DATA RACE INC
Form 10-K/A
April 03, 2002

Washington, DC 20549

AMENDMENT NO. 3
TO
FORM 10-K
ANNUAL REPORT
Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended June 30, 2001	Commission File Number 0-20706

DATA RACE, Inc.
(Exact name of registrant as specified in its charter)

Texas (State of Incorporation)	74-2272363 (I.R.S. Employer Identification No.)

6509 Windcrest Drive, Suite 120
Plano, Texas 75024
Telephone (972) 378-9677
(Address, including zip code, and telephone number,
including area code, of registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, no par value per share

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES [_] NO [X]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

On February 8, 2002, the aggregate market price of the voting stock held by non-affiliates of the Company was approximately $1,770,000 (For purposes hereof, directors, executive officers and 10% or greater shareholders have been deemed affiliates.)

On January 31, 2002, there were 35,373,477 outstanding shares of Common Stock, no par value.

DOCUMENTS INCORPORATED BY REFERENCE
None.

The registrant hereby files this report on Form 10-K/A to amend its Annual Report on Form 10-K, as amended on February 15, 2002 and March 11,2002 for the year ended June 30, 2001, to amend Part II, Item 8 "Management's Discussion and Analysis of Financial Condition and Results of Operation". No other items in the registrant's Annual Report on Form 10-K for the year ended June 30, 2001 are amended.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to Financial Statements

All schedules are omitted, because they are not required, are not applicable, or the information is included in the financial statements and notes thereto.

INDEPENDENT AUDITORS' REPORT

Board of Directors and Shareholders
DATA RACE, Inc.
Plano, Texas

We have audited the accompanying balance sheet of DATA RACE, Inc. as of June 30, 2001, and the related statements of operations, shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DATA RACE, Inc. as of June 30, 2001, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the

Company will continue as a going concern. As shown in the financial statements, the Company incurred a net loss of $16,775,750 for the year ended June 30, 2001 and has incurred substantial losses for each of the preceding 2 years. At June 30, 2001, current liabilities exceed current assets by $1,274,179 and total liabilities exceed total assets by $561,814. These factors and others discussed in Note 3, raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event the Company cannot continue in existence.

LAZAR LEVINE & FELIX LLP

New York, New York
November 2, 2001

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INDEPENDENT AUDITORS' REPORT

Board of Directors and Shareholders

DATA RACE, Inc.:

We have audited the accompanying balance sheet of DATA RACE, Inc. as of June 30, 2000, and the related statements of operations, shareholders' equity, and cash flows for each of the years in the two-year period ended June 30, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DATA RACE, Inc. as of June 30, 2000, and the results of its operations and its cash flows for each of the years in the two-year period ended June 30, 2000, in conformity with generally accepted accounting principles.

KPMG LLP

San Antonio, Texas
September 11, 2000

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DATA RACE, Inc.
BALANCE SHEETS

	As of June 3	
	2001	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,334	$
Accounts receivable, net	2,026	
Note receivable, current	--	
Inventory	2,876,506	
Prepaid expenses and deposits	--	
Total current assets	2,887,866	
Note receivable, non-current	--	
Property and equipment, net	674,798	
Other assets	84,630	
Total assets	$ 3,647,294	$
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 2,327,133	$
Accrued expenses	638,167	
Obligations under capital lease, current	125,078	
Convertible debentures	1,071,667	
Total current liabilities	4,162,045	
Non-current liabilities:		
Obligations under capital lease, non-current	47,063	
	4,209,108	
Commitments and contingencies		
Shareholders' equity (deficit):		
Common stock, no par value, 70,000,000 shares authorized 34,358,521 and 26,083,364 shares issued and outstanding at June 30, 2001 and 2000, respectively	62,420,978	
Additional paid-in capital	9,545,152	
Accumulated deficit	(72,527,944)	(
Total shareholders' equity (deficit)	(561,814)	
Total liabilities and shareholders' equity	$ 3,647,294	$

See accompanying notes to financial statements

DATA RACE, Inc.
STATEMENTS OF OPERATIONS

	Years Ended June 30, 2001	2000
Total revenue from continuing operations	$ 62,698	$ 316,212
Cost of revenue	1,344,506	761,759
Gross profit (loss)	(1,281,808)	(445,547)
Operating expenses:		
Engineering and product development	4,995,226	3,293,231
Sales and marketing	4,757,711	2,618,432
General and administration	5,211,493	3,118,612
Total operating expenses	14,964,430	9,030,275
Operating loss	(16,246,238)	(9,475,822)
Interest income	239,301	395,078
Interest expense	(856,233)	--
Other income	87,420	45,372
Loss from continuing operations	(16,775,750)	(9,035,372)
Income from discontinued operations	--	217,734
Net loss	$(16,775,750)	$ (8,817,638)
Per share data:		
Net loss	$(16,775,750)	$ (8,817,638)
Effect of beneficial conversion feature of convertible preferred stock	--	(235,718)
Net loss applicable to common stock	$(16,775,750)	$ (9,053,356)
Net basic and diluted loss from continuing operations per common share	$ (0.60)	$ (0.42)
Net basic and diluted loss per common share	$ (0.60)	$ (0.41)
Weighted average shares outstanding	27,812,000	21,940,000

See accompanying notes to financial statements

DATA RACE, Inc.
STATEMENTS OF SHAREHOLDERS' EQUITY

	Series A Convertible Preferred Stock		Series C Convertible Preferred Stock	
	Shares	Amount	Shares	Amount
Balances at June 30, 1998	175	$ 224,970	1,681	$ 1,380,001
Net loss	--	--	--	--
Issuance of convertible preferred stock, net of offering cost of $248,820	--	--	--	--
Redemption of preferred stock	(124)	(165,653)	--	--
Issuance of restricted common stock and warrants, net offering costs of $552,475	--	--	--	--
Accretion of beneficial conversion feature on convertible preferred stock	--	--	--	--
Conversion of convertible preferred stock to common stock	(51)	(59,317)	(1,681)	(1,380,001
Common stock issued for legal and consulting services	--	--	--	--
Exercise of stock options and warrants	--	--	--	--
Employee stock purchase plan	--	--	--	--
Balances at June 30, 1999	--	--	--	--
Net loss	--	--	--	--
Issuance of common stock and warrants, net of offering costs of $300,000	--	--	--	--
Issuance of common stock and warrants, net of offering costs of $419,999	--	--	--	--
Accretion of beneficial conversion feature on convertible preferred stock	--	--	--	--
Conversion of convertible preferred stock to common stock	--	--	--	--
Common stock issued for legal and consulting services	--	--	--	--
Exercise of stock options and warrants	--	--	--	--
Employee stock purchase plan	--	--	--	--
Balances at June 30, 2000	--	--	--	--

