DATA RACE INC
Form 10-Q
February 14, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q
QUARTERLY REPORT
Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarter Ended	Commission File Number
December 31, 2000	0-20706

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

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

6509 Windcrest, 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

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 X NO

On February 11, 2001, there were approximately 26,891,000 outstanding shares of Common Stock, no par value.

DATA RACE, Inc.
INDEX TO FORM 10-Q

PART I. FINANCIAL INFORMATION

ITEM 1. Interim Condensed Financial Statements

DATA RACE, Inc.
CONDENSED BALANCE SHEETS
UNAUDITED

		As
		Dec. 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents....................................	$	2,176,176
Accounts receivable, net.....................................		102,804
Inventory..		2,312,892
Notes receivable, current....................................		346,667

Prepaid expenses and deposits		585,371
Total current assets		5,523,910
Notes receivable, non-current		-
Property and equipment, net		2,005,893
Other assets, net		84,630
Total assets	$	7,614,433

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Accounts payable	$	1,066,851
Accrued expenses		844,813
Obligations under capital lease, current		28,818
Total current liabilities		1,940,482
Obligations under capital lease, non-current		62,570
Shareholders' equity:		
Common stock		60,855,962
Additional paid in capital		7,673,310
Retained deficit		(62,917,891)
Total shareholders' equity		5,611,381
Total liabilities and shareholders' equity	$	7,614,433

See accompanying notes to interim condensed financial statements

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DATA RACE, Inc.
CONDENSED STATEMENTS OF OPERATIONS
UNAUDITED

	Three Months Ended Dec. 31,				
	2000		1999		20
Total revenue	$	-	$	79,897	$
Cost of revenue		166,243		196,949	
Gross profit		(166,243)		(117,052)	
Operating expenses:					

Engineering and product development..........................	1,359,735	816,927	
Sales and marketing..................	1,419,930	464,198	
General and administration...........	1,072,586	688,232	
Total operating expenses..........	3,852,251	1,969,357	
Operating loss...................	(4,018,494)	(2,086,409)	
Other income...........................	70,395	125,749	
Loss from continuing operations	(3,948,099)	(1,960,660)	
Income from discontinued operation	-	57,094	
Net loss	$ (3,948,099)	$ (1,903,566)	$
Per share data:			
Net loss.......................	(3,948,099)	(1,903,566)	
Effect of beneficial conversion feature of convertible preferred stock..............	-	(79,723)	
Net loss applicable to common stock........................	$ (3,948,099)	$ (1,983,289)	$
Net basic/diluted loss from continuing operations per common share	$ (0.15)	$ (0.09)	$
Net basic/diluted loss per common share	$ (0.15)	$ (0.09)	$
Weighted average shares outstanding.....	26,682,000	21,145,000	

See accompanying notes to interim condensed financial statements

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DATA RACE, Inc.
CONDENSED STATEMENTS OF CASH FLOWS
UNAUDITED

	Six Months
	2000
Cash flows from operating activities:	

Net loss	$ (7,165,696)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:	
Depreciation and amortization	234,659
Non-cash consulting fee	-
Gain on sale of assets	(3,529)
Income from discontinued operations	-
Changes in assets and liabilities:	
Accounts and notes receivable	(93,070)
Inventory	(2,063,016)
Prepaid expenses, deposits, and other assets	(379,370)
Accounts payable	562,850
Accrued expenses	(115,533)
Net cash used in operating activities	(9,022,705)
Cash flows from investing activities:	
Purchase of property and equipment	(891,072)
Proceeds from sale of property and equipment	4,146
Provided by discontinued operations	-
Net cash used in investing activities	(886,926)
Cash flows from financing activities:	
Payment on capital leases	(22,791)
Net proceeds from the issuance of common stock and related warrants	1,049,537
Net cash provided by financing activities	1,026,746
Net increase (decrease) in cash and cash equivalents	(8,882,885)
Cash and cash equivalents at beginning of period	11,059,061
Cash and cash equivalents at end of period	$ 2,176,176

See accompanying notes to interim condensed financial statements

DATA RACE, Inc.
NOTES TO INTERIM CONDENSED FINANCIAL STATEMENTS
UNAUDITED

1) Summary of Significant Accounting Policies

Description of Business

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

Basis of Presentation

The unaudited interim financial statements reflect all adjustments (consisting of normal recurring accruals) that in the opinion of management are necessary for a fair presentation of the financial position, results of operations and cash flows for such periods. These financial statements should be read in conjunction with the Company's financial statements and notes thereto included in the June 30, 2000 Annual Report on Form 10-K and the Quarterly Report on Form 10-Q for the quarter ended September 30, 2000. The condensed balance sheet data as of June 30, 2000 included herein has been derived from such audited financial statements. Interim period results are not necessarily indicative of the results to be expected for any future periods or the full year.

