares of common stock for \$25,000.

During the quarter ended June 30, 2002 approximately 4 million shares of the Company's common stock held in treasury were determined to be cancelled.



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

FORWARD-LOOKING STATEMENTS

The following discussion contains forward-looking statements that involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, among others things, those risk factors set forth in this section and elsewhere in this report. We identify forward-looking statements by words such as may, will, should, could, expects, plans, anticipates, believes, estimates, predicts, potential, or continue or similar terms that refer to the future. We cannot guarantee future results, levels of activity, performance or achievements.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

Investing in our common stock involves a high degree of risk. Any of the following risks could materially adversely affect our business, operating results and financial condition and could result in a complete loss of your investment.

In addition to the other information in this Report, the following factors should be considered carefully in evaluating the Company and its business. This disclosure is for the purpose of qualifying for the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. It contains factors that could cause results to differ materially from such forward-looking statements. These factors are in addition to any other cautionary statements, written or oral, which may be made or referred to in connection with any such forward-looking statement.

The following matters, among other things, may have a material adverse effect on the business, financial condition, liquidity, or results of operations the Company. Reference to these factors in the context of a forward-looking statement or statements shall be deemed to be a statement that any one or more of the following factors may cause actual results to differ materially from those in such forward-looking statement or statements.

Before you invest in our common stock, you should be aware of various risks, including those described below. Investing in our common stock involves a high degree of risk. You should carefully consider these risk factors, together with all of the other information included in this Report, before you decide whether to purchase shares of our common stock. Our business and results of operations could be seriously harmed by any of the following risks. The trading price of our common stock could decline due to any of these risks, and you may lose part or all of your investment.

GENERAL RISKS

OUR BUSINESS FOCUS IS THE DEVELOPMENT AND ACQUISITION OF EARLY STAGE COMPANIES; HENCE, WE WILL ENCOUNTER NUMEROUS RISKS ASSOCIATED WITH OUR BUSINESS FOCUS AND OUR PRIOR OPERATING HISTORY MAY NOT BE A MEANINGFUL GUIDE TO EVALUATING OUR FUTURE PERFORMANCE.

At June 30, 2002 the Company held investments in three companies, Parago, River Logic and Encore. Other than our formation and development of these companies,

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we have a brief history in executing our business strategy. As a consequence, our prior operating history may not provide a meaningful guide to our prospects in emerging markets. Moreover, our business model and prospects must be considered in light of the risk, expense and difficulties frequently encountered by companies in early stages of development, particularly companies in new and rapidly evolving markets. We may be unable to execute our strategy of developing our business due to numerous risks, including the following:

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- We may be unable to identify or develop relationships with attractive emerging companies.
- Any companies that we are able to attract may not succeed and the value of our assets and the price of our common stock could consequently decline.
- Our business model is unproven and depends on the willingness of companies to participate in our business development model and collaborate with each other and us.
- Our expenses will increase as we build the infrastructure necessary to implement this model.
- We face competition from incubators, some of which are publicly traded companies, venture capital companies and large corporations; many of these competitors have greater financial resources and brand name recognition than we do, which may make it difficult for us to effectively compete.
- We will require additional capital resources in order to implement our business model and we may not be able to obtain these resources on attractive terms, if at all.

WE HAVE INVESTED IN EARLY STAGE VENTURES; AND THERE CAN BE NO ASSURANCE THAT OUR INVESTMENTS WILL PROVE TO BE FINANCIALLY ATTRACTIVE.

We have developed and/or invested in Parago, River Logic and Encore (our "investees" or "investee companies"). Inasmuch as our investee companies are early stage ventures, it is difficult to judge their future prospects. Economic, governmental, industry and internal company factors outside of our control affect each of our investee companies. A significant portion of our assets is comprised of ownership interests in our investee companies. If our investee companies do not succeed, the value of our assets will decline.

FOLLOWING THE DISTRIBUTION CT HOLDINGS DOES NOT HAVE ACCESS TO THE CASH FLOW OR ASSETS OF CITADEL, AND MAY BE UNABLE TO OPERATE PROFITABLY.

Historically, since the businesses that comprise each of Citadel and CT Holdings have been under one ultimate parent, they have been able to rely, to some degree, on the earnings, assets and cash flow of each other for capital requirements. After the Distribution, CT Holdings is not able to rely on the security software business for such requirements. Following the Distribution, CT Holdings will continue to maintain its own credit and banking relationships and perform its own financial and investor relations functions. Because a significant number of key employees of CT Holdings will be employed by Citadel following the Distribution, there can be no assurance that CT Holdings will be able to successfully put in place the financial, administrative and managerial structure necessary to continue to operate as an independent public company, or that the development of such structure will not require a significant amount of management's time and other resources.

WE MAY INCUR SIGNIFICANT COSTS TO AVOID INVESTMENT COMPANY STATUS AND MAY SUFFER OTHER ADVERSE CONSEQUENCES IF WE ARE DEEMED TO BE AN INVESTMENT COMPANY.

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We may incur significant costs to avoid investment company status and may suffer other adverse consequences if we are deemed to be an investment company under the Investment Company Act of 1940. Some of our contemplated equity investments

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in other businesses may constitute investment securities under the 1940 Act. A company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of its total assets, subject to certain exclusions. Investment companies are subject to registration under, and compliance with, the 1940 Act unless a particular exclusion or Securities and Exchange Commission safe harbor applies. If we were to be deemed an investment company, we would become subject to the requirements of the 1940 Act. As a consequence, we would be prohibited from engaging in some businesses or issuing our securities and might be subject to civil and criminal penalties for noncompliance. In addition, certain of our contracts might be voided, and a court-appointed receiver could take control of us and liquidate our business. Following the Distribution of Citadel, we may be deemed to be an investment company unless we qualify for a safe harbor within the time permitted under the 1940 Act.

Although we have yet to make any investments in the investment securities of companies other than Parago, River Logic and Encore, such investments, if and when made, could fluctuate in value, which may cause the value of such securities to exceed 40% of our total assets. Unless an exclusion or safe harbor were available to us, we would have to attempt to reduce our investment securities as a percentage of our total assets. This reduction could be accomplished in a number of ways, including the disposition of investment securities and the acquisition of non-investment security assets. If we were required to sell investment securities, we may sell them sooner than we may otherwise have preferred. These sales may be at depressed prices and we might never realize anticipated benefits from, and may incur losses on, these investments. Some investments may not be sold due to contractual or legal restrictions or the inability to locate a suitable buyer. Moreover, we may incur tax liabilities when we sell assets. We may also be unable to purchase additional investment securities that may be important to our operating strategy. If we decide to acquire non-investment security assets, we may not be able to identify and acquire suitable assets and businesses.

WE HAVE A HISTORY OF NET LOSSES AND WILL NEED ADDITIONAL FINANCING TO CONTINUE AS A GOING CONCERN.

We have incurred recurring operating losses and have a significant working capital deficiency and a significant stockholders' deficit. Cash used in continuing operations was approximately \$419,000 during the six months ended June 30, 2002. We have no cash balance at June 30, 2002 and current liabilities exceed current assets by approximately \$2.7 million. We and our investee companies continue to be dependent upon external financing to perform our business development activities, invest in unconsolidated affiliates and provide for ongoing working capital requirements. During the six months ended June 30, 2002 and the year ended December 31, 2001, substantially all of this financing has been provided by related parties.