Net loss	--	--	--	--
Issuance of common stock in exercise of warrants relating to class A and B preferred stock	--	--	--	--
Issuance of common stock in cashless exercise of warrants related to November 1998 private placement	--	--	--	--
Issuance of common stock and warrants in connection with March 2001 private placement net of offering costs	--	--	--	--
Modification of warrant terms to acquire common stock in connection with the sale of common stock in the March 2001 private placement	--	--	--	--
Stock option compensation	--	--	--	--
Issuance of common stock in connection with convertible debt	--	--	--	--
Exercise of warrants in connection with June 2001 warrant agreement	--	--	--	--
Exercise of stock options	--	--	--	--
Employee stock purchase plan	--	--	--	--
Balance at June 30, 2001	--	$ --	--	$ --

See accompanying notes to financial statements

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DATA RACE, Inc.
STATEMENTS OF SHAREHOLDERS' EQUITY

	Series E Convertible Preferred Stock		Series F Convertible Preferred Stock	
	Shares	Amount	Shares	Amount
Balances at June 30, 1998	--	$ --	$ --	9,126,4
Net loss	--	--	--	
Issuance of convertible preferred stock, net of offering cost of $248,820	750	473,425	750	491,1
Redemption of preferred stock	--	--	--	
Issuance of restricted common stock and warrants, net of offering costs of $552,475	--	--	--	
Accretion of beneficial conversion feature on convertible preferred stock	--	336,574	--	159,4

Conversion of convertible preferred stock to common stock	--	--	--	
Common stock issued for legal and consulting services	--	--	--	
Exercise of stock options and warrants	--	--	--	
Employee stock purchase plan	--	--	--	
Balances at June 30, 1999	750	809,999	750	650,5
Net loss	--	--	--	
Issuance of common stock and warrants, net of offering costs of $300,000	--	--	--	
Issuance of common stock and warrants, net of offering costs of $419,999	--	--	--	
Accretion of beneficial conversion feature on convertible preferred stock	--	53,426	--	182,2
Conversion of convertible preferred stock to common stock	(750)	(863,425)	(750)	(832,8
Common stock issued for legal and consulting services	--	--	--	
Exercise of stock options and warrants	--	--	--	
Employee stock purchase plan	5,293	12,935		
Balances at June 30, 2000	--	--	--	
Net loss	--	--	--	
Issuance of common stock in exercise of warrants relating to class A and B preferred stock	--	--	--	
Issuance of common stock in cashless exercise of warrants related to November 1998 private placement	--	--	--	
Issuance of common stock and warrants in connection with March 2001 private placement net of offering costs	--	--	--	
Modification of warrant terms to acquire common stock in connection with the sale of common stock in the March 2001 private placement	--	--	--	
Stock option compensation	--	--	--	
Issuance of common stock in connection with convertible debt	--	--	--	
Exercise of warrants in connection with June 2001 warrant agreement	--	--	--	
Exercise of stock options	--	--	--	
Employee stock purchase plan	--	--	--	
Balance at June 30, 2001	--	--	--	

See accompanying notes to financial statements

DATA RACE, Inc.
STATEMENTS OF SHAREHOLDERS' EQUITY

	Additional Paid-In Capital	Accumulated Defici
Balances at June 30, 1998	$ 1,882,303	$(34,265,055)
Net loss	--	(8,544,860)
Issuance of convertible preferred stock, net of offering cost of $248,820	2,725,954	--
Redemption of preferred stock	--	--
Issuance of restricted common stock and warrants, net of offering costs of $552,475	1,941,780	--
Accretion of beneficial conversion feature on convertible preferred stock	914,250	(3,888,923)
Conversion of convertible preferred stock to common stock	--	--
Common stock issued for legal and consulting services	--	--
Exercise of stock options and warrants	--	--
Employee stock purchase plan	--	--
Balances at June 30, 1999	7,464,287	(46,698,838)
Net loss	--	(8,817,638)
Issuance of common stock and warrants, net of offering costs of $300,000	--	--
Issuance of common stock and warrants, net of offering costs of $419,999	--	--
Accretion of beneficial conversion feature on convertible preferred stock	--	(235,718)
Conversion of convertible preferred stock to common stock	--	--
Common stock issued for legal and consulting services	209,023	--
Exercise of stock options and warrants	--	--
Employee stock purchase plan	--	12,935
Balances at June 30, 2000	7,673,310	(55,752,194)
Net loss	--	(16,775,750)
Issuance of common stock in exercise of warrants relating to class A and B preferred stock	--	--
Issuance of common stock in cashless exercise of warrants related to November 1998 private placement	--	--
Issuance of common stock and warrants in connection with March 2001 private placement net of offering costs	164,718	--

Modification of warrant terms to acquire common stock in connection with the sale of common stock in the March 2001 private placement	687,394	--
Stock option compensation	176,873	--
Issuance of common stock in connection with convertible debt	--	--
Exercise of warrants in connection with June 2001 warrant agreement	--	--
Accretion of beneficial conversion feature on convertible debentures issued in May 2001	685,074	--
Accretion of beneficial conversion feature on convertible debentures issued pursuant to convertible debentures purchase agreement executed in June 2001	157,783	--
Exercise of stock options	--	--
Employee stock purchase plan	--	--
Balance at June 30, 2001	$ 9,545,152	$(72,527,944)

See accompanying notes to financial statements

DATA RACE, Inc.
STATEMENTS OF CASH FLOWS

	Years Ended	
	2001	200
Cash flows from operating activities:		
Net loss from continuing operations	$(16,775,750)	$ (9,03
Adjustments to reconcile net loss from continuing operations to net cash (used in) operating activities:		
Depreciation and amortization	538,762	29
Non-cash consulting and legal fees	--	72
Non-cash beneficial conversion feature on convertible debentures for May and June 2001 private placements	842,857	
Non-cash stock option compensation	176,873	
Loss on impaired property and equipment	1,180,978	
Loss on sales of property and equipment	35,598	
Changes in assets and liabilities:		
Accounts and notes receivable	354,375	4
Inventory	(2,626,630)	(15
Prepaid expenses, deposits and other assets	206,001	(11
Accounts payable	1,823,132	27
Accrued expenses	(322,179)	7
Net cash used in operating activities	(14,565,983)	(7,87

Cash flows from investing activities:		
Purchase of property and equipment	(1,045,058)	(33
Proceeds from sale of property and equipment	4,146	
Net cash used in investing activities	(1,040,912)	(33
Cash flows from financing activities:		
Convertible notes	1,071,667	
Capital leases, net	18,836	
Redemption of Series A preferred stock	--	
Net proceeds from the issuance of preferred stock	--	
Net proceeds from issuance of common stock	3,466,665	11,10
Net cash provided by financing activities	4,557,168	11,10
Cash flows from discontinued operations	--	51
Net increase (decrease) in cash and cash equivalents	(11,049,727)	3,40
Cash and cash equivalents at beginning of year	11,059,061	7,65
Cash and cash equivalents at end of year	$ 9,334	$ 11,05
Supplemental Disclosure:		
Interest income (expense), net	$ (616,932)	$ 39
Taxes paid	$ --	$

See accompanying notes to financial statements.

