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DATA RACE INC
Form 10-K/A
February 15, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

AMENDMENT NO. 1
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) 265-4000
(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

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.

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.

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PART I.

ITEM 1. BUSINESS

DATA RACE, Inc. ("Data Race", "we" or the "Company"), currently doing business as IP AXESS, designs, manufactures, and markets a line of innovative communications products to meet the needs of remote workers. The Company's lead product, the VocalWare(TM) IP remote access system, provides virtual presence to the corporate environment by allowing a remote worker to connect to the corporate office over a normal dial-up telephone line or a number of broadband access mediums such as digital subscriber lines (DSL), cable modems, integrated services digital networks (ISDN), asynchronous transfer modes (ATM) and frame

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relay, and simultaneously have full access to the corporate data network, the office phone extension, and the office fax system.

Historically, the Company's revenue has come from custom modem and network multiplexer products. The Company's modem business comprised the design and manufacture of special custom modems on an original equipment manufacturer's (OEM) basis for the manufacturers of notebook computers. Today's notebook computers generally do not use such custom modems. The market for the Company's network multiplexer products has been in a state of steady decline. These units, deemed counterproductive to the future of the Company, have been either sold or discontinued. To develop a more reliable revenue base and a return to profitability, the Company is depending on the success of the VocalWare IP product line.

The Company's VocalWare IP product line is intended to capitalize on the communications requirements of the rapidly growing number of "teleworkers" who need convenient simultaneous access to all of their corporate information assets - voice, data and fax - when working from home or on the road. With VocalWare IP, a user can be logged in from home, a hotel room, or an airport lounge, reading e-mail and browsing the web. If a call comes into his normal office phone extension, an image of his office phone pops up on the screen and rings, showing Caller ID information. He can answer the phone, conference in colleagues, and transfer the call, all while continuing his data work. At the same time, he can read faxes sent to his office or can send faxes. The Company refers to this set of capabilities as Telepresence(TM). If working at home, normal home phone calls can also ring through while the data session continues, without requiring a second phone line.

The Company completed its second-generation development efforts in fiscal 2001, completing the evolution of its Be There! dial-up remote access solution into a integrated dial-up and broadband access server. This second generation solution allows users to access their office voice, e-mail, data and fax resources over any access medium dial-up or broadband and works with all of the leading manufacturers of voice and data products.

The Company seeks to capture a leadership position in the market for remote access solutions by capitalizing on its unique advanced technology, its patents, other intellectual property and on developing relationships with leading network and solution companies, which have influence with enterprise customers.

Industry Overview

The Company operates within the remote access segment of the digital communication products industry. VocalWare IP represents a new product category in this industry bridging the gap between traditional voice and data solutions. This industry has been characterized by high rates of growth and change due to the emergence of the

Internet and e-commerce. As the basis for value within the global economy shifts from goods to information, global instantaneous access to all forms of information, whether by phone, fax, or data link, is transitioning from a luxury to a necessity for businesses. This need to give dispersed-knowledge workers and consumers' instantaneous access to all forms of information has created a multi-billion dollar remote access market.

The Enterprise Market

As the workforce shifts from production worker to knowledge worker, the

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need for companies to physically cluster their workers is diminishing in many industries. Allowing employees to work at home or another location remote from the corporate office offers substantial advantages to the employer, to the employee, and to society as a whole. To the employer, remote work can yield improved productivity, reduced turnover, reduced facility cost, the ability to hire from a broader national labor pool, and an economical way of complying with the mandates of legislative initiatives such as the Clean Air Act, the Americans with Disabilities Act, and the Family and Medical Leave Act. To the employee, remote work offers improved quality of life by reducing commuting time and frustration, providing more family time, and the flexibility to live further from the workplace. To society, remote work can offer reduced traffic congestion and pollution.

Traditionally, companies have provided remote access services to their employees by purchasing and deploying data-only remote access hardware and software within the company. Recently, an increasing number of companies have begun to outsource their remote access capabilities to outside service companies.

Mobile Professional

The Company's VocalWare IP product line seeks to address the needs of so-called "mobile professionals," traveling workers who require efficient, readily available, phone, data, and fax connectivity to their offices. When working from a hotel room or airport lounge, a mobile professional often needs to retrieve and reply to e-mail, voice mail, and fax traffic, all within a very limited time. At other times, the mobile professional may need to work collaboratively with a colleague on a document while discussing it on the phone.

The Company believes that the needs of the mobile professional are uniquely met by the VocalWare IP system. We believe VocalWare IP's will increase a mobile professional's productivity by providing simultaneous phone, fax, and data connectivity to the office. When working from a hotel room or airport lounge, a mobile professional can use the VocalWare IP system to retrieve and reply to e-mail and fax traffic while simultaneously making phone calls and taking calls placed to his or her personal office phone. In addition to productivity improvements, VocalWare IP can yield hard-dollar savings for companies as a result of reduced cellular phone costs, hotel telephone surcharges and calling card rate long-distance charges.

Telecommuters

Over the past several years, an increasing number of companies have adopted telecommuting programs, either on a trial basis or as permanent programs, due to a variety of economic, social, and legislative pressures. Studies in the last few years have shown that there are substantial economic benefits to corporations with telecommuting programs. More importantly, numerous studies of telecommuting programs conducted in recent years have documented productivity improvements among telecommuters, typically in the range of 10% to 30%. Contributing to this improvement is the reduction in non-business discussions with colleagues and the longer hours worked after dinner or at other periods outside the traditional working day by someone whose office is in the home. Because a commute is not required,

companies are able to tap into labor resources for short peak-hour periods during the day in ways that were impractical before telecommuting. We believe the economic benefits currently outweigh the incremental costs by such a large margin that for the foreseeable future, technology, not price, will remain one

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of the major selection criteria for telecommuting products.

There are also a variety of legislative forces behind the increases in telecommuting. The Clean Air Act of 1990 encourages cities in non-attainment zones to implement plans to reduce automobile emissions. Telecommuting is a convenient and economical method of reducing such emissions. The Family and Medical Leave Act and the Americans with Disabilities Act both require companies to offer accommodations to workers who may not be able to work daily in the corporate office, but who may be able to work from home for all or part of a day.

In addition to the legislative and economic forces, there are significant social forces driving the increase in telecommuting. Eliminating the daily commute has clear benefits for the environment and for traffic. Telecommuting also improves workers' lifestyles as the time lost to commuting is recovered for more leisurely activities. In addition, the ability to spend the day at home with the family is attractive to many workers. For these and other reasons, studies report that telecommuting improves employee morale and reduces employee turnover.

With VocalWare IP, a telecommuter can use the office PBX or Centrex and its many features to send or receive network faxes and check e-mail all at one time using one conventional phone line. Incoming calls to the business phone ring immediately in the home so that telecommuting is completely transparent. Four-digit extension calls transfer automatically, so even co-workers cannot tell who is working from home. We believe VocalWare IP increases the productivity of telecommuters by allowing them to accomplish multiple tasks simultaneously.

Remote Call Center Workers

Call center workers are generally groups of workers that deal with customers over the telephone. Airline reservation centers are such an example in which workers are connected by phone to the customers and by a network to a computer database containing flight and space availability information. In certain applications, workers must also send and receive faxes. Incoming phone calls are typically routed through specialized computer systems to the next available worker. Computers allow the monitoring of individual and overall performance.