Revenue Recognition

Revenue is generally recognized upon shipment of products to customers or when contractual services have been provided to customers, the fee and terms are fixed or determinable, and collection is reasonably assured. Revenue from service obligations and licensing agreements are deferred and recognized ratably over the period of the obligation or agreement. The Company recognizes revenue and gross profit from evaluation units shipped only upon receipt of payment or upon customer acceptance and reasonably assured collection.

2) Liquidity and Capital Resources

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 depends on the success of the VocalWare IP product line.

To successfully penetrate its 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's ability to sustain operations, make future capital expenditures, and fund the development and marketing of new or enhanced products is highly dependent on existing cash, the ability to raise additional capital, and the ability to successfully develop and sustain strategic relationships. The failure to obtain such financing when needed and to attract a strategic partner would have a substantial adverse effect on the Company.

2) Earnings Per Share

Net loss per share of common stock is presented in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 128, Earnings Per Share. Under SFAS No. 128, basic earnings/loss per share excludes dilution for potentially dilutive securities and is computed by dividing income or loss available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings/loss per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Diluted loss per share and basic loss per share are the same, as no potential common shares are to be included in the computation when a loss from continuing operations available to common shareholders exists.

3) Inventory

Inventory is valued at the lower of standard cost (approximates first-in, first-out method) or market (net realizable value). Inventory consists of the following:

	December 31, 2000	June 30, 2000
Finished goods	$ 1,940,104	$ 138,014
Work in process	68,683	80,151
Raw materials	304,105	31,711
Total inventory	$ 2,312,892	$ 249,876

As of December 31, 2000, finished goods inventory included approximately $391,000 shipped and billed to third parties that is not recorded as costs as associated revenue has not been recognized and approximately $75,000 of inventory shipped as evaluation units.

4) Warrants

The following table summarizes the outstanding warrants as of the end of December 31, 2000 and June 30, 2000, respectively.

	December 31, 2000	June 30, 2000	Pr
June 2000 private placement	471,822	471,822	$
December 1999 private placement	571,429	571,429	
June 1999 private placement	693,888	693,888	
November 1998 private placement	-	956,655	
Series C Warrants	-	53,977	
Class A and B second close	-	24,968	
Class A and B first close	-	35,400	
Total warrants outstanding	1,737,139	2,808,139	

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

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

In November 2000, the remaining balance of Series C warrants expired.

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

Results of Operations

In March 2000, the Company sold its network multiplexer line to HT Communications. Since the second quarter of 1999, the Company has 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 discussed separately below.

In the second quarter ended December 31, 2000, the Company shipped VocalWare IP product and billed approximately $625,000 to third party resellers. Revenue was not recognized on the shipped servers and clients, as these transactions did not meet the Company's criteria for revenue recognition. As a result, total revenue from continuing operations for the three and six months ended December 31, 2000 decreased 100% and 98%, respectively, from the comparable periods for prior fiscal year.

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Engineering and product development expenses for the three and six months ended December 31, 2000 increased 66% and 50%, respectively, from the comparable periods for the prior fiscal year. 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 for the three and six months ended December 31, 2000 increased 206% and 160%, respectively, from the comparable periods of the prior fiscal year. This increase was primarily due to increased headcount in the sales staff and travel that are necessary to properly market, coordinate, distribute, and service VocalWare IP products.

General and administrative expenses for the three and six months ended December 31, 2000 increased 56% and 8%, respectively, from the comparable periods of the prior fiscal year. This increase reflects increased staffing that management believes are necessary to support recent organizational growth.

Income tax benefits related to the losses for the three and six months ended December 31, 2000 were not recognized because the realization of such benefits is not assured. As of December 31, 2000, the Company had Federal tax net operating loss carryforwards of approximately $54,000,000 that expire beginning in 2008. 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, the ability to utilize remaining NOL carryforwards may be significantly restricted.

Discontinued Operations

The majority of the Company's revenue in the three and six months of fiscal 2000 resulted from operations that the Company has now exited. Income from discontinued operations in first two quarters of fiscal 2000 was approximately $171,000. There was no income from discontinued operations for the corresponding six months ended December 31, 2000 as the Company exited that and other related business in March 2000.

Liquidity and Capital Resources

Operating losses have had and continue to have a significant negative effect on the Company's cash balance. At December 31, 2000, the Company had approximately $2,176,000 in cash and cash equivalents.

Historically, the majority of the Company's revenue was derived from shipments of custom modem and network multiplexer products. Revenue from shipments of custom modems has ended as the market has shifted away from custom modem products. The Company sold its network multiplexer products business to HT Communications, Inc in March 2000. The Company has focused all of its resources on the VocalWare IP product line since May 2000.

The Company's strategy is to focus its sales efforts on developing an increasing number of larger customers using the VocalWare IP products, to develop a new generation of products that will address the market's need for an easy-to-install software client that can operate over the new broadband communications services, including DSL, cable modems, and IP networks, and to establish one or more strategic partnerships with well-established companies that would enhance the Company's market presence and credibility and provide financial assistance. The ability of the Company to successfully execute its strategy to increase sales is subject to numerous risks and such success cannot be assured. The Company's return to profitability and development of a more dependable revenue base depends on the success of the VocalWare IP product line. The Company does not anticipate a return to profitability as long as its expenditures on the VocalWare IP system remain disproportionate to revenue.