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DATA RACE, Inc.
NOTES TO FINANCIAL STATEMENTS
June 30, 2001, 2000, and 1999

1) Description of Business and Summary of Significant Accounting Policies

Description of Business

DATA RACE, Inc. ("Data Race" or the "Company"), currently doing business as IP AXESS, provides integrated IP based remote work solutions over multiple access media. The Company's VocalWare(TM) IP client/server product line provides users in remote locations with simultaneous access to critical corporate resources including phone, fax, Internet, and E-mail over a single connection via: DSL, cable modem, LAN, Frame Relay, ATM or high speed dial-up through VPN, local ISP POP, or PSTN. The Company, after exiting the network multiplexer business in January 2000, currently operates in one business segment.

Summary of Significant Accounting Policies

Use of Estimates

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

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents.

Accounts Receivable

Accounts receivable as shown is net of allowance for doubtful accounts of approximately $2,000 and $500 at June 30, 2001 and 2000, respectively.

Inventory

Inventory is valued at the lower of cost (principally standard cost which approximates first-in, first-out) or market (net realizable value). Costs include materials, labor, overhead, and subcontract charges as applicable. If in the ordinary course of business, management determines that the utility of its inventory is no longer as great as its cost, due to obsolescence, physical deterioration, changes in price levels, etc., the Company will recognize a reduction in the value of its inventory and record a corresponding charge to income.

Property and Equipment

Property and equipment are stated at cost. Equipment under capital leases is stated at the present value of minimum lease payments. Major renewals and betterments are charged to the property accounts while replacements, maintenance, and repairs that do not improve or extend the lives of the respective assets are expensed currently. Depreciation of property and equipment is provided at amounts calculated to amortize the cost of the assets over their useful economic lives using the straight-line method for financial reporting purposes and accelerated methods for income tax purposes. Equipment held under capital leases and leasehold improvements are amortized over the shorter of the lease term or estimated useful life of the asset.

During fiscal year 2001, the Company invested approximately $434,000 in a new e-business platform in which the Company was unifying its sales, customer service, MRP and

accounting systems. Implementation of the system had to be abandoned during May of 2001 due to the Company's financial difficulties and the loss of key personnel responsible for implementation of the system. The Company recorded as an asset impairment, approximately $403,000 relating to the e-business platform. In addition the Company recorded approximately $778,000 in asset impairment on non-amortized leasehold improvements in August 2001 pertaining to the early termination of the San Antonio facilities. The Company anticipated this action as it was consolidating its facilities prior to the close of the fiscal year ending June 30, 2001. The Company believes its facilities are more than adequate to meet the current and future needs during fiscal 2002 without modification or further expense.

Convertible Preferred Securities

The beneficial conversion features of the Series A, C, D, E and F Convertible Preferred Stock ("Preferred Stock") have been recognized by allocating a portion of the proceeds to additional paid-in capital. The amount allocated to additional paid-in capital consists of the conversion discount on the Preferred Stock and the value attributed to the warrants. The conversion discount is calculated as of the date of issuance as the difference between the conversion price and the fair value of the common stock into which the security is convertible. Because the security provides for more than one conversion rate, the computation is made using the conversion terms most beneficial to the investor, regardless of the actual discount applied upon conversion. The value of the warrants is calculated using the Black-Scholes option pricing model and may not correspond to a market value.

The calculated intrinsic value of the beneficial conversion features of the Preferred Stock, the offering costs and the premium results in non-cash charges to the loss available to common shareholders in the computation of loss per common share over the conversion period. As a result, approximately $ 0, $236,000, and $3,889,000 in non-cash charges are reflected in the loss per common share for the years ended June 30, 2001, 2000, and 1999, respectively.

Fair Value of Financial Instruments

The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable and notes payable. The book value of cash and cash equivalents, accounts receivable, notes receivable, accounts payable and notes payable are representative of their respective fair values due to the short-term maturity of those instruments.

The benefical conversion features of the convertible debentures issued in May and June 2001 have been recognized by recording additional paid in capital and interest expense for the year ending June 30, 2001. The amount of the benefical conversion and interest expense is calculated as of the date of issuance as the difference between the conversion price and the fair value of the common stock into which the note is convertible. The value of the benefical conversion is calculate using the Black-Scholes option pricing model and may not correspond to market value. The May 2001 benefical conversion feature using the model assuming a risk free rate of return of 4.93% and a volatility of 152.96% resulted in the company recording a one time charge to additional paid-in-capital of $685,074 and a corresponding charge to interest expense in May 2001. The June 2001 benefical conversion feature relating to the June 2001 private placement using the Black-Scholes model assuming a volatility of 166.17% and risk free rate of return 4.35% resulted in the Company recording a one time charge to additional paid-in-capital of $ 157.783 and a corresponding charge to interest expense in June 2001.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Revenue Recognition

Revenue is generally recognized upon direct sale and shipment of products to end-user customers or when contractual services have been provided to end-user customers, title has passed to the end-user customer, the fee and terms are fixed or determinable, and collectibility is reasonably assured. Such method is in accordance with Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements. Revenue is generally recognized upon reseller (indirect) sale of products when title has passed to the reseller, a reseller agreement exists, the fee and terms are fixed or determinable, and collectibility is reasonably assured. The Company does have a reservation of title on resellers where the products are delivered to reseller's location or reseller's end-user location outside the United States. The Company reserves title in the products until either: a) reseller pays in full for the products; or b) reseller sells the product to a third party at which time title passes to the third party. The Company, in most reseller agreements, has an inventory balancing provision, which generally gives the reseller the opportunity to balance its inventory by returning for credit up to 20% of the value of the products shipped during a quarter. The Company will record a liability for up to 20% on sales by resellers for the inventory balancing provision. The Company also has price protection for most resellers where products shipped to resellers whose price have been decreased will be price protected if the resellers products are unopened and shipped to reseller 180 days or less prior to the effective date of price decrease. The reseller must submit a claim within 30 days of the effective date of the price decrease to receive credit in the amount of the price decrease multiplied by the qualifying units.