Hiring and employee scheduling are two of the most challenging and costly aspects of call center management. Many call centers operate on a 24 hour-a-day, 7 day-a-week basis, with peak call hours varying by industry, and by whether the call center is inbound, outbound or both. It is often more economical to staff the call center, at least partially, with part-time employees working from home. Such remote call center workers, often parents of young children who cannot afford to be away from home, can nevertheless work productively for a limited number of hours while their children are napping, at school, or otherwise occupied. Such part-time employees typically receive reduced benefits, making them less costly to their employers. Very substantial capital savings may also be realized, as additional facilities do not need to be built to house these workers. In June 2000, DataMonitor, a research firm in the call center market, estimated a cost saving of approximately \$6,000 per agent when using the VocalWare IP remote agent solution.

Without VocalWare IP, connecting remote workers to call centers is problematic. Such workers need a telephone connection to the customer and a simultaneous data connection to the database, and often the ability to send and receive faxes. To enable a remote call center worker to operate in this mode would generally require the installation of multiple additional telephone or ISDN lines to the worker's home. In addition to the expense of these connections, it may take

several months to get the service installed, connected, and operating properly. With the high turnover rates common among call center employees, it may not be feasible to have these services installed during the employee's tenure, and is typically economically impractical.

With the VocalWare IP system, the remote call center agent can use the office PBX and ACD systems with all of their functionality while they simultaneously access the corporate LAN for account information, as well as process screen pops. That means remote agents can send a network fax, access the Internet, and talk to a customer and review account information all at the same time. Incoming calls ring immediately at the remote site. Furthermore, a unique feature of the VocalWare IP system allows any calls placed to the worker's home phone to be re-routed through the call center and back to the worker. In this way, an emergency call from the school nurse, for example, will not be blocked because the worker's phone line is tied up with the connection to the call center. VocalWare IP provides the cost-effective, comprehensive solution that allows call center agents to work from home as productively as they would in the office.

Remote Offices

The benefits that VocalWare IP brings to the branch office are the ability to do true dynamic office space allocation. The flexibility of the VocalWare IP server and combination of voice and data over any IP connection enables the facilities manager to make every LAN outlet a portal to the enterprise's entire communication network. VocalWare IP reduces the need for customer premise equipment, such as physical devices, which many PBX extender products require. We believe VocalWare IP can save companies up to \$500 per user for every employee that is relocated to a branch office by eliminating the need for a switch technician to establish telephone service, reassign telephone numbers and reallocate inside wire to the new user. The enterprise VocalWare IP solution enables greater economies of scale and communications by aggregating all of the branch office traffic into headquarters, thereby allowing effective utilization of inter-exchange carriers and local exchange carriers. Once again, the enterprise is able to achieve greater economies of scale and communications by aggregating all of the branch office traffic into headquarters.

Another important feature for the branch offices is total flexibility no matter where the user moves in the enterprise. Whether the user is at the headquarters location or at a branch location, the LAN and voice communications are the same. With common dialing users retain all of their phone features. This means that employees who move between headquarters and branch locations are able to keep their same phone number and even more importantly, they do not have to learn new phone features and dial-in protocols. Since we are utilizing the centralized PBX instead of buying remote key systems and other remote access devices, we are getting more effective utilization of the enterprise network, thus enabling a greater ability to manage bandwidth requirements.

The use of hoteling or telecenters for office space allocation allows enterprises with a highly mobile workforce to dynamically assign office space based upon the need at that current time. Some of the key applications that fit a hoteling model are consulting firms, auditors, and in general any employer that has numerous employees that travel a good portion of the time.

Strategy

The Company strategy is to provide innovative, first-to-market,

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high-value-added solutions. In devising product solutions, The Company typically attempts to obtain input from prospective customers throughout the development process. The Company applies substantial engineering and technical capabilities to incorporate current remote access technologies, as well

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as the Company's own technological innovations and advances to the design of products intended to meet the market needs of the customer.

The Company believes that it has developed unique remote access technology for the integration of voice and data using Internet Protocols, and it has incorporated this technology into its VocalWare IP product line. The Company has focused its VocalWare IP sales efforts on the enterprise market segment. Its strategy has been to maintain a direct sales force while simultaneously developing distribution partners. The direct sales force is intended to sell directly to large potential customers and to support the initial sales efforts of the partners.

The Company's sales process relies on a four-step selling cycle. First, the salesperson calls upon a sales prospect to present and demonstrate the VocalWare IP product. In the second step, upon receipt of a conditional purchase order from the customer, The Company installs a trial system in the corporate offices of a prospect for technical evaluation. At the end of the specified trial period (usually 30 to 60 days) The Company will invoice the customer for the VocalWare product. In the fourth step, the Company anticipates that the number of users would then expand, as the benefits were experienced first-hand within the operating groups of the large target companies.

The Company believes that its strategy to generate significant sales to the enterprise market is dependent upon success in two important areas. First, the Company's sales resources are focused upon moving its early customers to rolling out the VocalWare IP products to a large number of their employees. The Company believes that such large-scale operational reference customers are critical to overcoming the Company's lack of name recognition and credibility in convincing new prospects to buy VocalWare IP. Second, the Company is attempting to establish one or more strategic relationships with other companies who have established name recognition and sales/distribution capabilities. The Company believes that such partnerships can greatly increase the visibility of its product with prospective customers and provide these partners with a unique solution to offer their customers. The Company is participating in a telecommuting "Proof of Concept" with a US government agency where the Company has installed a VocalWare server in November 2001 for testing purposes. A "Proof of Concept" is not a contract. Neither we nor the US government agency involved is committed to purchase the product during or after the term of the "Proof of Concept".

Products

VocalWare IP Remote Access System

VocalWare IP is a remote access system which allows a worker who is away from his office to connect in over a conventional phone line, or broadband connection such as DSL, ISDN or cable modem service, and have simultaneous access to his office telephone, fax, data network and Internet connections. The user can be connected from home or from a hotel room, anywhere in the world that Internet access is available. While reading and writing e-mail, synchronizing notes and calendars and surfing the Internet, a colleague or an outside caller calls the user's office. An image of the user's office phone pops up on his screen, rings and presents the caller's ID without interrupting the data

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connections. He answers the phone and carries on a normal business conversation while continuing to read e-mail and do other data work. He can also send a fax to the person he is talking to (or to anyone else) and receive faxes sent to his office while continuing to talk and use the full data capabilities. He can conference in colleagues in his office or transfer the call to colleagues by simply using the same button sequence on his phone that he would use if he were in the corporate office.

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Existing Approaches

The needs of teleworkers are currently being met by a variety of partial solutions, including computer modems and remote access servers to provide data connectivity; telephones (including cellular phones), PBX extenders, DSL, and a variety of software products and communications services providing some degree of phone access; and fax servers, fax modems, and software, as well as remote physical fax machines to support remote fax access. Although technology is advancing rapidly, the partial solutions currently available typically require multiple phone lines or ISDN lines, which are often unavailable and are generally expensive where they are available. These solutions also generally require that the user act as systems integrator to cause all of these disparate systems and services to function in unison. Such partial solutions fail to accomplish the fundamental objective of a remote access system, namely to allow teleworkers to perform their jobs at remote locations just as effectively as they would in their offices.

The VocalWare IP Solution

To address the teleworker market needs, the Company has developed the VocalWare IP system. With the VocalWare IP remote access system, e-mail, file server, intranet, Internet, fax and other data connections are supported, as they would be in the office. An image of the worker's office telephone appears on the worker's computer screen and has the same functions it would have in the office. The teleworker can dial colleagues or place local or long-distance calls through the company's WATS lines as if present in the office. Colleagues who dial a teleworker's extension, or outsiders who call in on the teleworker's corporate office direct line, will automatically and immediately be connected to the teleworker in the remote location, all without disturbing the data connections on which the teleworker is reading e-mail or browsing the Web. At the same time, the teleworker can send and receive faxes over the company's fax server, again without interrupting the phone and data connections. The Company refers to this transparent combination of data, fax, and voice features that enable a remote worker to operate just as he or she would in the office as Telepresence(TM).