Our strategy of continuing to support and expand our business development activities requires us to obtain additional capital. The complete implementation of this element of our strategy will not generate positive cash flow in the foreseeable future. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from our investments in unconsolidated affiliates. We estimate we will need to raise additional funds of \$1 million to \$1.5 million to support the incubator and business development activities of the

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Company through the next twelve months and substantially greater amounts if we expect to continue to acquire investments or if amounts become due to settle contingent liabilities. Historically, we have obtained short-term bridge funding from our Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available, or if available on terms that we would be willing to accept.

We received a report from our independent auditors for its year ended December 31, 2001 containing an explanatory paragraph that describes the uncertainty regarding our ability to continue as a going concern due to historical negative cash flows and because, as of the date they rendered their opinion, we did not have access to sufficient committed capital to meet our projected operating needs for at least the next 12 months. Until we are able to create liquidity

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from our investments through a sale to a strategic investor, an initial public offering or some other liquidity transaction, we will continue to require working capital to fund our own operating expenses.

There can be no assurance that management's plans will be successful or what other actions may become necessary. Although we have been successful raising capital in the past, any inability to raise capital may require us to sell assets or reduce the level of our operations. In addition, we may suffer dilution of our equity ownership in our investee companies if they require additional financing and we elect not to participate in those additional financings. Such actions could have a material adverse effect on our business and operations and result in charges that could be material to our business and results of operations.

OUR STOCK IS TRADED IN THE OVER THE COUNTER MARKET.

Our common stock now trades on the OTC Bulletin Board maintained by the National Quotation Bureau, Inc. The OTC Bulletin Board is generally considered to be a less efficient market, and our stock price, as well as the liquidity of our common stock, may be adversely impacted as a result.

WE ARE INVOLVED IN LEGAL PROCEEDINGS THAT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS.

We are involved in legal proceedings as described in Item 3. Legal Proceedings and from time to time, we may be subject to other legal proceedings, including but not limited to claims that we have infringed the intellectual property rights of others, product liability claims, or other claims incidental to our business. While we intend to defend such lawsuits, adverse decisions or settlements, and the costs of defending such suits, could have a material adverse effect on our business. In addition, in July 2002, the court in a lawsuit filed by Michael and Patricia Ferguson awarded approximately \$766,000 in damages, legal fees and interest. While the Company will appeal this decision, there can be no assurance that the Company will be successful in its appeal. They could have a material adverse effect on the Company and its financial condition.

OUR EARNINGS AND STOCK PRICE ARE SUBJECT TO SIGNIFICANT FLUCTUATIONS.

Due to the factors noted in this Report, our earnings and stock price have been and may continue to be subject to significant volatility, particularly on a quarterly basis. We have previously experienced shortfalls in revenue and earnings from levels expected by investors, which have had an immediate and significant adverse effect on the trading price of our common stock. This may

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occur again in the future.

### RISKS RELATED TO THE DISTRIBUTION OF CITADEL SECURITY SOFTWARE

MEMBERS OF CITADEL'S BOARD OF DIRECTORS AND MANAGEMENT MAY HAVE CONFLICTS OF INTEREST AFTER THE DISTRIBUTION.

Members of the board of directors and management of Citadel will own shares of both Citadel and CT Holdings common stock after the Distribution because of their prior relationship and, in some cases, continuing relationships as directors or executive officers with CT Holdings. In addition, two of the five initial directors of Citadel will also be directors of CT Holdings, and the Chief Executive Officer and Chief Financial Officer of Citadel will also continue to serve as Chief Executive Officer and Chief Financial Officer of CT Holdings. These relationships could create, or appear to create, potential conflicts of interest when Citadel's directors and management are faced with decisions that could have different implications for Citadel and CT Holdings. Examples of these types of decisions might include the resolution of disputes arising out of the agreements governing the relationship between CT Holdings and Citadel following the Distribution. Also, the appearance of conflicts, even if such conflicts do not materialize, might adversely affect the public's perception of Citadel following the Distribution.

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WE MAY INCUR INCREASED EXPENSES IF THE TRANSITION SERVICES AGREEMENT WITH CITADEL IS TERMINATED.

In connection with the Distribution, Citadel entered into a transition services agreement with CT Holdings. This agreement provides that CT Holdings and Citadel will provide each other services for a fee in such areas as information management and technology, employee benefits administration, payroll, financial accounting and reporting, claims administration and reporting, and other areas where CT Holdings and Citadel may need transitional assistance and support following the Distribution. The agreement will generally extend for one year after the Distribution, but may be terminated earlier under certain circumstances, including a default. If the agreement is terminated, we may be required to obtain such services from a third party or increase our headcount to provide such services. This could be more expensive than the fees which we will be required to pay under the transition services agreement.

MANAGEMENT BELIEVES THAT THE DISTRIBUTION HAS CAUSED THE TRADING PRICE OF CT HOLDINGS COMMON STOCK TO DECLINE.

Following the Distribution, our common stock continued to be listed and traded on the Over The Counter Bulletin Board under the symbol CITN. There can be no assurance that a trading market will continue for the shares of CT Holdings common stock. Management believes that as a result of the Distribution, the trading price of CT Holdings common stock immediately following the ex-dividend date for the Distribution was substantially lower than the trading price of CT Holdings common stock immediately prior to Distribution. Following the Distribution, CT Holdings' operations will consist of the equity interests in its incubation holdings, Parago, River Logic and Encore, and CT Holdings' related business development operations, including potential future acquisitions. Further, the combined trading prices of CT Holdings common stock and the Citadel Shares after the Distribution may be less than the trading price of CT Holdings common stock immediately prior to the Distribution.

SUBSTANTIAL SALES OF CT HOLDINGS COMMON STOCK MAY HAVE AN ADVERSE IMPACT ON THE TRADING PRICE OF THE CT HOLDINGS COMMON STOCK.

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After the Distribution, some CT Holdings stockholders may decide that they do not want shares in a company consisting of the incubation ventures and related business development operations, and may sell their CT Holdings common stock following the Distribution. If CT Holdings stockholders sell large numbers of shares of CT Holdings common stock over a short period of time, or if investors anticipate large sales of CT Holdings common stock over a short period of time, this could adversely affect the trading price of the CT Holdings common stock.

THERE CAN BE NO ASSURANCE THAT AN ACTIVE TRADING MARKET FOR CT HOLDINGS COMMON STOCK WILL RETURN.

Even though CT Holdings is currently a publicly held company, there can be no assurance as to whether an active trading market for CT Holdings common stock will be maintained after the Distribution or as to the prices at which the CT Holdings common stock will trade. Some CT Holdings stockholders may decide that they do not want shares in a company consisting of the incubation ventures and related business development operations, and may sell their CT Holdings common stock following the Distribution. These and other factors may delay or hinder the return to an orderly trading market in the CT Holdings common stock following the Distribution. Whether an active trading market for CT Holdings common stock will be maintained after the Distribution and the prices for CT Holdings common stock will be determined in the marketplace and may be

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influenced by many factors, including the depth and liquidity of the market for the shares, CT Holdings' results of operations, what investors think of CT Holdings and the incubation ventures and business development industries, changes in economic conditions in its industries and general economic and market conditions. Market fluctuations could have a material adverse impact on the trading price of the CT Holdings common stock.