Revenue from service obligations and licensing agreements are deferred and recognized ratably over the period of the obligation or agreement. The Company recognizes revenue and gross profit from evaluation units shipped only upon receipt of payment or upon customer acceptance and reasonably assured collection.

Comprehensive Income

The Financial Accounting Standards Board ("FASB") issued Statement No. 130, "Reporting Comprehensive Income", in June of 1997. This statement established standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. For all periods presented, no elements of comprehensive income exist other than loss from operations.

Warranty Expense

The Company generally offers one or two year warranty coverage on the majority of its products. Warranty costs are accrued and expensed when revenue is recognized based upon the Company's experience with such costs. As of June 30, 2001, the Company had no accrual for warranty costs.

Research and Development

All engineering and product research and development expenditures are charged against operations as incurred. Research and development costs charged to continuing operations

aggregated approximately $5,000,000, $3,293,000 and $2,385,000 in fiscal 2001, 2000, and 1999, respectively.

Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired on this basis, the impairment loss to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Stock Based Compensation

The Company accounts for stock-based compensation using the intrinsic value method described in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and related interpretations (including FASB Interpretation No. 44). Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's Common Stock at the date of the grant over the amount an employee must pay to acquire the stock. The Company has adopted the disclosure requirements of SFAS No. 123, "Accounting for Stock Based Compensation."

Equity instruments issued to non-employees that are fully vested and non-forfeitable are measured at fair value at the issuance date and expensed in the period over which the benefit is expected to be received. Equity instruments issued to non-employees which are either unvested or forfeitable, for which counter-party performance is required for the equity instrument to be earned, are measured initially at fair value and subsequently adjusted for changes in fair value until the earlier of: (1) the date at which a commitment for performance is required for performance by the counter-party to earn the equity instrument is reached, or (2) the date of which the counter-party's performance is complete.

Earnings (Loss) Per Share

Net loss per share of common stock is presented in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 128, Earnings Per Share. Under SFAS No. 128, basic earnings/loss per share excludes dilution for potentially dilutive securities and is computed by dividing income or loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings/loss per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Potentially dilutive securities are excluded from the computation of diluted earnings/loss per share when their inclusion would be antidilutive. The Company had approximately 3,434,000 and 2,734,000 options outstanding as of June 30, 2001 and 2000, respectively. The Company had no preferred stock outstanding as of June 30, 2001 and 2000. As of June 30, 2001, the Company had warrants outstanding to purchase 20,575,180 shares of common stock. As of June 30, 2000 the Company had warrants outstanding to purchase 2,808,139 shares of common stock.

New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under the new rules, the pooling of interest method of accounting is no longer allowed for business combinations and goodwill and other intangible assets deemed to have indefinite lives will no

longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

In August 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (FASB 144) which is effective for fiscal years beginning after December 15, 2001. FASB 144 supercedes FASB 121 on the impairment of long-lived assets and certain reporting provision of APB 30 dealing with the disposal of a business segment.

2) Discontinued Operations

The Board of Directors approved discontinuing the network multiplexer product business segment in January 2000. Accordingly, the financial statements for the years ended June 30, 2000 and 1999 reflect the operations of the multiplexer product business as a discontinued operation. The Company sold its network multiplexer business to HT Communications in March 2000 for $350,000. The Company to date has received approximately $6,000 in principal payments and $4,500 in royalty payments. The Company is in the process of filing suit against HT Communications demanding payment on the past due balances. Due to defaults upon the agreement between the Company and HT communications, the Company removed the unrecognized portion of the deferred gain in the amount of $331,601 from its books along with the associated note receivable balance.

3) Going Concern Uncertainty

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplates continuation of the Company as a going concern. As shown in the financial statements, the Company incurred a substantial loss of $16,775,750 for the year ended June 30, 2001 and has incurred losses for each of the preceding 2 years. At June 30, 2001, current liabilities exceed current assets by $1,274,179, total liabilities exceed total assets by $561,814 and the accumulated deficit aggregated $72,527,944. In view of these matters, realization of a major portion of the assets in the accompanying balance sheet is dependent upon the Company's ability to meet its financing requirements, and the success of its future operations. See ITEM 1 BUSINESS - Certain Business Risks - We Will Need Additional Capital to Sustain Operations and footnote 10, Shareholders' Equity - Equity Line of Credit.

In addition, effective July 11, 2001, the Company's common stock was delisted by The Nasdaq National Market due to a failure to pay overdue annual and additional listing fees in the amount of $44,125 and the inability to meet the minimum bid price requirements for continued listing.

Operating losses have had and continue to have a substantial negative effect on the Company's cash balance. The Company's goal of returning to profitability and developing a more dependable revenue base relies on the success of the VocalWare IP product line. To successfully penetrate the target markets, the Company expects that significant additional resources will need to be expended in order to expand its sales and marketing infrastructure and operation systems, and to finance inventory and receivables.

The Company has historically funded operations with the proceeds from the sale of equity securities and has not generated positive cash flows from operations for the past three years. The Company will need to raise more money to continue to finance its operations and may not be able to obtain additional financing on acceptable terms, or at all. Any failure to raise additional financing will likely place the Company in significant financial jeopardy.

During July 2001 (subsequent to the balance sheet date) the Company decreased its overhead through payroll reductions and related benefit costs (reducing its workforce from 77 employees to 6 employees). Management is also currently consolidating operations into one location thereby effecting savings on rent and associated facility costs. The Company believes

that these cost reductions and the raising of additional financing will allow them to continue in existence.

4) Accounts Receivable and Major Customers

During fiscal 2001 aggregate revenues from shipments to three customers represented 85% of total revenues. Revenue from shipments to and fees from Sabratek (a significant customer) represented 65.2% and 50% of revenue from continuing operations for fiscal 2000 and 1999, respectively. Credit limits, ongoing credit evaluation, and account-monitoring procedures are used by the Company to minimize the risk of loss on accounts receivable. Generally, collateral is not required. Export revenues were 4% of total revenue for fiscal 1999. Export revenues were not significant during fiscal 2001 or fiscal 2000.

5) Inventory

Inventory consists of the following:

	June 30, 2001	June 30, 2000
Finished goods	$1,054,557	$ 138,014
Work in progress	322,797	80,151
Raw materials	1,499,152	31,711
Total net inventory	$2,876,506	$ 249,876

Inventory is valued at the lower of cost (principally standard cost which approximates first-in, first-out) or market (net realizable value). Costs include materials, labor, overhead, and subcontract charges as applicable. If in the ordinary course of business, management determines that the utility of its inventory is no longer as great as its cost, due to obsolescence, physical deterioration, changes in price levels, etc., the Company will recognize a reduction in the value of its inventory and record a corresponding charge to income.