Current Product

A VocalWare IP remote access system is made up of client software and accessory products installed on the user's desktop or notebook computer, and a server installed at the office. These components, along with their connections, are diagrammed in Figure 1.

[GRAPHIC OMMITED]

VocalWare IP is the next generation of the Company's integrated IP based voice and data solutions. The VocalWare IP, which includes patented voice-quality technology, utilizes the powerful new generation of Pentium processors to perform speech and data compression, as well as multiplexing functions while using the computer's microphone speaker and sound systems to act

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as a telephone. The equipment is easy to install, use and manage and the VocalWare IP Enterprise Access server is able to communicate with any industry-standard v.90-capable modem. VocalWare also features a comprehensive suite of simulated phones that provide a user-friendly interface and function as a user's own office environment.

The Company has also released two other client accessory products for inclusion in the VocalWare IP family - VocalWare(TM) Turbo, and VocalWare(TM) RealPhone. These new products provide the benefits of VocalWare 56k bandwidth, improved voice quality and flexibility for those users whose systems do not fully meet the basic requirements for VocalWare.

The VocalWare Turbo is designed to work with laptops. It takes the place of the sound-system and off-loads voice compression from the CPU. The RealPhone, which targets desktop

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systems, connects to a standard home telephone (including cordless phones) and features an industry-standard modem in addition to the functions of VocalWare Turbo. This enables it to replace the previous generation of client cards.

The VocalWare IP Enterprise Access Server transforms a computer into an office. When in the office, a user simply connects to the office network and works normally. When at home, the user can connect with cable modem, DSL line, ISDN line or a dial-up modem and click on the VocalWare IP icon to be connected to the office network, telephone and fax. The VocalWare IP Enterprise Access Server supports V.90 (so-called "56k") connections, higher port densities to support greater numbers of users per server, redundant fault-tolerant configurations, voice over IP connections and users connecting over Local Area Networks (LANs), DSL lines and cable modems.

Technology and Product Development

The Company believes that the extension and enhancement of the existing VocalWare product line and the development of new products that leverage state-of-the-art local and wide-area connectivity technologies to provide remote access to both corporate data and telephony facilities are critical to its future success. The Company seeks to implement its innovative products using the latest industry standards and technologies, thus enabling the Company to develop and introduce products quickly in response to customer requirements and identified market trends.

When appropriate industry standards are not available, The Company may, from time to time, seek to introduce and promote the required new standards in the various industry forums and standards organizations.

The Company regularly uses information derived from interaction with key customers, its distribution channel partners, participation in industry standards organizations, and market and technical research to set its development directions and make design and product decisions.

Users of the Company's products for telephone communication expect a standard of reliability closer to that for normal telephony than that for normal data communications software and other software applications. As a result, the Company's development priorities include significant testing, quality assurances as well as focus on a development and planning methodology and processes.

Company-sponsored research and development expenses for continuing operations were \$5.0 million, \$3.3 million, and \$2.4 million for fiscal years

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2001, 2000, and 1999, respectively.

Manufacturing and Suppliers

The Company purchases key components used in the manufacture of its products from third-party suppliers. The Company does not have any agreements with component suppliers as the Company ordinarily avoid fixed long-term commitments for components. This allows the Company to better coordinate component inventory build-up and to select suppliers who have the most technologically advanced, cost-effective components available at the time. The Company also does not have any manufacturing agreements.

The Company has moved all of its production for customer goods to outside turnkey system integrators. We qualify and monitor our system integrators and subcontractors through a stringent vendor-quality program to ensure they consistently provide a quality product on time.

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This strategy was adopted to increase our flexibility and effectiveness in responding to customer needs. At the same time, it allows us to reduce our overall manufacturing costs by leveraging key strategic partnerships developed by our system integrators with their suppliers. We are continually searching to find top quality system integrators and subcontractors to ensure that we can always meet our customers' requirements with the highest quality product.

Marketing, Sales, Distribution and Support

In order to successfully penetrate the enterprise market, the Company believes that it will need to maintain a small direct sales force while simultaneously developing distribution partners. The small direct sales force is intended to sell directly to large potential customers and to support the initial sales efforts of the partners. The product is distributed to customers in one of two ways: 1) shipped directly from the Company on direct sales or 2) shipped directly to the resellers who ship to the end customer. Customer support is through the Company's technical support group which is staffed five days a week during normal business hours.

Competition

Historically, there has been little to no other direct competition with VocalWare. We believe VocalWare is the only product in the remote access segment that can connect remote workers through a conventional phone line connection or a broadband connection through the VocalWare IP server. However, there are alternative solutions available today and other related products and services have recently been announced. Many prospective customers, especially "mobile professionals", can use a cell phone along with a notebook computer and modem to receive many of the benefits of VocalWare. Certain PBX extender products (including those from MCK, Multitech, and TelTone) can provide some of the benefits of VocalWare to teleworkers working from home. In addition, ISDN, DSL and cable modem services provide some of the benefits of VocalWare, in that they can provide simultaneous voice and data without tying up the primary home phone line. In this dynamic market, new products or services are announced frequently and many of these may provide competitive solutions to our prospective customers.

There can be no assurance that competitors will not introduce comparable or superior products incorporating more advanced technology at lower prices. See "Certain Business Risks - We May Not Be Able to Compete Effectively with Companies Having Greater Resources."

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Intellectual Property

The Company's success depends in part upon its proprietary technology, including both its software programs and its hardware designs. The Company relies upon patent, copyright, trademark, and trade secret laws to protect its proprietary technology. The Company generally enters into nondisclosure agreements with persons to whom it reveals its proprietary information, such as component suppliers, subcontractors, and OEMs that the Company works with concerning future products. Although it is unusual in the industry for patents to be of substantial strategic value, the Company has ongoing programs seeking patent and other intellectual property protection for its technologies and products, and it sometimes grants licenses of its technology to other companies. There can be no assurance that the Company's present protective measures will be adequate to prevent misappropriation of its technology or independent third party development of the same or similar technology. Many foreign jurisdictions offer less protection of intellectual property rights than the United States, and there can be no assurance that the protection provided to the Company's proprietary technology by the laws of the United States or foreign jurisdictions will be sufficient to protect the Company's technology.

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While the Company's competitive position may be affected by its ability to protect its proprietary information, the Company believes that the rapid pace of technological change in the remote access products industry will cause other factors to be more significant in maintaining our competitive position. These factors include the technical expertise, knowledge and innovative skill of our management and technical personnel, name recognition, the timeliness and quality of support services provided by us and our ability to rapidly develop, produce, enhance, and market innovative products.

In the current market, in which voice and data communications are converging rapidly, the Company believes that the intellectual property of its "virtual presence to an office" product innovations may be of significant strategic value. Therefore, the Company protects its new ideas by regularly filing patent applications on new product concepts and implementation methods. In June 1998, the United States Patent and Trademark Office issued patent number 5,764,639 entitled "System and Method for Providing a Remote User with a Virtual Presence to an Office." This patent will expire in November 2015. The patented system and method provide remote users with the ability to work outside of the office just as if they were physically located in the corporate office. The Company also has other patents issued and pending related to the VocalWare IP product technology. The Company intends to aggressively protect its rights under its patents. See "Certain Business Risks - We Depend upon Our Proprietary Technology and We May Not Be Able to Adequately Protect It."

We commonly enter into licensing agreements with suppliers of components that it desires to incorporate into its products. The Company may choose to obtain additional licenses in the future, but believes that any necessary licenses could be obtained on terms that would not have a material adverse effect on our business.