FAILURE TO QUALIFY AS A TAX-FREE TRANSACTION COULD RESULT IN SUBSTANTIAL LIABILITY.

CT Holdings and Citadel intend for the Distribution to be tax-free for U.S. federal income tax purposes. Neither CT Holdings nor Citadel has requested an advance ruling from the Internal Revenue Service, or any opinion of their tax advisors, as to the tax consequences of the Distribution. No assurance can be given that the Internal Revenue Service or the courts will agree that the Distribution is tax-free.

If the Distribution does not qualify for tax-free treatment, a substantial corporate tax would be payable by the consolidated group of which CT Holdings is the common parent measured by the difference between (1) the aggregate fair market value of the Citadel Shares on the Distribution Date and (2) CT Holdings' adjusted tax basis in the Citadel Shares on the Distribution Date. The corporate level tax would be payable by CT Holdings. However, Citadel has agreed under certain circumstances to indemnify CT Holdings for all or a portion of this tax liability. This indemnification obligation, if triggered, could have a material adverse effect on the results of operations and financial position of Citadel. In addition, under the applicable treasury regulations, each member of CT Holdings' consolidated group (including Citadel) is severally liable for such tax liability.

Furthermore, if the Distribution does not qualify as tax-free, each CT Holdings stockholder who receives Citadel Shares in the Distribution would be taxed as if he had received a cash dividend equal to the fair market value of his Citadel Shares on the Distribution Date.

Even if the Distribution qualifies as tax-free, CT Holdings could nevertheless

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incur a substantial corporate tax liability under Section 355(e) of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code or the Code), if CT Holdings or Citadel were to undergo a change in control (whether by acquisition, additional share issuance or otherwise) pursuant to a plan or series of related transactions which include the Distribution. Any transaction which occurs within the four-year period beginning two years prior to the Distribution is presumed to be part of a plan or series of related transactions which includes the Distribution unless CT Holdings establishes otherwise. Under certain circumstances, Citadel would be obligated to indemnify CT Holdings for all or a portion of this substantial corporate tax liability under the tax disaffiliation agreement. This indemnification obligation would have a material adverse effect on the results of operations and financial position of Citadel.

### RISKS RELATED TO OUR INVESTEEES

The following are some risks related to the business of Parago, River Logic and Encore, our investees, and should be considered in addition to the risk factors described in this Report. Any of these factors could have a material adverse effect on us.

THERE CAN BE NO ASSURANCE THAT OUR INVESTEEES WILL COMPLETE AN INITIAL PUBLIC OFFERING OR OTHER LIQUIDITY EVENT.

There can be no assurance that any of our investees will complete an initial public offering or other liquidity event. The failure to complete an offering or other liquidity event such as an acquisition by a third party could have a material adverse effect on our stock price. You cannot be assured that an initial public offering or other liquidity event will occur in the near future or ever at all. In addition, we have agreed to convert the shares of Parago

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common stock issued in connection with the acquisition of 2-Lane Media by Parago into up to 500,000 of our shares at the option of the 2-Lane Media shareholders. During the quarter ended June 30, 2002 shareholders owning 1,200 of these shares of Parago stock exercised their option to obtain 139,806 shares of CT common stock. Pursuant to the terms of the subscription agreements between Parago and some of its stockholders, we may be required to issue up to 414,000 shares of our common stock based on a conversion price of \$3.75 per share (above the fair market value on the dates of issuance) at the option of such stockholders. Shareholders owning 40 of these shares of Parago stock exercised their option to obtain 16,000 shares of CT common stock. These provisions could have the effect of diluting our stockholders if the market price for our stock is above that price at the time of conversion.

OUR INVESTEEES' BUSINESSES AND FUTURE PROSPECTS ARE EXTREMELY DIFFICULT TO EVALUATE BECAUSE THEIR OPERATING HISTORIES ARE VERY LIMITED AND THEIR BUSINESS MODELS ARE NEW, UNPROVEN AND EVOLVING.

Our investees were formed recently, therefore each investee has only a limited operating history on which one can base an investment decision. You should consider their prospects in light of the uncertainties and difficulties frequently encountered by companies in their early stages of development.

In addition, each investee's business model is new, unproven and evolving. We cannot assure that our investees' business models will be commercially successful, or that their solutions will be accepted by businesses or consumers. If our investees are unable to establish pricing and service models acceptable to manufacturers, retailers and service providers and attractive to their customers, their solutions may not be commercially successful.

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EACH INVESTEE HAS A HISTORY OF NET LOSSES AND EXPECTS TO CONTINUE TO INCUR SUBSTANTIAL NET LOSSES IN THE FUTURE.

Each investee had a unaudited net losses for the year ended December 31, 2001 and we anticipate that each investee will incur additional losses for the foreseeable future. If our investees' revenues do not grow as they anticipate, our investees may never be profitable.

TO CONTINUE THEIR OPERATIONS AND BUSINESSES, OUR INVESTEES MUST RAISE ADDITIONAL FINANCING.

Our investees' ability to maintain and grow their businesses is dependent on access to sufficient funds to support their working capital and capital expenditure needs. If our investees do not raise additional funds, their businesses and results of operations will be seriously harmed, and our assets and share price would be materially and adversely impacted. This additional financing may not be available to our investees on a timely basis if at all, or, if available, on terms acceptable to our investees. Moreover, additional financing may cause material and immediate dilution to existing stockholders of our investees, including us.

IN THE EVENT OF THE COMPLETION OF AN INITIAL PUBLIC OFFERING BY ANY OF OUR INVESTEES, THEIR STOCK PRICE IS LIKELY TO BE VERY VOLATILE.

Currently, the securities of our investees cannot be bought or sold publicly. There can be no assurance that any of our investees will be able to complete an initial public offering. Although it is anticipated that the initial public offering price (if an initial public offering is completed) would be determined based on several factors, the market price after the offering may vary significantly from the initial offering price. The market price of our

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investees' common stock is likely to be highly volatile and could be subject to wide fluctuations in response to factors that are beyond its control. A decline in their stock price will adversely affect our stock price.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations, could adversely affect the market price of Parago's common stock, if it becomes publicly traded.

Sales of a substantial number of shares of our investees' common stock in the public market after its initial public offering could depress the market price of their common stock and could impair their ability to raise capital through the sale of additional equity securities.

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

You should read the following discussion in conjunction with our audited financial statements for the year ended December 31, 2001 and the ten month period ended December 31, 2000 and the related notes in the Company's Form 10-KSB. Our fiscal year ends on December 31, and each of our quarters end on the final day of a calendar quarter (each March 31, June 30 and September 30).



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The following discussion contains forward-looking statements. Please see Forward-Looking Statements for a discussion of uncertainties, risks and assumptions associated with these statements.

### OVERVIEW

CT Holdings, Inc. provides management expertise and capital to early stage companies. At June 30, 2002 the Company held investments in Parago, River Logic and Encore. The Company was incorporated in Delaware in 1992 and previously operated under the name Citadel Technology Inc. Our business model is designed to enable the companies in whom we invest or acquire to become market leaders in their industries. Our strategy over the years has led to the development, acquisition and operation of primarily technology based businesses with compelling valuations and strong business models. We believe that the anticipated growth in technology creates strong opportunities for us to increase shareholder value by investing in well-positioned early stage ventures. Our goal is to realize the value of our investments for our shareholders through a subsequent liquidity event such as a spin-off, sale, merger or initial public offering of the investee companies.