6) Property and Equipment

Property and equipment consists of the following:

	June 30, 2001	June 30, 2000	Useful Lives
Leasehold improvements	$ --	$ 1,560,385	

Furniture, fixtures and equipment	3,103,959	2,345,925	2 - 5 yrs.
	3,103,959	3,906,310	
Accumulated depreciation	(2,429,161)	(2,670,391)	
Total property and equipment	$ 674,798	$ 1,235,919	

Because the Company terminated the lease for the San Antonio, Texas facility after the close of its fiscal year 2001 (August, 2001), the Company elected to record an asset impairment for the San Antonio leasehold improvements resulting in a loss of $778,278. The Company also wrote off $402,700 in impaired assets relating to its inability to further proceed with the implementation of its new e-business integrated operating platform. The e-business platform was to internally unify the Company's sales, customer service, material resources planning (MRP) and accounting systems activities. The cost of this operating platform consisted of the cost to acquire servers, associate server software, applications software, initial training and external consultant implementation. Implementation of the system had to be abandoned during May of 2001 due to financial difficulties and the loss of key personnel responsible for implementing this system. The total impairment loss of $1,180,978 is included in General and Administration expenses.

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7) Accrued Expenses

Accrued expenses consists of the following:

	June 30, 2001	June 30, 2000
Deferred gain	$ --	$334,788
Payroll	399,651	215,833
Accrued vacation	133,764	82,164
Other	104,752	327,561
Total accrued expenses	$638,167	$960,346

Due to defaults upon the agreement between the Company and HT communications, the Company removed the unrecognized portion of the deferred gain in the amount of $331,601 from its books along with the associated note receivable (see Note 2).

8) Income Taxes

As a result of operating losses sustained, there was no income tax expense (benefit) for the fiscal years ended June 30, 2001, 2000 and 1999. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at June 30, 2001 and 2000 are presented below:

	June 3
Deferred tax assets:	2001

Accounts receivable due to allowances for financial reporting purposes	$ 700
Inventory, principally due to write-down for financial reporting purposes	327,800
Property and equipment, due to difference in depreciation	67,300
Accrued expenses	168,500
Net operating loss carryforwards	24,396,100
Alternative minimum tax credit carryforwards	93,700
Research and experimentation credit carryforwards	881,600
Other, net	--
Total gross deferred tax assets	25,935,700
Less valuation allowance	(25,935,700)
Net deferred tax asset	$ --

The valuation allowance related to deferred tax assets increased by approximately $5,096,000 and $3,040,000 during the years ended June 30, 2001 and 2000, respectively.

In assessing the realization of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Based upon the level of historical taxable income, management has provided a 100% valuation allowance for the Company's deferred tax assets at June 30, 2001. The amount of the deferred tax asset considered realizable, however, could fluctuate in the near term if estimates of future taxable income during the carryforward period are adjusted.

Reconciliation of the U.S. Federal statutory rate to the Company's effective tax rate for each fiscal year is as follows:

	2001	2000	1999
U. S. Federal statutory rate	34.0%	34.0%	34.0%
Increase (reduction) in income taxes resulting from:			
Provision for valuation allowance	(34.0)	(34.0)	(34.0)
Net effective tax rate	--	--	--

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At June 30, 2001, the Company had net operating loss ("NOL") carryforwards for federal and state income tax purposes of approximately $70,980,000, which expire beginning in 2008. The Company also has research and experimentation credit carryforwards for federal income tax purposes of approximately $678,000, which began expiring in 2000, and alternative minimum tax credit carryforwards of approximately $84,000. The Internal Revenue Code section 382 limits NOL and tax credit carryforwards when an ownership change of more than fifty percent of the value of stock in a loss corporation occurs within a three-year period. In fiscal 1999, 1998 and 1997 the Company issued preferred stock that has since been converted into common stock. Accordingly, the ability to utilize remaining NOL and tax credit carryforwards may be significantly restricted.

9) Convertible Debentures

May 2001 Private Placement of Convertible Notes

In May 2001 the Company issued two 10% secured convertible promissory notes with principal amounts, in the aggregate, of $700,000, and 1,166,667 common stock purchase warrants. The notes mature one year from their date of issuance. The notes and warrants were issued pursuant to Section 4(2) of the Securities Act, as amended, in equal amounts to two accredited investors. The proceeds to the Company from the sale of the notes was $700,000. The Company used the proceeds from the private placement primarily for general corporate purposes. The notes are convertible at any time at the holders option into common stock at $0.30 per share. The warrants of which the total value are $110,179, are exercisable at a price of $0.30 per share through May 2006.

June 2001 Private Placement of Convertible Debentures

On June 12, 2001 the Company signed an agreement to place up to $1 million in 6% convertible debentures and warrants to two accredited investors. The parties amended the agreement on July 17, 2001 and October 18, 2001. The convertible debentures have an interest rate of 6% per annum and mature 3 years from their date of issuance. Under the terms of the convertible debentures, the holders can elect at any time prior to maturity to convert the balance outstanding on the debentures into shares of Company common stock at the lesser of a fixed price that represents a 10% premium to the closing bid price of common stock at the time the debentures were issued and 50% of the average of the 5 lowest closing bid prices of Company common stock during the 25 business days immediately preceding the conversion date. Under the agreements, as amended, and pursuant to Section 4(2) of the Securities Act of 1933, as amended, the Company issued to the investors $500,000 principal amount of convertible debentures on June 18, 2001, $240,000 principal amount of convertible debentures on July 30, 2001, $130,000 principal amount of convertible debentures on September 6, 2001 and $277,499 principal amount of convertible debentures on October 18, 2001. On June 18, 2001, the Company also issued to the investors common stock purchase warrants to purchase up to 1,000,000 shares of common stock at an exercise price of $0.14. On October 18, 2001 the parties amended the agreement to increase the investment amount by $147,499 and the Company granted to the investors a security interest in all of the assets of the Company covering all prior and future indebtedness of the Company to the investors. We have received proceeds from the sale of the convertible debentures equal to $1,147,499 less $80,000 to Hadrian Investments Limited for placement agent fees, or 8% of the proceeds received for the first $1,000,000 principal amount of convertible debentures issued to the investors, and less $25,000 to cover the legal expenses of the investors. We currently owe Hadrian Investments Limited an additional $11,799.92 in connection with this financing, or 8% of the last $147,499 convertible debentures issued to the investors. The Company used the proceeds from the private placement primarily for general corporate purposes. The Company is obligated to file a registration statement for the shares issuable upon conversion of the convertible debentures and warrants with the SEC. The Company was also obligated to cause the registration statement to be declared effective by

October 2, 2001 and is currently accruing liquidated damages at the rate of 2%

of the outstanding principal amount of the convertible debentures per month. These penalties may be paid in cash or, at the investors' option, in common stock. In addition, if the Company issues additional shares of common stock, then antidilution provisions contained in the convertible debentures may reduce the conversion price of the shares issued to the investors so as to prevent dilution of the their investment in the Company.