Significant Customers

During fiscal year ended June 30, 2001, we recorded revenues from shipments of approximately 85% from three customers. The customers were Deloitte & Touche LLP for approximately \$22,000, Motorola Inc. for approximately \$21,000, and Minnesota National Guard for approximately \$10,000. During fiscal years ended June 30, 2000 and 1999 revenues from shipments to and fees from Sabratek

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represented approximately 65% and 50% of revenues from continuing operations respectively.

Backlog

The Company's backlog at June 30, 2001 was not significant. The Company does not believe that its backlog as of any particular date is necessarily indicative of future sales because, as is customary in the industry, the Company often allows changes in delivery schedules or certain order cancellations without significant penalty, and because the time between order placement and shipment is short.

Employees

As of June 30, 2001, the Company employed 77 employees, including 8 in manufacturing, 33 in engineering, 20 in sales, marketing and customer support, and 16 in general and administration. None of our employees is represented by a labor union. Subsequent to the fiscal year end we substantially reduced our workforce to 6 employees. The Company believes its relations with its employees are good. Competition for qualified personnel is intense, especially for talented engineers and senior marketing personnel, and the Company believes that

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its prospects for future growth and success will depend, in a significant part, on its ability to retain and continue to attract highly skilled and capable personnel in all areas of operations.

Certain Business Risks

This Report contains certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements, which are often identified by words such as "believes", "anticipates", "expects", "estimates", "should", "may", "will" and similar expressions, represent our expectations or beliefs concerning future events. Numerous assumptions, risks, and uncertainties, including the factors set forth below, could cause actual results to differ materially from the results discussed in the forward-looking statements.

We Have Received a "Going Concern" Opinion from Our Independent Accountants and May Be Forced to Sell or Merge Our Business or Face Bankruptcy Unless We Are Able to Immediately Raise Capital to Fund Our Near Term Cash Needs

The report of Lazar Levine & Felix LLP covering the financial statements for fiscal 2001 included in this report contains an explanatory paragraph that states that the Company's recurring losses from operations and accumulated deficit raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments to asset carrying values or the classification of liabilities that might result from the outcome of that uncertainty. The Company will need to raise more money to continue to finance our operations. The Company 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. The going concern opinion by our independent auditors may adversely impact our dealings with third parties, such as customers, suppliers and creditors, because of concerns about our financial condition.

The going concern modification is contained in an explanatory paragraph to the Independent Accountants' Report that also references note 3 to the financial

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statements for the year ended June 30, 2001. Note 3 states that the following factors raise substantial doubt about our ability to continue as a going concern: (i) we have generated net losses for the years ended June 30, 2001, 2000 and 1999 and have generated an accumulated deficit of \$ 72.5 million as of June 30, 2001, (ii) we have historically funded operations with the proceeds from the sale of preferred and common stock and (iii) we have not generated positive cash flows from operations in either of the three years in the period ended June 30, 2001.

We anticipate that we will have insufficient working capital to fund our near term cash needs unless we are able to raise additional capital in the near future. Any failure to obtain an adequate and timely amount of additional capital on commercially reasonable terms will have a material adverse effect on our business, financial condition and the results of operations, including our viability as an enterprise, and we may be forced to sell or merge our business or face bankruptcy unless we are able to timely raise additional capital.

We Have a History of Operating Losses and Expect to Have Continued Losses

We have suffered substantial recurring losses, and sales of our VocalWare products have not resulted in significant revenue. For the fiscal years ended June 30, 2001, 2000 and 1999 we have incurred operating losses (from continuing operations) of approximately \$16.8 million, \$8.8 million and \$8.5 million on approximately \$63,000, \$316,000 and \$836,000 of VocalWare sales respectively. Although we have made reductions in workforce and associated expenses since

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July 2001, we may never return to profitability or attain future revenue levels sufficient to support our operations. In recent years we have funded operations from the sale of equity securities.

We Will Need Additional Capital to Sustain Operations

Because we have been unable to raise sufficient capital financing recently, we have been required to suspend many of our operations and scale down our operations. We may be required to suspend additional or all of our operations if we cannot obtain additional long-term financing. It is possible that sources of capital, such as investors, lenders or strategic partners, may perceive our recent history of losses, current financial condition, reduction in the scope of our operations or lack of significant VocalWare product sales as too great a risk to bear. As a result, we may not be able to obtain additional capital on favorable terms, if at all. Further, if we issue equity securities, shareholders may experience additional dilution or the new equity securities may have rights and preferences senior to the common stock. Even if our sales grow, we may require additional capital to hire additional personnel and increase inventory levels. We cannot predict the timing and amount of our future capital requirements.

Finally, there can be no assurance that we will be able to access additional funds under our equity line of financing with Grenville Finance Ltd. First, before we are permitted to draw down on the equity line of credit financing, a registration statement registering for resale the shares to be issued to Grenville under the financing must be declared effective by the Securities and Exchange Commission. We can give no assurance and may be unable to cause the registration statement to be declared effective. Second, the maximum draw down amount of a draw down under our equity line facility will be equal to (A) the lesser of (i) \$1,000,000 and (ii) 15% of the weighted average price for our common stock for the 30 calendar day period immediately prior to the date that we deliver notice to the Investor of our intention to exercise a

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draw down multiplied by (B) the total trading volume in respect of our common stock for such period. Accordingly, if our stock price and trading volume do not increase above current levels, then the maximum draw down amount formula will severely restrict our ability to draw down all \$30,000,000 pursuant to the equity line facility with Grenville.

We Have Limited Liquidity and Capital Resources

We have limited liquidity and capital resources and must obtain substantial additional capital to support our research and development, sales and marketing initiatives and general corporate purposes. If we do not obtain the necessary capital resources, we may have to delay, reduce or eliminate some or all of our initiatives.

If we are unable to draw down on our equity line or choose not to do so, we intend to pursue our needed capital resources through equity and debt financings and strategic partnerships. We may fail to obtain the necessary capital resources from any such sources when needed or on terms acceptable to us.

Our Future Success Depends on the Success of Recently Introduced VocalWare Products

Our success depends almost entirely on the success of our VocalWare product line. The VocalWare products have not yet been and may never be widely accepted in the market. We cannot assure the reader that we will establish a market for VocalWare products or establish our credibility in that market. The market may elect to embrace alternative products or service solutions to satisfy the need for communication between the corporate headquarters and workers who are away from their headquarters. The Be There! system which was the predecessor to

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VocalWare had very limited success and failed to generate significant revenue from the time it was released in 1997. The majority of our historical revenue has come from products other than Be There!/VocalWare, and we are no longer manufacturing or selling those other products. In March 2000, we sold our network multiplexer business segment to concentrate all our efforts on the VocalWare product line. Our inability to penetrate our target markets and increase VocalWare sales would materially and adversely affect our business and operations.

Our Dependence on Third Party Manufacturers and Third Party Component Suppliers Increases Potential Manufacturing Problems and Adversely Affects Our Customer Relationships and Operating Results

In fiscal year 2001 we outsourced all of the manufacturing of our products. Because of this reliance on third party manufacturers we cannot always exercise direct control over manufacturing quality and costs. We use third party component suppliers to provide components for our manufacturing of our products. Because of this reliance on third party component suppliers, we can experience delays in the manufacturing of our products based on external demands the third party component suppliers may face in component allocations, component shortages and component suppliers financial viability. We may also have problems with production schedules of our products because of other demands placed on the third party manufacturers and component suppliers.