In November 2001 the Company announced a plan to spin-off of its Citadel subsidiary as a special dividend to shareholders of CT Holdings. (See "The Citadel Security Software Distribution and Discontinued Operations" below). The distribution of the Citadel shares closed on May 17, 2002, the Distribution Date. While Citadel continues to operate its security software business, generally accepted accounting principles requires that the financial statements of Citadel, previously consolidated with the financial statements of the Company, be presented in these financial statements as discontinued operations through the Distribution Date and accordingly are included in the statements of operation for the three and six months ended June 30, 2002 and 2001 respectively.

### THE CITADEL SECURITY SOFTWARE DISTRIBUTION AND DISCONTINUED OPERATIONS

In November 2001, the board of directors of CT Holdings approved the spin-off of Citadel through the declaration of a pro rata dividend distribution to the holders of record of the outstanding shares of CT Holdings common stock (the "Distribution"). The Distribution consists of one (1) share of Citadel common stock for every four (4) shares of CT Holdings (the Distribution Ratio) held by CT Holdings shareholders as of May 6, 2002 (the "Record Date"). Following the Distribution on May 17, 2002 (the "Distribution Date"), Citadel became an independent company and CT Holdings has no continuing ownership interest in Citadel. The Distribution is intended to be a tax free distribution for U.S. federal tax purposes although neither we nor Citadel have requested or obtained any opinions as to the tax treatment of the Distribution. On the Distribution Date, CT Holdings and Citadel entered into a series of agreements including a distribution agreement, a transition services agreement and a tax disaffiliation agreement which provide for, among other things, the principal corporate transactions required to effect the Distribution, to provide for an orderly transition to the status of two independent companies and to define the continuing relationship between Citadel and CT Holdings after the Distribution.

After the Distribution, two of five directors of CT Holdings are directors of Citadel and the Chief Executive Officer and the Chief Financial Officer of CT Holdings hold the same positions with Citadel. It is expected that 20% to 33% of the officers' time will be allocated to CT Holdings. All other employees of CT Holdings became employees of Citadel following the Distribution. Under the

transition services agreement Citadel will provide accounting, administrative,

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information management and other services, including the services of the two officers, to CT Holdings in return for a payment of a monthly administrative fee initially estimated at \$20,000 per month. The fee may be adjusted quarterly subject to a reallocation of the estimated time devoted to each company.

As a result of the Distribution, the financial statements and the results of operations of Citadel are presented as discontinued operations in CT Holdings' financial statements. Summary financial information with respect to Citadel is provided below:

	Period January 1, 2002 Through May 17, 2002 -----	Six Months Ended June 30, 2001 -----
Revenue	\$ 130,519	\$ 181,418
Net loss	\$ (942,939) =====	\$ (1,028,750) =====

At December 31, 2001 the net current liabilities and the net long-term assets of Citadel were as follows:

	December 31, 2001 -----
BALANCE SHEET DATA:	
Current assets	\$ 171,954
Current liabilities	1,107,647
Property and equipment	43,006
Capitalized software development costs	174,110
Stockholder's (deficit)	(693,926)

### OVERVIEW OF PARAGO

We began our business development activities in January 1999 with the formation of Parago, Inc., an application service provider (ASP) and Internet based business process outsourcer (BPO) that provides a suite of technology offerings (including PromoCenter, ValueRewards and KnowledgeCenter) designed to increase sales, reduce costs, and retain customers for retailers, manufacturers and service organizations. Parago's continuous customer interaction services include online promotional management (including online rebate processing), proactive email, online surveys, and customer data analysis and reporting. Through December 2001, Parago had received approximately \$96.3 million in private equity financing from venture capital investors including TH Lee Putnam Ventures, Dain Rauscher Wessels Investors, Watershed Capital and Seaboard Ventures, as well as angel investors. CT Holdings continues to hold 20,000 shares of Parago common stock and warrants to purchase 28.8749 shares of Parago's Series A-3 Preferred Stock (convertible into 2,887 shares of Parago's common stock).

Parago provides Internet-based solutions that automate customer relationship management. Parago's solutions enable both brick-and-mortar and e-commerce businesses to more efficiently develop, retain and extend customer relationships and improve sales, marketing and customer retention. Parago's Internet-enabled enterprise solutions include PromoCenter, ValueRewards and KnowledgeCenter. By automating customer care activities such as online and traditional rebate

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processing and promotions, Parago allows its clients to enhance customer retention, increase revenue opportunities and improve operating efficiencies. Parago's Internet-based solutions seek to transform promotional management and product information from customer service liabilities to retention and extension opportunities.

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Parago's online solutions provide a vehicle for its clients to conduct targeted marketing to customers with whom they have traditionally lost contact subsequent to the point of purchase. Parago is developing proprietary software that will provide an online mechanism for customers, many of whom have immediate purchasing power in the form of promotional proceeds, to apply those proceeds towards the purchase of additional products or services. Parago's solutions also capture valuable customer information that can help its clients better understand customer behavior. Parago plans to provide fee-based customer specific or aggregated data analyses to assist clients in designing future promotions. Parago's solutions also enable businesses to improve operating efficiencies by allowing them to analyze the results of their promotions and manage these promotions on a real time basis. Parago markets its solutions to retailers, manufacturers and service providers across multiple industries.

In connection with an acquisition by Parago in March 1999, we agreed to convert the Parago shares of common stock issued in connection with the merger into up to 500,000 of our shares at the option of the shareholders of the Company acquired by Parago. In May 2002 the Company exchanged 139,806 shares of the Company's common stock for 1,200 shares of Parago common stock with some of these shareholders. In addition, pursuant to the terms of the subscription agreements between Parago and some of its stockholders, we may be required to issue up to 414,000 shares of our common stock to such stockholders based upon a conversion price of \$3.75 per share. In May 2002, the Company exchanged 16,000 shares of the Company's common stock for 40 shares of Parago common stock with one of these shareholders. These provisions could have the effect of diluting our stockholders.

After a 1 for 1000 reverse stock split by Parago in connection with its Series E preferred stock offering in December 2001 to February 2002, in which the Company elected not to participate, the Company holds 20,000 shares of common stock of Parago and warrants to purchase 28.8749 shares of Parago's Series A-3 Preferred Stock (convertible into 2,887 shares of Parago's common stock) at March 31, 2002. In December 2001 Parago completed the first closing (\$13.6 million) of an equity financing of approximately \$15.0 million. Approximately \$1.4 million of equity financing was closed in February 2002. As a result of the equity financing our ownership percentage in Parago was reduced to approximately 1%. Our investment in Parago for the period from January 1, 2001 through December 12, 2001 and the ten months ended December 31, 2001 was accounted for under the equity method of accounting for investments and accordingly as a result of our ownership falling below 20%, has been accounted for using the cost method of accounting since December 13, 2001. Under the cost method of accounting, the Company's share of the income or loss from Parago is not included in operations. Under the equity method of accounting, the Company's share of the investee's income or losses is included in the statements of operations. If the carrying value of the Company's net investment falls below zero, the Company discontinues applying the equity method until the carrying value of the net investment rises above zero. In addition, in the event the Company's ownership percentage exceeds 20% and the value of the Company's equity investment rises above zero, the Company will resume applying the equity method and will recognize an investment in Parago after the Company's share of net losses not recognized is recovered through our proportionate share of net income if Parago turns profitable. While Parago continues to incur operational losses we believe that our \$50,000 investment in Parago represented by 20,000 shares of Parago's common stock (plus

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1,240 shares to be received from the exchanges in May 2002) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of Parago common stock) may ultimately provide an appropriate return.