10) Shareholders' Equity

Equity Line of Credit

In July 2001, subsequent to the balance sheet date , the Company signed what is sometimes termed an equity line of credit or an equity draw down facility with an accredited investor, Grenville Finance Ltd. In general, Grenville has committed up to $30 million to purchase our common stock over a 36 month period beginning after and during the period a resale registration statement registering the shares purchased pursuant to the equity line of credit is effective. During the periods the resale registration statement is effective, the Company may request a draw of up to $1 million of that money, subject to a formula based on average stock prices and average trading volumes, setting the maximum amount of any request for any given draw. The amount of money that Grenville will provide and the number of shares to be issued to Grenville in return for that money is settled twice during a 22 day trading period following the draw down request based on the formula in the stock purchase agreement. Grenville receives a 17.5% discount to the market price of Company common stock during the 22-day period and the Company receives the settled amount of the draw down, less 8% of such amount to Hadrian Investments Limited for placement agent fees. Additionally, we issued to Hadrian 500,000 shares in lieu of a cash payment of $25,000 for services rendered to the Company by Hadrian. Also in July 2001, the Company issued a warrant to Grenville to purchase up to 16,366,612 shares of Company common stock at an exercise price of $0.07027 and paid Grenville $20,000 for its legal fees and expenses incurred in connection with the equity line of credit. The issuances of the securities to the accredited investors are made pursuant to Section 4(2) of the Securities Act. The Company will use the proceeds from the equity line for general corporate purposes.

March 2001 Private Placement

On March 2, 2001, the Company completed a Section 4(2) private placement of 3,047,620 shares of its common stock, and warrants to purchase 304,762 shares of common stock to three accredited investors, Protius Overseas Limited, Keyway Investments Ltd., and Lionhart Investments Ltd., for an aggregate price of $2,000,000. The warrants are exercisable at a price of $0.9875 per share through March 2, 2006. The Company used the proceeds from the private placement primarily for general corporate purposes.

The Company has agreed to file a registration statement under the Securities Act of 1933, covering the resale of the common shares and the shares of common stock issuable upon exercise of the warrants. The Company has incurred, and continues to incur, certain penalties since the registration statement was not declared effective by May 31, 2001. These penalties may be paid in cash or, at the investors' option, in common stock. In addition, if the Company issues additional shares of common stock prior to the effective date of the registration statement, then antidilution provisions contained in the securities purchase agreement may require the Company to issue additional shares of common stock to the investors so as to prevent dilution of the investors' investment in the Company.

In connection with the private placement, (i) the Company granted to the Investors a right of first refusal to purchase additional securities issued by the Company (subject to certain exceptions) prior to August 29, 2001 and (ii) agreed to reduce to $0.9875 the exercise price of warrants to purchase an aggregate of 1,265,317 shares of the Company's Common Stock issued

in connection with the Company's June 1999 and December 1999 private placements and to extend the term of these warrants for two years to December 10, 2003.

June 2000 Private Placement

On June 13, 2000, the Company completed a private placement of 1,572,738 shares of its common stock and warrants to purchase 471,822 shares of common stock to six institutional investors including three investors from the Company's June 1999 and December 1999 private placements for an aggregate price of $6,000,000. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $5.45 at any time through June 12, 2002.

December 1999 Private Placement

On December 10, 1999, the Company completed a private placement of 1,904,761 shares of its common stock and warrants to purchase 571,429 shares of common stock to three institutional investors for an aggregate price of $4,000,000. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $3.00 through December 10, 2001.

June 1999 Private Placement

In June 1999, the Company completed a private placement of 2,132,955 shares of its common stock, and warrants to purchase 693,888 shares of common stock to three institutional investors for an aggregate price of $6,000,000. Each investor purchased one-third of the securities issued in the private placement. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $4.02 through June 2001.

November 1998 Private Placement

In November 1998, the Company obtained a binding commitment for a private placement (the "November Private Placement") of its restricted common stock and common stock purchase warrants to up to five accredited investors, for an aggregate price of $2,200,000. The purchase price for one share of common stock and one warrant was $2.25. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $2.25 per share, at any time on or before the second anniversary of the closing date.

The investors included the Company's former President and CEO and Liviakis Financial Communications Inc. ("LFC").

Series E & F Convertible Preferred Stock

In July 1998, the Company completed the first closing of a private placement of its Series E Convertible Preferred Stock ("Series E Preferred Stock") and related Common Stock Purchase Warrants ("Class B Warrants") to First Capital Group of Texas L.P. (the "Class B Investor"), an investment firm managed by the Company's Chairman of the Board, at an aggregate price of $750,000. In January 1999, the Company completed the second closing of the private placement of its Series F Convertible Preferred Stock (Series F Preferred Stock) and related Class B Warrants to the Class B Investor for an aggregate price of $750,000.

In June 2000 all of the 750 shares of Series E Preferred Stock and 750 shares of Series F Preferred Stock had been converted and all the Class B

Warrants were exercised.

Warrants

In June 2001, the Company issued 1,000,000 warrants in conjunction with the 6% convertible debentures totaling $1,000,000. The warrants are exercisable at a price of $0.14 per share through June 2004.

In May 2001, the Company issued 1,166,667 warrants in conjunction with 10% secured convertible promissory notes totaling $700,000. The warrants are exercisable at a price of $0.30 per share through May 2006.

In March 2001, the Company issued 304,762 warrants at $0.9875 to acquire its common stock in conjunction with its private placement.

Also, in connection with the private placement of common stock and warrants to acquire common stock for proceeds of $2 million in March 2001, the Company agreed to modify the terms of pre-existing warrants to acquire an aggregate of 1,265,317 shares of the Company's common stock. The Company reduced the strike price of these warrants from a weighted-average amount of $3.56 to $0.98 per share, and extended the expiration date of the warrants from December 2001 to December 2003. The change in the fair value of these warrants as a result of the modifications is $687,394, which has been recorded as a cost of the issuance of the common stock and related warrants.

In September 2000, the Company issued 210,222 shares of its common stock in conjunction with the exercise of 210,222 warrants from the November 1998 private placement. In a cashless exercise, the Company issued 297,313 shares of its common stock as result of the exercise of 690,333 warrants. The remaining 56,110 warrants balance of the November 1998 private placement expired in November 2000. In November 2000, the remaining balance of Series C Warrants expired.