We May Not Be Able to Respond Effectively to Rapid Technological Change in Our Industry

The rapid pace of technological change may prevent us from developing and

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marketing new products, enhancing our existing products, or responding effectively to emerging industry standards or new product introductions by others. Our future success will be largely dependent on our ability to enhance our existing products and to develop and introduce successful new products. Rapidly changing technology, emerging industry standards, product proliferation and short product life cycles characterize the market for our products. As the technical complexity of new products increases, it may become increasingly difficult to introduce new products quickly and according to schedule. Delays in developing or shipping new or enhanced products could adversely affect our operating results and customer relationships.

We May Not Be Able to Compete Effectively with Companies Having Greater Resources

The communications industry is intensely competitive. Several of our existing and potential competitors have far more extensive financial, engineering, product development, manufacturing, and marketing resources than we have. As a result, these competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote much greater resources to the development, promotion, and sale of their products and services than we can. Many of these competitors have far greater brand recognition, which places us at a competitive disadvantage for product acceptance with an established competitor. In addition, some competitors have a lower cost structure that gives them a competitive advantage on the basis of price due to their financial condition and purchasing power. There is a growing array of solutions for communication between the corporate headquarters and remote workers, presenting a variety of alternatives to our VocalWare products. We expect new competing alternatives to arise as new technologies develop. There can be no assurance that consumers will choose our solution.

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Our Business Could Suffer if We Lose Key Personnel or Cannot Attract Qualified Personnel

Our success is dependent largely on the skills, experience and performance of key management, sales and technical personnel. We are especially dependent on our senior officers and VocalWare products sales executives. Michael McDonnell resigned his positions as President and Chief Executive Officer of the Company and as a member of our Board of Directors on July 11, 2001, and we do not yet know the extent to which his departure will adversely affect our business. James G. Scogin, our chief financial officer since December 1999, has succeeded Mr. McDonnell as President and Mr. Scogin has no prior experience as the president or chief executive officer of a business. We have also substantially reduced our staff to six full time employees to reduce our monthly cash expenditures. We do not yet know the extent to which this reduction in staff will adversely affect our business. We are also dependent on key technical personnel to introduce new products and to remain in the forefront of technological advances. Due to the complexity of our product, the loss of key personnel affects us in the time it would take to replace the personnel and train them in our product, if we could replace them at all. None of our senior executives or other employees has employment contracts with us and may leave our employ at any time and engage in competitive ventures. We do not have any insurance on our employees. Our future success will also depend on our ability to attract highly skilled personnel. Competition for qualified personnel is intense in our industry and we may not be able to retain our key employees or attract and retain other qualified personnel.

We Depend upon Our Proprietary Technology and We May Not Be Able to Adequately Protect It

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Intellectual property laws of the United States and foreign countries may not be adequate to protect our proprietary rights. Because our success depends in part on our technological expertise and proprietary technologies, the loss of our proprietary rights could have a material adverse effect on our business. We rely on trade secret protection and, to a lesser extent, on patents and copyrights to protect our proprietary technologies. These steps may not be adequate to deter misappropriation or infringement of our proprietary technologies. Competitors may also independently develop technologies that are similar or superior to our technology. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent, as do the laws of the United States. We have in the past and may in the future be involved in intellectual property litigation, which could adversely affect our intellectual property rights, could be costly, and could divert management's attention away from the business. We may be required to bring or defend against litigation to enforce our patents, to protect our trademarks, trade secrets, and other intellectual property rights, to defend against infringement claims, to resolve disputes under technology license arrangements, and to determine the scope and validity of our proprietary rights or those of others. Our limited resources may limit our ability to bring or defend against intellectual property litigation. Adverse determinations in litigation, including litigation we initiate, could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties, or prevent us from manufacturing or selling our products.

Our Levels of Inventory Could Adversely Affect Our Liquidity and Viability or Increase the Risk of Inventory Write-Offs

Our business and financial condition could be materially adversely affected if we do not effectively manage purchasing activities in the face of uncertain revenue levels. In the past we have substantially increased our inventory levels to meet anticipated shipment requirements. Increased levels of inventory without corresponding sales could adversely affect our cash flow and increase the risk of inventory write-offs pertaining to slow moving or obsolete product.

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Failure of Our Products to Meet FCC and other Regulatory Standards Could Delay the Introduction of New Products or Require Us to Modify Existing Products

The failure of our products to conform to the regulations established by the Federal Communications Commission or similar foreign regulatory bodies or to meet applicable testing requirements could adversely affect our business. The FCC and foreign regulators regulate aspects of our products. Our products must typically be tested before they are sold. Foreign authorities often establish telecommunications standards different from those in the United States, making it difficult and more time consuming to obtain the required regulatory approvals. A significant delay in obtaining regulatory approvals could delay the introduction of our products into the market and adversely affect operating results. In addition, changes in regulations or requirements applicable to our products could affect the demand for our products or result in the need to modify products, either of which could involve substantial costs or delays in sales and adversely affect our operating results.

Our Common Stock has been Delisted by the NASDAQ National Market

Effective July 11, 2001, our common stock was delisted by The Nasdaq National Market due to our failure to pay overdue annual and additional listing fees in the amount of \$44,125 and our inability to meet the minimum bid price requirements for continued listing. Effective November 6, 2001, our common stock

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was delisted from the Over the Counter Bulletin Board (OTCBB) for failure to timely file reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934. Our common stock continues to be traded on the "pink sheets" under the symbol "RACE". We can provide no assurance that an active public trading market for our common stock will be re-established.

The Issuance of Stock Pursuant To The Equity Line of Credit With Grenville May Substantially Dilute the Interests of Other Security Holders Because the Number of Shares the Company Will Sell Depends upon the Trading Price of the Shares During Each Draw Down Period

The shares issuable to Grenville pursuant to the equity line of credit will be issued at a 17.5% discount to the average daily price of the common stock. The number of shares that the Company will sell is directly related to the trading price of its common stock during each draw down period. As the price of the Company's common stock decreases, and if the Company decides to draw down on the equity line of credit, it will be required to issue more shares of our common stock for any given dollar amount invested by Grenville. Accordingly, the shares of common stock then outstanding will be diluted.

The Issuance of Stock Pursuant to the Conversion of the 6% and 10% Convertible Debentures May Substantially Dilute the Interests of Other Security Holders Because the Number of Shares the Company Will Issue upon Conversion Will Depend upon the Trading Price of Our Common Stock at the Time of Conversion if the Trading Price Is Less Than the Set Price of the Debenture

The holders of the our 6% convertible debentures may elect to convert the debentures into shares of our common stock at any time at a discount of the lesser of 110% of the market price of our common stock as of the date of issuance of the debentures and 50% of the average of the 5 lowest closing bid prices of our common stock during the 20 business days immediately preceding the date notice of conversion is given to us by the holder. The table set forth below outlines the number of shares of common stock that would be issuable upon conversion in full of the debentures at several hypothetical conversion prices. The table also sets forth the total

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number of shares the investors would beneficially own at such hypothetical adjustment prices, and assuming exercise in full of the warrants, and the percentage that such shares would constitute of our resulting outstanding common stock, assuming the investors had not purchased or sold any of our securities.

Hypothetical Conversion Price (1)	Shares Issuable Under Convertible Debentures (1)	Shares Issuable Under Warrants	Total Shares Issuable to Investors	Total Shares as a Percent of Outstanding Stock (2)
-----	-----	-----	-----	-----
\$0.01	113,000,000	1,000,000	114,000,000	322.32%
\$0.05	22,600,000	1,000,000	23,600,000	66.73%
\$0.10	11,130,000	1,000,000	12,130,000	34.78%
\$0.154(3)	12,356,828	1,000,000	13,356,828	37.76%

(1) Assumes conversion in full of all \$1,130,000 principal amount of convertible debentures at the hypothetical conversion price set forth

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above. Assumes interest is paid in cash and not in shares of common stock.