### OVERVIEW OF RIVER LOGIC

In May 2000, we made an investment in River Logic by acquiring shares of common stock of River Logic from several of its existing shareholders in exchange for 333,333 shares of our common stock. We also acquired shares of Series A Convertible Preferred Stock ("Series A") from River Logic in exchange for the contribution of assets acquired from a third party by the Company through exchange of 666,667 shares of our common stock. In connection with the

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investment in River Logic, we also made two bridge loans totaling \$600,000 to River Logic that were convertible into shares of capital stock of River Logic. Each of the bridge loans (i) bears interest at a rate of 12% per annum through its first anniversary and at one percent above the prime rate per annum thereafter, (ii) is secured by certain assets of River Logic, (iii) is payable upon the Company's demand and (iv) is repayable by River Logic commencing on its third anniversary date. In addition, we also incurred cash expenses for professional fees related to these transactions and we issued 50,000 shares of our common stock to a consultant for identifying this investment. After the closing of the transaction the consultant became the Chief Operating Officer of River Logic and we granted him 100,000 fully vested options to purchase our common stock at \$5 per share (which was above the fair market value at the date of issuance).

In April 2001, River Logic received a strategic investment from the Intel 64 Fund, Cardinal Investment, Inc, eMed Ventures and Mercury Ventures, and the Company converted \$450,000 of the principal amount of the notes into shares of the Series C Preferred Stock, and River Logic repaid the \$216,000 balance of these notes plus interest in April 2001. Since the Company's initial investment, River Logic has made progress in executing its strategy through its development and introduction of new products and establishment of new customer relationships. Similar to the investments in Parago, the Company recognized that this investment would be initially illiquid. However during the three months ended June 30, 2002 general economic conditions worsened, stock market valuations declined from the values at December 31, 2001 and raising capital at previous historical valuations became difficult. We considered all the facts and circumstances of River Logic's business, marketplace and cost of new capital and based on an this consideration we determined that the fair market value of the Company's investment in River Logic had declined to approximately \$500,000 and accordingly wrote down the investment by \$2,203,975. Our investment in River Logic is accounted for using the cost method of accounting for investments in common stock therefore no proportionate share of equity in income or loss is recorded.

### CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on going basis, we evaluate our estimates, including those related to our investments in our investee companies and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which

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form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies are most important to the presentation of our financial statements and require the most difficult, subjective and complex judgments.

### IMPAIRMENT CHARGES

We periodically evaluate the carrying value of our ownership interests in our investee companies for possible impairment based on achievement of business plan objectives and milestones, the value of each ownership interest in the investee company relative to carrying value, the financial condition and prospects of the investee company, and other relevant factors. The business plan objectives and milestones we consider include, among others, those related to financial performance such as achievement of planned financial results or completion of capital raising activities, and those that are not primarily financial in nature such as obtaining key business relationships or the hiring of key employees.

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If an indication of impairment exists with respect to the carrying value of an investee company, we perform an evaluation by comparing the estimated fair value of the asset with its carrying value. Fair value is determined by estimating the cash flows related to the asset, including estimated proceeds on disposition, if any. If the fair value is less than the carrying value a loss is recorded.

### COMMITMENTS AND CONTINGENCIES

From time to time, we are a defendant or plaintiff in various legal actions, which arise in the normal course of business. We are also a guarantor of various third-party obligations and commitments. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required for these contingencies, if any, which would be charged to earnings, is made after careful analysis of each individual issue. The required reserves may change in the future due to new developments in each matter or changes in circumstances, such as a change in settlement strategy. Changes in required reserves could increase or decrease our earnings in the period the changes are made.

### EFFECT OF VARIOUS ACCOUNTING METHODS FOR EQUITY INVESTMENTS

The various interests that we acquire in our investee companies are accounted for under three broad methods: consolidation, equity method and cost method. The applicable accounting method is generally determined based on our percentage ownership in an investee company.

**CONSOLIDATION METHOD:** Investee companies in which we directly or indirectly own more than 50% of the outstanding securities or those where we have effective control are generally accounted for under the consolidation method of accounting. Under this method, an investee company's accounts are consolidated within our financial statements. Participation of other unrelated stockholders in the earnings or losses of a consolidated investee company would be reflected as a minority interest in consolidated financial statements. Minority interest adjusts our consolidated net results of operations to reflect only our share of the earnings or losses of the consolidated investee company. At December 31, 2001 and June 30, 2002 we had no investee company qualified for this accounting method.

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**EQUITY METHOD:** Investee companies whose results we do not consolidate, but over whom we exercise significant influence, are generally accounted for under the equity method of accounting. Whether or not we exercise significant influence with respect to an investee company depends on an evaluation of several factors including, among others, representation on the investee company's board of directors and percentage ownership level, which is generally a 20% to 50% interest in the securities of the investee company, including our holdings in common, preferred and other convertible instruments in the investee company where we may have voting rights. Under the equity method of accounting, an investee company's accounts are not reflected within our financial statements; however, our share of the earnings or losses of the investee company is reflected in our statements of operations.

**COST METHOD:** Investee companies not accounted for under either the consolidation or the equity method of accounting are accounted for under the cost method of accounting. Under this method, our share of the earnings or losses of these companies is not included in our statements of operations.

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### RESULTS OF OPERATIONS

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

CT Holdings' continuing operations consists of costs and expenses for providing services to our investee companies and the activities to identify additional technologies and companies in which CT Holdings might invest. Due to the spin-out distribution of Citadel on May 17, 2002 the results of operations and the balance sheet of Citadel are presented as discontinued operations in all periods presented prior to the distribution date. Citadel's loss from operations through May 17, 2002 are included as loss from discontinued operation for the three and six months ended June 30, 2002.

Our investment in Parago prior to June 30, 2001 was accounted for using the equity method of accounting. In 2000 our investment in Parago was reduced to zero as a result of our share of cumulative losses since our initial investment was made in Parago. An additional investment in Parago in December 2001 by unrelated third parties has caused our ownership percentage to fall below the 20% ownership threshold required to account for the investment under the equity method and accordingly we record our investment in Parago using the cost method. Our investments in River Logic and Encore are recorded using the cost method.

Loss from continuing operations for the three and six months ended June 30, 2002 includes legal and administrative costs and the costs of shared personnel and office costs allocated from Citadel under the transition services agreement entered into as a part of the Distribution. Loss from continuing operations for the three and six months ended June 30, 2001 consists of the costs and expenses of maintaining an office and legal and administrative expenses. For the periods prior to the distribution date costs and expenses related to the Citadel security software business have been allocated to Citadel based on an estimate of the proportion of amounts allocable to Citadel utilizing such factors as revenues, number of employees, and other relevant factors.