In February 2001, the Company has received non-binding commitments for additional financing. Portions of these commitments are expected to be funded by the end of February 2001.

The Company's ability to sustain operations, make future capital expenditures, and fund the development and marketing of new or enhanced products is highly dependent on existing cash, the ability to raise additional capital, and the ability to successfully develop and sustain strategic relationships. The failure to obtain such financing when needed and to attract a strategic partner would have a substantial adverse effect on the Company. The timing and amount of the Company's future capital requirements cannot be accurately predicted. The Company believes its current cash balances and commitments for additional financing will be sufficient to meet its anticipated cash needs for the next 12 months.

In October 2000, the Company entered into a nonbinding agreement to acquire substantially all the assets of Voiceboard Corporation ("Voiceboard"), a significant component supplier to the Company. In December 2000, the Company terminated its offer to acquire VoiceBoard. On January 11, 2001, the Company notified the Escrow Agent that Voiceboard was in default of the OEM Purchase Agreement between the Company and Voiceboard and a condition of release of the escrowed materials had occurred. Voiceboard has disputed the default notice and the Company is starting the process for a dispute resolution.

Disclosure Regarding Forward Looking Statements

Except for the historical information, this report contains various "forward-looking statements" which represent the Company's expectations or beliefs concerning future events, including expectations regarding the rate of use of existing cash and the success of the Company's strategy to increase sales and return to profitability. The Company cautions that these forward-looking statements involve a number of risks and uncertainties and are qualified by important factors that could cause actual results to differ

materially from those in the forward-looking statements. Such factors include lack of adequate capital; changing market trends and market needs; uncertainty regarding the breadth of market acceptance of the remote worker products; uncertainty regarding the length of the sales process; uncertainty regarding the supply of components; rapid or unexpected technological changes; new or increased competition from companies with greater resources than the Company; inability to resolve technical issues or overcome other development obstacles and the Company's success in developing new strategic and financial partnerships. Additional factors which qualify forward-looking statements are set forth in the Company's other SEC filings, including the Form 10-K for fiscal 2000 and the Form 10-Q for the quarter ended September 30, 2000. The Company's failure to succeed in its efforts, including its development of new strategic and financial partnerships, could have a material adverse effect on the Company's financial condition and operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company does not believe that it is currently exposed to material risks associated with market risk sensitive instruments.

Part II - Other Information

DATA RACE, Inc.

Item 1. Legal proceedings

None.

Item 2. Changes in securities

None.

Item 3. Defaults upon senior securities

None.

Item 4. Submission of matters to a vote of security holders

An annual meeting of shareholders of the Company was held on November 9, 2000. Tom Bishop, Jeffery P. Blanchard, George R. Grumbles, Matthew A. Kenny, Michael A. McDonnell and Byron Smith were elected as directors of the Company, each to hold office until the next annual meeting of shareholders or until his successor has been elected and qualified, subject to earlier resignation or removal. Additionally, the shareholders approved the DATA RACE, Inc. 2000 Stock Option Plan, approved the amendment to the Company's Articles of Incorporation to change its name from DATA RACE, Inc. to IP AXESS, Inc. and ratified the appointment of KPMG LLP as independent accountants for the 2001 fiscal year.

The results of the voting at the annual shareholders meeting held on November 9, 2000 were as follows:

Proposal No. 1
(Election of Directors)

Company Nominee	For	Against	Non- Votes
Tom Bishop	21,290,170	-	125,162
Jeffery P. Blanchard	21,303,655	-	111,677
George R. Grumbles	21,296,890	-	118,442
Matthew A. Kenny	21,298,890	-	118,442
Michael A. McDonnell	21,299,570	-	115,762
Byron Smith	21,286,370	-	128,962

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Proposal No. 2
(Approval of DATA RACE, Inc. 2000 Stock Option Plan)

For	Against	Abstain	Non-Votes
20,819,705	390,564	205,063	-

Proposal No. 3
(Approval of amendment to the Company's Articles of Incorporation to change its name from DATA RACE, Inc. to IP AXESS, Inc)

For	Against	Abstain	Non-Votes
21,036,277	346,689	32,366	-

Proposal No. 4
(Ratification of KPMG LLP as independent accountants)

For	Against	Abstain	Non-Votes

21,294,191	72,682	48,459	-

Item 5. Other information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits.

None

(b) Reports on Form 8-K.

A report on Form 8-K was filed on November 20, 2000, to report the resignation of the Company's independent accountants KPMG L.L.P.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DATA RACE, INC.

By: /s/ James G. Scogin

James G. Scogin, Vice President,
Chief Financial Officer, Treasurer and Secretary
(Principal Financial and Accounting Officer)

Date: February 14, 2001

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