(2) Based on 35,373,477 shares of common stock outstanding on November 9, 2001, plus the shares issuable to the investors under the debentures and the warrants shown above.

(3) At floating conversion prices above \$0.154 per share, the investors would convert at the fixed conversion price of, as to \$500,000 principal amount of convertible debentures, \$0.154 per share, as to \$240,000 principal amount of convertible debentures, \$0.0715 per share, as to \$130,000 principal amount of convertible debentures, \$0.0561 per share and, as to \$277,499 principal amount of convertible debentures, \$0.0484 per share.

The Sale of Material Amounts of the Company's Common Stock Could Reduce the Price of Its Common Stock and Encourage Short Sales

As the Company sells shares of its common stock pursuant to the equity line of credit and then Grenville sells the common stock, the Company's common stock price may decrease due to the additional shares in the market. The price may also decrease if the holders of the convertible debentures elect to convert the debentures into common stock and to sell the common stock. As the price of our common stock decreases, and if the Company decides to draw down on the equity line of credit, it will be required to issue more shares of its common stock for any given dollar amount invested by Grenville, subject to a designated minimum threshold price specified by us. This may encourage short sales, which could place further downward pressure on the price of the Company's common stock.

Our Stock Price is Highly Volatile

The market price of our common stock in the past has been highly volatile, and likely will continue to be highly volatile. This is caused in part by the relatively low aggregate market value of our publicly traded shares. Events or circumstances may cause a much greater percentage change in the market price of our shares than the market price of a company with a higher aggregate market value. There are many events or circumstances, including those highlighted in these risk factors, which could cause the market price of our stock to fluctuate. Many of those events or circumstances are outside our control. In addition, stock prices for many technology companies fluctuate widely for reasons unrelated to their business, financial condition or operating results.

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Our Business May Be Adversely Affected by Class Action Litigation Due to Stock Price Volatility

The filing of securities class action litigation against companies often occurs following periods of volatility in the market price of a company's securities. We are currently and may in the future be a target of securities litigation. See "Item 3. LEGAL PROCEEDINGS." Securities litigation could have a material adverse effect on our business if it is filed against us because it could result in substantial costs and a diversion of management's attention and resources. It may also adversely affect our ability to raise capital, our sales efforts, and our ability to attract a strategic partner.

We could be required to pay infringement damages, licensing fees or modify our products if our products are found to be infringing upon the rights of others

It is common in the computer industry for companies to assert intellectual property infringement claims against other companies. As a consequence, the

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Company indemnifies some OEM customers in certain respects against intellectual property claims relating to our products. The Company presently is not aware of any material intellectual property claims pending against it. If an intellectual property claim were brought against the Company and one of Company's products were found to be infringing upon the rights of others, the Company could be required to pay infringement damages, pay licensing fees, modify its products so that they are not infringing, or discontinue offering products that were found to be infringing, any of which could materially adversely affect our business and results of operations. In addition, the assertion of such claims against one or more of the Company's vendors could adversely affect the availability from those vendors of components used by us.

The "penny stock" rules may restrict the ability of broker-dealers to sell the Company's securities in the secondary market.

The trading of our shares is subject to limitations set forth in Rule 15c-9 of the Securities Exchange Act. This rule imposes sales practice requirements on broker-dealers who sell so-called penny stocks to persons other than established customers, accredited investors or institutional investors. Accredited investors are generally defined to include individuals with a net worth in excess of \$1,000,000 or annual income exceeding \$200,000 or \$300,000 together with their spouses during the previous two years and expected annual income of that amount during the current year. For sales of shares to other persons, broker-dealers must make special suitability determinations, and obtain the written consent of the purchaser to the sale prior to consummating the sale and are generally prohibited from making cold-calls or other unsolicited inquiries to purchasers without complying with these rules. These rules may adversely affect the ability of broker-dealers and others to sell our shares or to sell shares in the secondary market.

ITEM 2. PROPERTIES

In June 2000, the Company's corporate headquarters, sales and marketing, product development and engineering were relocated to Plano, Texas and consist of one building totaling approximately 10,000 square feet of leased space. Also, the Company had a facility for distribution, co-engineering, accounting and sales and technical support in one building totaling approximately 21,000 square feet of leased space in San Antonio, Texas. In August of 2000, a second building located in San Antonio, Texas of approximately 29,000 square feet was subleased. The building located in Plano, Texas, is subject to a five-year lease that commenced in June 2000. The buildings located in San Antonio, Texas, consisting of approximately 21,000

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and 29,000 square feet, are subject to ten- and seven-year leases, respectively, which commenced in April 1996. In August 2001, the Company terminated its lease for 21,000 square feet in San Antonio, Texas and leased approximately 1,000 square feet in San Antonio, Texas for distribution and accounting. This lease is on a month-to-month term. The Company believes that its existing facilities are adequate to meet current requirements, including foreseeable short-term requirements to support the growth of its VocalWare product line.

ITEM 3. LEGAL PROCEEDINGS

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

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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.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock was traded on the NASDAQ National Market under the symbol RACE since the Company's initial public offering on October 7, 1992. For the two most recent fiscal years ended June 30, 2000 and June 30, 2001, the following table lists on a per share basis for the period indicated, the high and low reported sale prices for the Company's Common Stock as quoted on, prior to July 11, 2001, the NASDAQ National Market, after July 10, 2001 and prior to November 6, 2001, the OTCBB and after November 5, 2001 the "pink sheets". These price quotations reflect inter-dealer prices, without adjustment for retail mark-ups, markdowns or commissions and may not necessarily represent actual transactions.

Period	High	Low
-----	----	---
July 1, 1998 to September 30, 1999	\$3.75	\$2.25
October 1, 1998 to December 31, 1999	5.00	.875
January 1, 1999 to March 31, 2000	6.875	2.50
April 1, 1999 to June 30, 2000	8.50	2.813
July 1, 1999 to September 30, 2000	6.75	4.375
October 1, 1999 to December 31, 2000	5.625	.75
January 1, 2000 to March 31, 2001	1.75	.359
April 1, 2000 to June 30, 2001	.93	.07

As of January 31, 2001, the last sale price of the Company's Common Stock was \$0.05 as reported on the "pink sheets". As of January 31, 2001, there were 231 shareholders of record, although the Company believes that the number of beneficial owners is significantly greater.

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The Company has never declared or paid cash dividends on the Common Stock. The Company presently intends to retain earnings, if any, for the operation and development of its business and does not anticipate paying any cash dividends on the Common Stock in the foreseeable future. Future earnings, capital requirements, the financial condition and prospects of the Company, and other relevant factors as determined by the Board of Directors, will influence the determination of any future cash dividend decisions. There is no assurance that the Company will pay any dividends in the future.

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data presented below for, and as of the end of, each of the fiscal years in the five-year period ended June 30, 2001, are derived from the audited financial statements of DATA RACE, Inc. The selected financial data should be read in conjunction with the Company's financial statements and notes thereto appearing elsewhere in this report and "Management's Discussion and Analysis of Financial Condition and Results of Operations".