### GENERAL AND ADMINISTRATIVE EXPENSES

We had general and administrative expenses for the three months ended June 30, 2002 and 2001 of \$321,858 and \$190,404, respectively, an increase of \$131,454 or 69%. For the six months ended June 30, 2002 and 2001 we incurred general and administrative expenses of \$775,928 and 351,844, respectively an increase of

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\$424,084, or 121%. The increases in both the three and six month periods are primarily a result of legal fees associated with ongoing legal matters and defense costs related to the various legal claims and consulting fees associated with business development and incubator activities.

### COMMON STOCK ISSUED AS COMPENSATION

During the quarter ended June 30, 2002 the Company issued 6,647,500 shares of common stock to employees and directors of the Company pursuant to the exercise of stock options. The aggregate exercise price of these stock options was approximately \$1,347,000. Notes receivable for \$1,312,500 were received for the exercise price and subsequently fully reserved and expensed as stock compensation expense. An additional \$34,500 was recorded as a stock bonus expense. The shares of common stock issued pursuant to the exercise of the stock options are unregistered shares subject to the requirements of Rule 144.

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### ACCRUAL FOR LITIGATION

In June 2000, CT Holdings was served with a lawsuit filed in state court in Houston, Texas by Michael and Patricia Ferguson for breach of contract, tortious interference and negligence. Specifically, the Fergusons claimed that they were damaged when they attempted to exercise warrants during a time when CT Holdings' related registration statement could not be used. CT Holdings continues to believe that the claims asserted by the Fergusons are without merit and will vigorously defend the claims. The trial in this case was held from April 22, 2002 until May 1, 2002, and the Company received the judgment from the trial court in July 2002. The trial court awarded the Fergusons approximately \$766,000 in damages, interest and legal fees. CT Holdings intends to appeal the decision of the trial court. As a result of the judgment, the Company has recorded approximately \$766,000 as a nonrecurring charge related to the litigation pending appeal.

### REVERSAL OF LEGAL SETTLEMENT

In August 1998, Janssen-Meyers Associates L.P. (JMA) filed a lawsuit against the Company arising out of an alleged 1995 contract with the Company's predecessor. The suit alleged that this predecessor breached a letter of intent dated September 1995 and/or a Placement Agency Agreement dated November 1995 between JMA and the predecessor. As its damages, JMA claimed that it was entitled to, among other things, the cash value of warrants to purchase of 1.8 million shares of CT Holdings common stock at an exercise price of \$0.89 per share valued during May 1996. According to JMA's valuation of those warrants, potential damages were alleged to exceed \$40 million. The Company vigorously disputes that it breached either the letter of intent or the Placement Agency Agreement or that it is liable to JMA. The lawsuit was styled Janssen-Meyers Associates, L.P. v. Citadel Technology, Inc., and was filed in the Supreme Court of the State of New York, County of New York. We removed the case to federal court in the Southern District of New York.

Following mediation in July 2000, the Company entered into a settlement term sheet, to attempt to resolve the disputes between it and JMA, pursuant to which the Company and JMA agreed in principle to settle the lawsuit for an aggregate of \$3 million, in a combination of \$1.5 million in cash and 300,000 shares of the Company's common stock with a guaranteed value of \$5 per share as of January, April and October 2001 (with respect to 100,000 of the shares for each period). The settlement was subject to execution of definitive settlement documents and approval of the boards of directors of the companies. As a result, the Company recorded approximately \$1,912,500 as a nonrecurring charge related to the proposed settlement of the litigation.

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The Company and JMA were unable to negotiate the final definitive settlement agreement and, as a result, the matter is still not settled. The case was dismissed in August 2000 without any resolution of this issue. On March 27, 2001, JMA attempted to reopen this matter, but the Court hearing the JMA lawsuit issued a Summary Order denying JMA's motion to enforce the settlement term sheet and confirmed the prior dismissal of the lawsuit. The Court further ruled that JMA would either have to bring an action on the proposed settlement or move to re-open the dismissed case. The Court stated that it did not express any view with respect to the merits of the proposed settlement that brought about the dismissal of the case. There was no activity on the case from March 2001 through August 2001. On August 27, 2001 JMA refiled its lawsuit with a federal court in New York, and the Company filed its motion to dismiss the case because the plaintiffs lacked the required diversity jurisdiction to pursue the claims in federal court. On October 31, 2001 the case was dismissed in federal court. In December 2001, the plaintiffs refiled the lawsuit in the state court seeking to enforce the proposed settlement term sheet. The case was filed in Supreme Court of New York, that state's trial court, in a case styled Roan Meyers v. CT Holdings. Given these recent events, the Company is unable to estimate the potential loss related to this matter and therefore has removed the previously recorded accrual for legal settlement of \$1,912,500. The Company has also filed a lawsuit against JMA to recover excess amounts charged by JMA in connection with related bridge loans.

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### WRITEDOWN OF INVESTMENT IN AFFILIATE

During the three months ended June 30, 2002 general economic conditions worsened, stock market valuations declined from the values at December 31, 2001 and raising capital at previous historical valuations became difficult. We considered all the facts and circumstances of River Logic's business, marketplace and cost of new capital and based on an this consideration we determined that the fair market value of the Company's investment in River Logic had declined to approximately \$500,000 and accordingly wrote down the investment by \$2,203,975. Our investment in River Logic is accounted for using the cost method of accounting for investments in common stock therefore no proportionate share of equity in income or loss is recorded.

### EQUITY IN LOSS OF UNCONSOLIDATED AFFILIATE

In May 2001, Parago obtained a Term Loan from Comerica Bank--Texas (Comerica) in the principal amount of \$8.0 million. The funds from the Term Loan were necessary to enable Parago to continue operations, as Parago's cash resources were depleted. Parago repaid the Term Loan with proceeds from the sale of shares of a the Series E Stock preferred stock issued in December 2001. As a condition to the extension of the Term Loan, Comerica required a guarantee of Parago's obligations under the Term Loan from certain affiliates of TH Lee.Putnam Internet Partners, L.P. (collectively, "TH Lee"), which own shares of Parago's Series C Convertible Preferred Stock ("Series C Stock") and Series D Convertible Preferred Stock ("Series D Stock"), common stock and certain warrants. TH Lee executed the Guaranty in consideration of its receipt of 110,000 warrants to purchase shares of Parago's Series A-3 Preferred Stock, convertible into 11,000,000 shares of Parago common stock, a new series of preferred stock that was created in connection with the bridge loan and guaranty transaction, and, in the event that TH Lee is called upon to make payment under the Guaranty, its receipt of shares of Series A-1 Stock and Series A-2 Stock, two new series of preferred stock the issuance of which could have the effect of substantially diluting Parago's existing stockholders, including CT Holdings, in the event such holders do not participate in the guaranty.