In July 2000, remaining warrants for the class A and B first and second close expired.

The following table shows the outstanding warrants for each of the fiscal years ending June 30, 2001, 2000 and 1999 respectively. Each warrant in the table is convertible to one share of the Company's common stock for the indicated price.

Warrants outstanding as of June 30,	2001	2000	1999	Pri
June 2001 6% convertible debentures	1,000,000	--	--	$
May 2001 10% convertible notes	1,166,667	--	--	
March 2001 private placement	304,762	--	--	0.
June 2000 private placement	471,822	471,822	--	
December 1999 private placement	571,429	571,429	--	0.
June 1999 private placement	693,888	693,888	693,888	0.
November 1998 private placement	--	956,655	1,001,109	
Series C Warrants	--	53,977	53,977	6
Class A and B second close	--	24,968	249,383	0.
Class A and B first close	--	35,400	35,400	0.
Class A and B first and second close	--	--	281,250	
Series A warrants	--	--	25,274	16

Total warrants outstanding	4,208,568	2,808,139	2,340,281
	=========	=========	=========

Stock Option Plans

Under the Company's existing stock option plans (the "Plans"), stock options to purchase up to 4,680,842 shares of common stock were originally authorized to be granted to employees, directors, and certain other persons. As of June 30, 2001, 3,434,057 stock options covering shares of common stock were outstanding under the Plans and 1,246,785 shares were available for issuance upon exercise of options, which may be granted in the future under the Plans.

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Options under the Plans may either be incentive stock options or non-qualified stock options (except in the case of the Company's non-qualified stock option plan which permits only the issuance of non-qualified stock options). Options under the Plans may be granted for a term not to exceed ten years (five years with respect to incentive stock options granted to any person having 10% or more voting power of the Company) and are not transferable other than by will or the laws of descent and distribution. Incentive stock options may be exercised within 90 days after the optionee's termination of employment (to the extent exercisable prior to such termination), and one year after the optionee's disability. The exercise price of the options under the Plans must be at least equal to the fair market value of the common stock on the date of grant, or 110% of such value for incentive stock options granted to any person having 10% or more of the voting power of the Company. The aggregate fair market value of the common stock for which any employee may be granted incentive stock options that first become exercisable in any one calendar year may not exceed $100,000. Options may be exercised by payment of cash or by tender of shares of common stock (valued at their then current market value). The Compensation Committee of the Board of Directors administers the Plans.

On December 10, 1998, the Compensation Committee and the Board of Directors authorized and granted the Board of Directors and the Chief Executive Officer of the Company the right to exchange up to 100% of their outstanding options, both vested and unvested, for replacement options at a rate of three replacement options for every four options surrendered. These replacement options are exercisable at a price of $3.625 per share (the fair market value at the date of repricing). A total of 609,500 options were exchanged for 442,125 replacement options. The replacement options vest in two equal installments on June 10, 1999 and December 10, 1999.

On September 12, 2000, the Company's Board of Directors adopted the Stock Option Plan, authorizing the grant of 1,250,000 incentive stock options and non-qualified stock options to employees, directors and certain other persons. On November 11, 2000, the shareholders approved the 2000 Stock option plan authorizing 1,250,000 options for future grants.

On April 21, 1998, the Board of Directors authorized and granted the non-officer employees of the Company, the right to exchange up to 100% of their outstanding options, both vested and unvested, for replacement options at a rate of one replacement option for each option surrendered. These replacement options are exercisable at a price of $1.7813 per share (the fair market value at the date of repricing). A total of 341,604 options were exchanged. Officers, other than the Chief Executive Officer, were authorized and granted the right to exchange up to 100% of their outstanding options; both vested and unvested, for replacement options at a rate of two replacement options for every three options surrendered. These replacement options are exercisable at a price of $1.7813 per share (the fair market value at the date of repricing). A total of 294,750 options were exchanged for 196,499 replacement options. The replacement options vest in two equal installments on October 21, 1998 and April 21, 1999.

A summary of option activity under the Plans for the fiscal years ended June 30, 2001, 2000 and 1999 is as follows:

	2001		2000		
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Sha
Outstanding at beginning of year	2,733,708	$ 3.77	1,689,516	$ 3.21	1,49
Granted	1,555,748	3.86	2,147,650	3.63	1,29
Exercised	272,142	2.10	565,132	2.28	29
Expired	583,257	4.88	538,326	2.99	80
Outstanding at year End	3,434,057	$ 3.75	2,733,708	$ 3.77	1,68
Options exercisable at year end	2,143,142	$ 3.47	1,373,145	$ 3.51	91
Shares available for future grant	1,246,785	--	697,784	--	57

The following summarizes information regarding the Company's stock options outstanding at June 30, 2001:

Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life Years	Weighted Average Exercise Price	Number Exercisable at June 30, 2001
$ .01 - $ 1.13	412,046	9.7	$ .62	197,646
1.63 - 2.06	427,070	6.7	1.70	364,568
2.50 - 2.94	150,650	8.5	2.69	126,900
3.37 - 3.97	694,000	8.0	3.61	647,666
4.13 8.88	1,735,291	8.8	5.08	791,362
13.00 - 14.50	15,000	4.5	14.00	15,000
$ 1.63 - $ 14.50	3,434,057	8.5	$ 3.75	2,143,142

The Company applies APB Opinion No. 25 and related interpretations in accounting for its stock option and stock purchase plans. Had compensation cost been recognized consistent with SFAS No. 123, the Company's net loss and loss per share would have been increased to pro forma amounts indicated below for the years ended June 30, 2001, 2000 and 1999

		2001	2000	1999
Net loss applicable to common stock	As Reported	$ (16,775,750)	$ (9,053,356)	$ (12,433,783)
	Pro Forma	(17,519,425)	(11,699,109)	(13,415,803)
Net diluted loss per share	As Reported	$ (0.60)	$ (0.41)	$ (0.77)
	Pro Forma	(0.63)	(0.53)	(0.83)

The per share weighted average value of stock options issued by the Company during fiscal 2001, 2000 and 1999 was $4.34, $5.81 and $2.80 respectively, on the date of grant using the Black-Scholes option-pricing model. The Company used the following weighted-average assumptions to determine the fair value of stock options granted for the fiscal years ended June 30, 2001, 2000 and 1999:

	Stock Option Plans			Employee Stock Purchase Plan	
	2001	2000	1999	2001	2000
Dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%
Expected volatility	208.7%	137.3%	142.0%	92.3%	92.3%
Risk-free rate of return	4.67%	5.23%	4.7%	4.67%	5.23%
Average expected option life	3.6yrs	3.6yrs	3.6yrs	0.5yrs	0.5yrs

Consultant and Advisor Stock Plan

In April of 1999, the Company established a Consultant and Advisor Stock Plan (the "Consultant and Advisor Stock Plan") for the purpose of providing incentives to and compensating consultants and advisors for their contributions to the Company. In June 2001 the Company amended the plan by increasing the number of shares issuable under the plan from 500,000 shares to 1,000,000 shares of the Company's common stock.