	Fiscal Years Ended June	
	2001	2000
	(in thousands, except per s	
Operating Statement Data:		
Revenue from continuing operations	\$ 63	\$ 316
Cost of revenue	1,345	762
Gross profit (loss) from continuing operations	(1,282)	(446)
Total operating expenses from continuing operations	14,964	9,030
Operating loss	(16,246)	(9,476)
Other (loss) income, net	(530)	440
Income (loss) from continuing operations	(16,776)	(9,036)
Income (loss) from discontinued operations	--	218
Net loss	\$ (16,776)	\$ (8,818)
Loss per share:		
Net loss	\$ (16,776)	\$ (8,818)
Effect of beneficial conversion features of convertible preferred stock	--	(235)
Net loss applicable to common stock	\$ (16,776)	\$ (9,053)
Net loss per common share -basic and diluted	\$ (.60)	\$ (0.41)
Weighted average shares outstanding	27,812	21,940
Balance Sheet Data (at year end):		
Working capital (deficit)	\$ (1,274)	\$ 10,290
Total assets	3,647	13,192
Shareholders' equity (deficit)	(562)	11,728

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

From its inception in 1983, the Company has designed, manufactured, and marketed advanced technology communication products. The Company's strategy is to provide innovative, first-to-market, high-value-added solutions to meet the needs of knowledge workers who are remote from their headquarters office.

During fiscal year 2001, the Company completed the development of the VocalWare IP integrated server by integrating the dial up remote access solution of the formerly marketed Be There! product line with the broadband remote access solution of the VocalWare product line. This solution allows users to access their office voice, e-mail, data and fax resources over any access medium with all of the leading manufacturers of voice and data products. The Company entered into beta program agreements with a major global carrier, a major cable provider, a major airline and an agency of the federal government for the VocalWare IP integrated server. From the beta agreements the Company shipped 35 VocalWare servers and 840 VocalWare user licenses for approximately \$701,000 and entered into an exclusive licensing rights agreement for approximately \$365,000 with LINUX.

In January 2001, these servers were returned based on non-payment from LINUX and the Company notified LINUX that the exclusive licensing rights agreement had been terminated. The Company in the quarter ended December 31, 2000 reversed the accounts receivable and deferred revenue for approximately \$365,000. During the second quarter of fiscal 2001, the Company shipped \$625,000 of servers and user licenses to a reseller. This transaction was not recorded as revenue as the transaction did not meet the Company's criteria for revenue recognition. The reseller was given extended terms over normal reseller agreements. In July 2001, the reseller returned the servers and user licenses back to the Company based on the uncertainty of the Company continuing as a going concern.

The Company was disappointed in its revenue for the fiscal year. This was based on the following factors. (i) A longer sales cycle than originally planned. The Company originally planned for a sales cycle of 30 days where the potential customer would place an order after a 30-day trial period. In reality the sales cycle can be as long as one year. (ii) A decline in the general economic conditions in the telecommunications industry and decreases in spending for information technology. (iii) The Company's inability to show its viability as a going concern. Potential customers have concerns about the Company's ability as a going concern. The VocalWare IP product line is considered a strategic asset of the customer and questions concerning the viability of the Company can delay or terminate potential orders.

The Company's goal of returning to profitability and developing a more dependable revenue base depends on the success of the VocalWare IP product line. Although the Company has not recorded significant revenue from sales of the VocalWare IP product line, the Company has expended substantial resources on its development and market introduction.

Fiscal 2001 Compared to Fiscal 2000 for Continuing Operations

Total revenue from continuing operations in fiscal 2001 decreased 80.2% to approximately \$63,000 from approximately \$316,000 in fiscal 2000. This decrease is attributable to the following conditions: 1) the financial condition of the Company as a viable ongoing business, 2) the longer than expected sales

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cycle of placing the product with a potential

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customer and receiving an order, and 3) the changes in general economic conditions and specific market conditions in the communications industries and the overall decrease in information technology spending.

Total gross profits (loss) from continuing operations in fiscal 2001 increased 187.7% to approximately \$1,282,000 from approximately \$446,000 in fiscal 2000. This increase was primarily the result of a 27% increase in material and overhead production cost coupled with the Company recording a provision for potential inventory obsolescence in the amount of approximately \$422,000. The additional material costs were necessary to insure product supply from its key component supplier and material purchased by the Company's contract manufacturing integrator. Materials held on behalf of the Company at the manufacturing integrator's facility are recorded as inventory as well as any associated accounts payable for unpaid balances. See note 5 "Inventory" in the accompanying notes to the financial statements.

Engineering and product development expenses have increased by 51.7% to approximately \$5.0 million in fiscal 2001 from approximately \$3.3 million in fiscal 2000. This increase was primarily due to outside contract engineering expenditures and workforce increases for continued development and enhancements of the VocalWare IP products.

Sales and marketing expenses increased 81.7% during fiscal 2001 to approximately \$4.8 million from approximately \$2.6 million in fiscal 2000. This increase was primarily due to increased headcount in the sales and marketing staff and the associated travel which were both necessary to properly market, coordinate, distribute, train and service VocalWare IP products.

General and administrative expenses increased 67.1% during fiscal 2001 to approximately \$5.2 million from approximately \$3.1 million in fiscal 2000. This increase reflected increased staffing that management believed was necessary to support recent organizational growth as well as impairment adjustments for assets no longer deemed viable by the Company.

Income tax benefits related to losses for fiscal year 2001 are not recognized because the utilization of such benefits cannot be assured. Accordingly, a 100% valuation allowance has been recorded against the Company's deferred income tax asset. As of June 30, 2001, the Company had federal and state tax net operating loss carryforwards of approximately \$70,980,000 that expire beginning in 2008. The Internal Revenue code section 382 limits NOL carryforwards when an ownership change of more than 50% of the value of stock in a loss corporation occurs within a three-year period. Accordingly, due to such ownership change, the ability to utilize remaining NOL carryforwards may be significantly restricted.

Fiscal 2000 Compared to Fiscal 1999 for Continuing Operations

In March 2000, the Company sold its network multiplexer line to HT Communications. Also during the second quarter of fiscal 1999, the Company did not bid on additional custom modem business. Therefore, the following discussion is limited to the Company's continuing operations of its VocalWare IP business segment. Discontinued operations are separately discussed below.

Total revenue from continuing operations in fiscal 2000 decreased 62.2% to \$316,000 from \$836,000 in fiscal 1999. The decrease is primarily due to decreased shipments to Sabratek Inc, as a result of that customer's bankruptcy

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filing and declines in custom modem revenue from fiscal 1999. Also impacting revenue is the Company's decision to discontinue the first

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generation Be There! remote access system in favor of the Company's new generation of VocalWare IP products which were scheduled to be released throughout fiscal 2001.

Gross profit (loss) margins for fiscal 2000 from continued operations decreased to (140.9)% from (83.4)% for fiscal 1999. The decline in gross margin from continuing operations is directly related to decreased shipments to Sabratek Inc. and manufacturing variances caused by the decreased volumes. Due to financial difficulties and eventual bankruptcy, Sabratek, Inc. unexpectedly cancelled its purchase agreement with the Company in the second quarter of fiscal year 2000. The Company was not able to adjust its production overhead until after the third quarter of the fiscal year 2000 and therefore incurred manufacturing variances associated with decreased volumes.

Engineering and product development expenses had increased by 38.1% to \$3.3 million in fiscal 2000 from \$2.4 million in fiscal 1999. This increase was primarily due to workforce increases and outside project development contracts associated with development expenditures necessary for the Company's new VocalWare IP product line.

Sales and marketing expenses increased 35.8% during fiscal 2000 to \$2.6 million from \$1.9 million in fiscal 1999. This increase was primarily due to the Company ramping up its sales and marketing forces in anticipation of delivering its new VocalWare IP product line to the market in early fiscal 2001.

General and administrative expenses decreased 27.3% during fiscal 2000 to \$3.1 million from \$4.3 million in fiscal 1999. This decrease was attributable to decreases in non-cash expenses associated with a consulting agreement and non-cash legal expenses associated with a patent infringement lawsuit. The decrease is offset in part by severance and retirement packages for two officers totaling approximately \$480,000.