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Parago security holders (including CT Holdings) who met the required suitability criteria were offered the opportunity to participate in the Guaranty through a Pro Rata Participation Interest. In the event that TH Lee was required to pay all or a portion of the Term Loan under the Guaranty, those offerees who had participated in the offering and paid their pro rata portion of the Guaranty when it would have been due would maintain their percentage equity ownership in Parago, while those offerees who did not participate in the offering, and those participants who failed to make their Guaranty payments when due, would be substantially diluted. If offerees holding a significant portion of Parago's current equity ownership failed to make their Guaranty payments when due, had they become due, then TH Lee would gain a controlling interest in Parago as a result of the transactions. CT Holdings participated in this offering. Pursuant to the participation in the Parago bridge loan guaranty the Company was required under the equity method of accounting to recognize equity in losses equal to its cash participation of \$692,739 and the Company's share of the guaranty of \$1,406,472 in the three and six months ended June 30, 2001. Following the Parago equity financing in December 2001 the \$692,739 loan was repaid and the \$1,406,472 loan guarantee was released. Accordingly the adjustment to equity in losses of \$2,099,211 was reversed in December 2001.

### INTEREST EXPENSE, INTEREST INCOME AND OTHER INCOME

Interest expense for the three and six months ended June 30, 2002 was \$35,650 and \$73,582, respectively. This compares to \$3,372 and \$7,879 for the similar periods of 2001. The increase is due to higher average debt balances outstanding during the three and six month periods ended June 30, 2002 as well as the recognition of \$25,650 of interest expense in the three months ended June 30, 2002 and \$51,300 of interest expense in the six months ended June 30, 2002 associated with the beneficial conversion feature of the \$600,000 convertible note from a shareholder.

No interest income was earned in the three months or six months ended June 30, 2002. Interest income in the three and six month periods ended June 30, 2001 represented interest on notes receivable from affiliates.

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Other expense for the three and six months ended June 30, 2002 was \$29,951 and is net of a \$9,000 gain resulting from the issuance of common stock to settle a liability and \$38,452 for the fair market value of common stock issued for the exercise of exchange rights granted by the Company.

Other income for the three and six months ended June 30, 2001 represents miscellaneous receipts unrelated to the operations.

### NET LOSS

As a result of these factors, for the quarters ended June 30, 2002 and 2001 we reported a loss from continuing operations of \$4,704,434 and \$365,140. The loss from discontinued operations related to Citadel for the quarters ended June 30, 2002 and 2001 was \$373,357 and \$518,971. For the six months ended June 30, 2002 and 2001 the loss from continuing operations was \$5,196,436 versus \$509,837, respectively and the loss from discontinued operations was \$942,939 and \$1,028,750, respectively. In addition to the loss from discontinued operations we recorded transaction costs directly related to the spin-off transaction, primarily, legal and accounting fees, of \$26,714 for the three months ended June 30, 2002 and \$185,431 for the six months ended June 30, 2002.

### LIQUIDITY AND CAPITAL RESOURCES

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The Company has incurred recurring operating losses and has a significant working capital deficiency at June 30, 2002 of \$3.2 million and a stockholders' deficit of \$2.7 million. Cash used in operations was approximately \$419,000 during the six months ended June 30, 2002. The Company had no cash balance at June 30, 2002. Immediate funding needs of the business are expected to be provided by financings through advances, short-term notes payable and additional investments from related parties.

The Company has been and continues to be dependent upon outside financing to perform its business development activities, make investments in new technology companies and to fund operations. During the six months ended June 30, 2002, related parties provided substantially all of this financing. The financings during the six months ended June 30, 2002 included proceeds of \$600,000 from the issuance of a convertible note to a shareholder described further in Note C and advances and proceeds of notes payable from the Company's CEO, directors and other related parties. Future cash may come from the realization of the value of our investments in Parago, River Logic and Encore, although there can be no assurance that any value will ever be realized from these investments.

The Company's strategy of continuing to support and expand its business development activities will not generate positive cash flow in the foreseeable future. The complete implementation of this element of our strategy requires the Company to obtain additional capital. Achieving positive cash flow is currently highly dependent upon obtaining liquidity from the Company's investments in unconsolidated affiliates. The Company estimates it will need to raise \$1 million to \$1.5 million to support its incubator and business development activities through the next twelve months. Historically, the Company has obtained short-term bridge funding from its Chief Executive Officer or Directors of the Company. While this may occur in the future there can be no assurance that such financing will be available or if available with terms that the Company would be willing to accept.

The Company has made investments in entities that it believes may provide liquidity to the Company in the long term. The Company believes that its investment in Parago has been successful with Parago having had no revenue at the time of the Company's initial \$50,000 equity investment, growing revenue to approximately \$26 million during the year ended December 31, 2001. As expected in an early stage company, Parago has not been profitable and has experienced cash flow deficiencies as it implements its business plan. During 2001 the

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Company's percentage ownership in Parago was reduced to approximately 1% as a result of an additional equity financing raised by Parago in December 2001 in which the Company chose not to participate. The Company believes, however, that its investment of 20,000 common shares of Parago (following a 1-for-1000 reverse stock split) and warrants to purchase 28.8749 shares of Series A-3 preferred stock (convertible into 2,887 shares of common stock) may ultimately provide an appropriate return.

Similarly, the Company believes its investment in River Logic has also been successful. Since the Company's initial investment, River Logic has made progress in executing its strategy through its development and introduction of new products and establishment of new customer relationships. In addition, during April, 2001 River Logic obtained a strategic investment from the Intel 64 Fund, Cardinal Investments, eMed Ventures, and Mercury Ventures. Similar to the investments in Parago, the Company recognized that this investment would be initially illiquid. However during the three months ended June 30, 2002 general economic conditions worsened, stock market valuations declined from the values at December 31, 2001 and raising capital at previous historical valuations became difficult. Management considered all the facts and circumstances of

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River Logic's business, marketplace and cost of new capital and based on an this consideration determined that the fair market value of the Company's investment in River Logic had declined to approximately \$500,000 and accordingly wrote down the investment by \$2,203,975.

The Company's minority position in Encore is immaterial and is not expected to provide liquidity to the Company in the foreseeable future.

While the Company is pleased with the performance of its investee companies to date, there can be no assurance that the Company will ever achieve liquidity for its investments. In addition there can be no assurance that management's plans will be successful or what other actions may become necessary. Until the Company is able to create liquidity from its investments through sale to a strategic investor, an initial public offering or some other liquidity transaction, the Company will continue to require working capital to fund its own operating expenses. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's business and operations and result in charges that could be material to the Company's business and results of operations.

CT Holdings has no cash at June 30, 2002. The net cash used in operations of \$418,934 for the six months ended June 30, 2002 is principally a result of the net loss of \$6,324,806 offset by a net loss from discontinued operations of \$942,939, stock compensation expense of \$1,347,000, a writedown of our investment in River Logic of \$2,203,975, a legal settlement accrual of \$766,000 and the changes in operating assets and liabilities of \$560,559. In the six months ended June 30, 2001 net cash used in operating activities was \$211,969 primarily consisting of the net loss from continuing operations of \$1,538,587 partially offset by a net loss from discontinued operations of \$1,028,750 and a \$2,099,211 bank debt guaranty of an affiliate partially offset by the reversal of a legal settlement accrual in the amount of \$1,912,500.