Under the Consultant and Advisor Stock Plan, the Company may issue up to an aggregate of 1,000,000 shares of Common Stock to consultants and advisors whom are natural persons providing bona fide services to the Company. Shares may not be issued under the Consultant and Advisor Stock Plan to directors or officers of the Company, or for services rendered in promoting or maintaining a market in the Company's securities.

The Company recognizes as expense the market value of shares on the day of issuance for such consulting services as the recipients generally sold the shares upon issuance. The Company does not amortize additional compensation expense for this plan. For the years ended June 30, 2000 and 1999, the Company issued approximately 190,000 and 100,000 shares of common stock with a value of approximately $520,000 and $428,000 respectively. The company did not issue any other shares in conjunction with this plan for the year ending June 30, 2001.

11) Commitments

The Company's facilities consisted of three buildings of approximately 21,000, 29,000 and 10,000 square feet, which are subject to ten, seven and five year operating leases, respectively. The total net rent expense charged to operations was approximately $290,000, $282,000, and $286,000, in fiscal 2001, 2000, and 1999 respectively.

In September 2000, the company sublet 29,000 square feet of its San Antonio, Texas facilities to Teftec, Inc. a nonaffiliated company with the approval of Crow Holdings Company, the company's landlord. In fiscal 2001, the company received $125,000 in rents from Teftec resulting in net rent expense of $290,000 for fiscal 2001, for all leased facilities.

The following is a schedule of future minimum lease payments under non-cancelable operating leases as of June 30, for each fiscal year shown below:

Fiscal year ending June 30,	Operating Leases
2002	$ 387,000
2003	347,000
2004	229,000
2005	229,000
Thereafter	148,000
	$ 1,340,000

During fiscal year 2001, the company entered into three capital leases for capital equipment. A summary is presented below for all capital leases including provisions for interest. Each lease may be bought out at the end of its term for $1.00

Fiscal year ending June 30,	Capital Leases
2002	$ 141,000
2003	42,000
2004	21,000
Total future payments for capital leased	204,000
Less interest under capital lease obligations	(32,000)
Net present value of capital leases	$ 172,000

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Each leased asset is depreciated over the life of the lease. The maximum lease term is 36 months. Prior to June 30, 2001 the Company recorded asset impairment for these leases since completing the original lease obligation will be dependent upon additional cash being generated by the Company. The company is also responsible for all property taxes that may be assessed from time to time per the agreement.

12) Related Party Transactions

Certain outside directors also receive consulting fees for services rendered from time to time to the Company. In fiscal 1999, no such person received in excess of $60,000 for such services. In fiscal 2001 and fiscal 2000, First Capital Group of Texas II, L.P., an investment firm managed by Jeffery P. Blanchard, the Company's Chairman of the Board, respectively received $74,000 and $71,000 in consulting fees. In February 2001, the Company received a 30-day loan from First Capital Group of Texas II, L.P in the amount of $150,000 that the Company repaid in March including a nominal amount of interest. In May 2001 First Capital Group of Texas II, L.P., as part of the Company's May private placement, invested $350,000 in the form of a convertible promissory note (see Note 9.)

In July 1998, and January 1999, the Company completed the first and second closings respectively, of a Private Placement (see Note 9) involving, among other things, the sale of its Series E and F Preferred Stock and related Common Stock Purchase Warrants to First Capital Group of Texas II, L.P., an investment firm managed by Jeffery P. Blanchard, the Company's Chairman of the Board, at an aggregate amount of $750,000 for each closing.

In fiscal 2000, two officers resigned their positions with the Company. The total severance and retirement package was approximately $480,000 and was recorded as an expense in fiscal 2000.

13) Employee Benefit Plans

Effective March 1, 1992, the Company adopted the DATA RACE, Inc. 401(k) Plan under section 401(k) of the Internal Revenue Code of 1986, as amended. Under the Plan, substantially all employees eligible to participate may elect to contribute up to the lesser of 15% of their salary or the maximum allowed under the Code. All full time employees with at least one year of continuous service and who have completed 1,000 work hours are eligible for the Plan. The Company may elect to make contributions to the Plan at the discretion of the Board of Directors. The Company made contributions of approximately $76,000 in fiscal 2001, $65,000 in fiscal 2000, and $68,000 in fiscal 1999. Subsequent to the close of its fiscal year on June 30, 2001, the Company terminated its 401k plan through board of director resolution on July 13, 2001. For the quarter ending June 30, 2001, the company opted not to match employee contributions.

In December 1993, the Company adopted the DATA RACE, Inc. Employee Stock Purchase Plan ("ESPP") pursuant to which eligible employees may purchase up to an aggregate of 200,000 shares of the Company's common stock at 85% of the fair market value of the common stock through payroll deductions. In 1997, the ESPP was amended to offer two consecutive six-month plan periods, beginning February 1 and August 1, respectively. Of the 200,000 shares available in this Plan, approximately 194,000 shares have been purchased as of June 30, 2001.

14) Legal Matters

On May 18, 2001, the Company, executive officers, Michael McDonnell, previously the President and Chief Executive Officer (resigned in July 2001), James Scogin, Acting President and Chief Financial Officer, and John Liviakis, one of our significant shareholders, were sued in the United States District Court for the Northern District of Illinois, Eastern Division, by Robert Plotkin, a Chicago-based attorney, and several of Mr. Plotkin's relatives and family trusts, who are all shareholders of the Company. The amount of the monetary damages being sought is $20,000,000. The complaint alleges that the plaintiffs were induced to purchase shares of our common stock based upon alleged misrepresentations and omissions of material fact. The proceeding has been moved to the United States District Court for the Eastern District of Texas, Sherman Division in October 11, 2001. Discovery has not commenced, but we believe the lawsuit is without merit and intend to vigorously defend the Company against these allegations.

The Company is not aware of any other legal matters.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended the Registrant has duly caused this report to be signed on behalf of the undersigned, thereunto duly authorized.

DATA RACE, INC., DBA IP AXESS

By: /s/ JAMES G. SCOGIN

James G. Scogin
President, Chief Financial Officer and
Principal Accounting Officer

Date: April 3, 2002