Income tax benefits related to losses for fiscal year 2000 are not recognized because the utilization of such benefits cannot be assured. Accordingly, a 100% valuation allowance was recorded against the Company's deferred income tax asset. As of June 30, 2000, the Company had federal and state tax net operating loss carryforwards of approximately \$53,664,000, which expire beginning in 2009. The Internal Revenue code section 382 limits NOL carryforwards when an ownership change of more than 50% of the value of stock in a loss corporation occurs within a three-year period. Accordingly, due to such ownership changes, the ability to utilize remaining NOL carryforwards may be significantly restricted.

Discontinued Operations and HT Communications Receivable

The majority of the Company's revenue in fiscal 1999 and in prior years resulted from operations that the Company has now exited. Revenues from discontinued operations decreased 64.0% in fiscal 2000 to \$720,000 from \$1,999,000 in fiscal 1999 as a result of the Company's decision to exit that market. 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

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gain in the amount of \$331,601 from its books along with the associated note receivable.

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Liquidity and Capital Resources

Operating losses have had and continue to have a substantial negative effect on the Company's cash balance. At June 30, 2001, the Company had approximately \$9,000 in cash and cash equivalents, compared to approximately \$11,059,000 at June 30, 2000.

At the beginning of fiscal 2001, the company recorded a note receivable of \$350,000 due from HT Communications resulting from the sale by the Company of a discontinued segment in March 2000. Subsequent to the end of fiscal year 2001 this note became uncollectable due to HT Communications filing bankruptcy. As such, the Company wrote off the receivable in September 2001.

During fiscal year 2001, the Company increased its inventory in response to business opportunities forecasted and the lead-time required to receive the material components. The Company's inventory at retail is valued at \$4,000,000 to \$7,000,000 depending on the size and type of server configuration.

The build up in inventory was the result of the Company having to procure unique key components essential for the deployment of the Vocal Ware server. Approximately 400 units of a unique component board were procured during the fiscal year along with nearly 210 chassis units that make up the Vocal Ware server. The Company anticipates that the number of units on hand at the end of the fiscal year will be sufficient for the immediate future to meet any need that current potential customers would require during fiscal 2002. The general slow down in the economy and the longer than anticipated sales cycle however make it difficult for the Company to estimate additional requirements. The inventory value at year ending June 30, 2001 is net of inventory reserves of approximately \$1.0M.

During the first half of fiscal year 2001, in anticipation of projected sales, the Company increased its staff by over 50% by adding 31 people to field key positions to assure its growth. To support its business model and the additional staff, the Company invested approximately \$1,000,000 in equipment purchases in fiscal 2001. Approximately \$434,000 of those purchases pertained to 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 as an asset impairment on non-amortized leasehold improvements pertaining to the early termination of the San Antonio facilities in August 2001. 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. Further, the Company feels that capital expenditures in fiscal 2001 for capital equipment are adequate to support foreseeable needs throughout fiscal 2002.

Accounts payable during fiscal 2001 increased by 85% compared to the increase reflected in the cash flow statement for fiscal 2000. This increase is directly attributable to inventory purchases as discussed above.

An increase in notes payable of approximately \$1,072,000 during fiscal 2001

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reflect the Company's reliance upon outside financing to continue its operations until such time revenues are sufficient to sustain the Company's future operations.

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The Company does not believe that current cash will be sufficient to meet the Company's current and ongoing operating expenses and capital requirements and it is continuing to explore financing alternatives.

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 "Financing Activities - Equity Line of Credit" below as part of this ITEM 7.

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. Effective November 6, 2001, our common stock was dropped from the OTCBB for failure to timely file reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934. Our common stock continues to be traded in the "pink sheets" under the symbol "RACE".

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.

Financing Activities

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March 2001

In March 2001, the Company received net proceeds of approximately \$2,000,000 for issuance of common stock and warrants. (See Note 10 of Notes to the Financial Statements)

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May 2001

In May 2001, the Company issued 10% secured convertible promissory notes and common stock purchase warrants for \$700,000. (See Note 9 of Notes to the Financial Statements)

6% 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.

Equity Line of Credit

On July 26, 2001 the Company signed what is sometimes termed an equity line

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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

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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. In addition, 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.

ITEM 7A. DISCLOSURES ABOUT MARKET RISK

The following discusses our exposure to market risk related to changes in interest rates, equity prices and foreign currency exchange rates. This discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors including those set forth in the "Certain Business Risk" section.

At June 30, 2001, we had approximately of \$1.1 million of interest bearing indebtedness. The interest rates are fixed and therefore, we do not have any significant interest rate risk.

At June 30, 2001 we did not own any equity investments. Therefore, we did not have any direct equity price risk.

Substantially all Company revenues are realized in U.S. dollars and no significant asset or cash account balances are maintained in currencies other than the United States dollar. Therefore, we do not have any significant direct foreign currency exchange rate risk.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Independent Auditors' Report - Current.....
Independent Auditors' Report - Predecessor.....

Financial Statements
Balance Sheets as of June 30, 2001 and 2000.....
Statements of Operations for the years ended June 30, 2001, 2000 and 1999.....
Statements of Shareholders' Equity for the years ended June 30, 2001, 2000 and 1999.....
Statements of Cash Flows for the years ended June 30, 2001, 2000 and 1999.....
Notes 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.

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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

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ASSETS

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Current assets:

Cash and cash equivalents	\$
Accounts receivable, net	
Note receivable, current	
Inventory	2,8
Prepaid expenses and deposits	

Total current assets 2,8

Note receivable, non-current	6
Property and equipment, net	
Other assets	

Total assets \$ 3,6
=====

LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)

Current liabilities:

Accounts payable	\$ 2,3
Accrued expenses	6
Obligations under capital lease, current	1
Convertible debentures	1,0

Total current liabilities 4,1

Non-current liabilities:

Obligations under capital lease, non-current	
--	--

4,2

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	62,4
Additional paid-in capital	9,5
Accumulated deficit	(72,5)

Total shareholders' equity (deficit) (5)

Total liabilities and shareholders' equity \$ 3,6
=====

See accompanying notes to financial statements

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	2001	

Total revenue from continuing operations	\$ 62,698	\$
Cost of revenue	1,344,506	

Gross profit (loss)	(1,281,808)	

Operating expenses:		
Engineering and product development	4,995,226	
Sales and marketing	4,757,711	
General and administration	5,211,493	

Total operating expenses	14,964,430	

Operating loss	(16,246,238)	
Other income (loss)	(529,512)	

Loss from continuing operations	(16,775,750)	
Income from discontinued operations	--	

Net loss	\$ (16,775,750)	\$
	=====	
Per share data:		
Net loss	\$ (16,775,750)	\$
Effect of beneficial conversion feature of convertible preferred stock	--	

Net loss applicable to common stock	\$ (16,775,750)	\$
	=====	
Net basic and diluted loss from continuing operations per common share	\$ (0.60)	\$
	=====	
Net basic and diluted loss per common share	\$ (0.60)	\$
	=====	
Weighted average shares outstanding	27,812,000	
	=====	

See accompanying notes to financial statements

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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	--	--	--	--

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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	--	\$ --	--	\$ --
Net loss	--	--	--	--
Issuance of convertible preferred stock, net of offering cost of \$248,820	750	473,425	750	491
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
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

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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
Conversion of convertible preferred stock to common stock	(750)	(863,425)	(750)	(832)
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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	Additional Paid-In Capital	Accumulated Deficit
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)
C		