There was no cash flow from investing activities in the six months ended June 30, 2002. This compares to \$102,570 of net cash provided from the payments of notes receivable to related parties of \$588,559, payments from non related party notes receivable of \$206,750 partially offset by \$692,739 of cash paid to guaranty the bank debt of an affiliate. Cash flows provided by financing activities was \$619,066 for the six months ended June 30, 2002, primarily resulting from the proceeds of a convertible note from a shareholder of \$600,000, proceeds of notes and advances payable from related parties of \$526,500 offset by payments on notes payable to related parties of \$532,434. During the six months ended June 30, 2001 cash provided from financing activities was \$537,275 primarily from the \$489,983 of proceeds from notes payable

As a result of the aforementioned factors, net cash provided by continuing operations was \$200,132 and \$427,876 for the six months ended June 30, 2002 and 2001 respectively. The net contribution by CT Holdings to Citadel was \$200,132 and \$427,876 for the same periods, respectively. The net result was no cash balance to the Company.

In the future, CT Holdings will incur expenses relating to corporate overhead related to the execution of its business model and the operations of businesses acquired. The Company will require cash from financing activities to fund the deficits expected over the next year. The Company's operation requires the Company to obtain additional capital. The Company will need to raise additional capital to fund its incubator and business development activities through 2002.

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Historically, the Company obtained short-term bridge loans from its Chief Executive Officer or Directors of the Company. The Company has been and continues to be dependent upon related party financing to fund its business development and incubator activities. During the six months ended June 30, 2002 and year ended December 31, 2001, related parties have provided substantially all financing and management will continue to rely on related parties to fund future operations. We may need to rely on similar funding from related parties for future funding needs. While this may occur in the future there can be no assurance that such financing will be available or if available, on terms the Company would be willing to accept. There can be no assurance that management's plans for CT Holdings incubator business model will be successful or what other actions may become necessary. Although the Company has been successful raising capital in the past, the inability of the Company to raise capital may require the Company to sell assets or reduce the level of its operations. Such actions could have a material adverse effect on the Company's investee companies, its business or operations and may result in charges that could be material to the Company's business and results of operations. The Company has no material purchase commitments for property and equipment at June 30, 2002.

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### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

Set forth below are litigation matters to which we are a party. We believe that we have meritorious defenses and will vigorously defend ourselves. However, an unfavorable resolution of, settlement, or defense costs related to one or more of these lawsuits could have a material adverse effect on our business, results of operations or financial condition.

In June 2000, CT Holdings was served with a lawsuit filed in state court in Houston, Texas by Michael and Patricia Ferguson for breach of contract, tortious interference and negligence. Specifically, the Fergusons claimed that they were damaged when they attempted to exercise warrants during a time when CT Holdings' related registration statement could not be used. CT Holdings continues to believe that the claims asserted by the Fergusons are without merit and will vigorously defend the claims. The trial in this case was held from April 22, 2002 until May 1, 2002, and the Company received the judgment from the trial court in July 2002. The trial court awarded the Fergusons approximately \$766,000 in damages, interest and legal fees. CT Holdings intends to appeal the decision of the trial court. As a result of the judgment, the Company has recorded approximately \$766,000 as a nonrecurring charge related to the litigation pending appeal.

In June 2000, Tech Data Corporation filed suit against CT Holdings, alleging a breach of a Software Distribution Agreement ("the Agreement") with CT Holdings. The lawsuit is styled Tech Data Corporation v. Citadel Technology, Inc. (now known as CT Holdings), and was filed in Dallas County Court at Law No. 2. Because CT Holdings was not properly served, Tech Data obtained a default judgment for \$101,049. When CT Holdings discovered the default judgment, it filed and won a motion to set aside this judgment. In June 2001, Tech Data properly served CT Holdings. CT Holdings answered and demanded binding arbitration pursuant to the agreement. The parties filed a Joint Motion to Arbitrate in December 2001. The judge granted this motion, and CT Holdings expects that this matter will be referred to binding arbitration in the fourth quarter of 2002. The Company has recorded a liability of \$101,049 at December 31, 2001 related to this lawsuit. As part of the Distribution, Citadel assumed responsibility for this lawsuit, although there can be no assurance that we will be released from the lawsuit.

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We may become involved from time to time in litigation on various matters which are routine to the conduct of our business. We believe that none of these actions, individually or in the aggregate, will have a material adverse effect on our financial position or results of operations, though any adverse decision in these cases or the costs of defending or settling such claims could have a material adverse effect on our business.

### ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

#### Recent Sales of Unregistered Securities

For all of the transactions listed below the shares were issued pursuant to the exemption from registration contained in Section 4(2) of the Securities Act of 1933.

During May 2002 the Company sold 100,000 restricted shares of common stock for \$25,000 to an accredited investor.

In May 2002 a shareholder received 250,000 restricted shares of the Company's common stock for consulting services to the Company in the first quarter of 2002. These services were valued at \$62,500.

During the six months ended June 30, 2002, 25,000 restricted shares of common stock of the Company were issued to a consultant in lieu of cash compensation. The fair value of these services was \$11,250. The consultant later became the Company's Chief Financial Officer.

In May 2002 the Company issued 250,000 restricted shares of common stock for the services of an attorney who is a former employee and a relative of the Company's CEO. The fair value of these services was \$62,500,

In connection with an acquisition by its former subsidiary Parago in 1999, the Company agreed to exchange up to 500,000 shares of the Company's common stock for shares of Parago common stock at the option of the stockholders of the company acquired by Parago. In May 2002 the Company exchanged 139,806 restricted shares of the Company's common stock for 1,240 shares of common stock of Parago as a result of this conversion feature.

Pursuant to subscription agreements between Parago and some of its stockholders, the Company may be required at the option of such stockholders, to issue up to 414,000 shares of the Company's common stock. In May 2002 one such stockholder was issued 16,000 restricted shares of common stock of the Company.

In May 2002 a total of 6,647,500 restricted shares of the Company's common stock were issued pursuant to the exercise of stock options. Officers, directors and employees of the Company exercised stock Options for 6,500,000 restricted shares of common stock for an aggregate exercise price of \$1,313,000 in exchange for notes which have been fully reserved and the charge recorded as stock compensation expense. In addition an officer and two employees of the Company exercised options for 147,500 restricted shares of common stock of the Company with an aggregate exercise price of \$34,500 and because no cash was exchanged, the \$34,500 was recorded as stock compensation expense.

In May 2002, the Company issued 100,000 restricted shares of common stock to an independent consultant in the settlement of liability recorded for the performance of consulting services. The Company recognized a gain of \$9,000 resulting from this settlement.

### ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

At August 19, 2002 the Company was in default on four notes payable from

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shareholders and related parties in the total amount of \$534,395. At June 30, 2002 the Company had an 8% note payable due June 30, 2002 to an entity related to an employee of the Company for \$49,000, an 8% note payable to a shareholder for \$9,000, an 8% note payable due April 30, 2002 to a director of the Company for \$750,000, and a 5% note payable due July 1, 2002 to the Company's CEO for \$226,395. Interest in arrears is approximately \$16,000.

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ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

99.1 Certification of Chief Executive Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002

99.2 Certification of Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002

(b) The Company filed no reports on Form 8-K during the quarter for which this report is filed.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

CT HOLDINGS, INC.

(REGISTRANT)

Date: August 19, 2002

By: /s/ STEVEN B. SOLOMON

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Steven B. Solomon,  
President and Chief Executive Officer  
(Duly Authorized Signatory and  
Principal Executive Officer)

/s/ RICHARD CONNELLY

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Richard Connelly,  
Chief Financial Officer  
(Duly Authorized Signatory and  
Principal Accounting and Financial Officer)

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