MINDARROW SYSTEMS INC
Form 10-Q
February 14, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549-1004

FORM 10-Q

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

For the quarterly period ended December 31, 2000

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

For the transition period from ________ to ________

Commission File Number: 0-28403

MindArrow Systems, Inc.
(formerly eCommercial.com, Inc.)
(Exact name of registrant as specified in its charter)

Delaware	77-0511097
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

101 Enterprise, Suite 340, Aliso Viejo, California 92656
(Address of principal executive offices)

(949) 916-8705
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and formal fiscal year, if changed since last report)

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 [_]

The number of shares outstanding of each of the Registrant's classes of common stock:

10,695,717

(Number of shares of common stock outstanding as of January 31, 2001)

MindArrow Systems, Inc.

Quarterly Report on Form 10-Q
For the three months ended December 31, 2000

INDEX

		Page
	Part I. Financial Information	
Item 1.	Consolidated Financial Statements:	
	Consolidated Balance Sheets - December 31, 2000 (unaudited) and September 30, 2000	3
	Consolidated Statements of Operations (unaudited) - Three Months Ended December 31, 2000 and 1999	4
	Consolidated Statement of Changes in Stockholders' Equity (unaudited) - Three Months Ended December 31, 2000	5
	Consolidated Statements of Cash Flows (unaudited) - Three Months Ended December 31, 2000 and 1999	6
	Notes to Consolidated Financial Statements (unaudited)	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	25
	Part II. Other Information	
Item 1.	Legal Proceedings	26
Item 2.	Changes in Securities and Use of Proceeds	26
Item 3.	Defaults Upon Senior Securities	26
Item 4.	Submission of Matters to a Vote of Security Holders	26
Item 5.	Other Information	26
Item 6.	Exhibits and Reports on Form 8-K	26
Signatures		27

MindArrow Systems, Inc. and Subsidiaries
Consolidated Balance Sheets

	December 31, 2000	Sep
	(unaudited)	

ASSETS		
Current Assets:		
Cash	$ 7,410,356	$ 1
Cash, pledged	115,400	
Accounts receivable	1,010,060	
Prepaid expenses	207,311	
Due from related parties	488,894	
Other current assets	2,500	
Total current assets	9,234,521	1
Fixed Assets, net	2,884,009	
Intangible Assets, net	2,379,789	
Investments	--	
Deposits	52,691	
Total assets	$ 14,551,010	$ 1
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	$ 964,285	$
Customer deposits	1,151,286	
Due to related parties	589,521	
Total current liabilities	2,705,092	
Stockholders' Equity:		
Series B Convertible Preferred Stock, $0.001 par value; 1,750,000 shares authorized; 1,182,199 and 1,476,698 shares issued and outstanding as of December 31 and September 30, 2000; $9,457,592 and $11,813,584 aggregate liquidation preference as of December 31 and September 30, 2000	1,182	
Series C Convertible Preferred Stock, $0.001 par value; 3,000,000 shares authorized; 725,775 shares issued and outstanding; $18,144,735 aggregate liquidation preference	726	
Common Stock, $0.001 par value; 30,000,000 shares authorized as of December 31 and September 30, 2000; 10,5098,592 and 10,110,760 shares issued and outstanding as of December 31 and September 30, 2000	10,509	
Additional paid-in capital	49,687,070	4
Accumulated deficit	(37,589,468)	(3
Unearned stock-based compensation	(264,101)	
Total stockholders' equity	11,845,918	1
Total liabilities and stockholders' equity	$ 14,551,010	$ 1

The accompanying notes are an integral part of these statements.

MindArrow Systems, Inc. and Subsidiaries
Consolidated Statements of Operations

	Three Months Ended December 31, 2000	Three Months Ended December 31, 1999
	(unaudited)	
Revenues	$ 998,726	$ 29,390
Operating expenses:		
Development	814,241	385,651
Production	434,386	90,064
Sales and marketing	2,158,432	789,840
General and administration	2,324,509	909,091
Depreciation and amortization	668,531	157,998
	6,400,099	2,332,644
Operating loss	(5,401,373)	(2,303,254)
Interest income	120,709	52,269
Provision for income taxes	--	(1,600)
Other expense	(100,000)	--
Net loss	$ (5,380,664)	$ (2,252,585)
Basic and diluted loss per share	$ (0.53)	$ (0.23)
Shares used in computation of basic and diluted loss per share	10,240,954	9,616,204

The accompanying notes are an integral part of these statements.

MindArrow Systems, Inc. and Subsidiaries
Consolidated Statement of Changes in Stockholders' Equity

	Series B Preferred Stock		Series C Preferred Stoc	
	Shares	Amount	Shares	Amount
Balance, September 30, 2000	1,476,698	$ 1,477	725,775	$
Conversion of preferred stock to common stock	(294,499)	(295)	--	-
Issuance of common stock pursuant to exercise of options	--	--	--	-
Compensation expense on option and warrant grants	--	--	--	-
Stockholder repayment per indemnification agreement	--	--	--	-
Net loss	--	--	--	-
Balance, December 31, 2000 (unaudited)	1,182,199	$ 1,182	725,775	$

Additional Paid-In	Accumulated	Unearned Stock-Based

	Capital	Deficit	Compensation	Total
Balance, September 30, 2000	$ 49,181,513	$(32,208,804)	$ (310,383)	$ 16,674,
Conversion of preferred stock to common stock	--	--	--	-
Issuance of common stock pursuant to exercise of options	103,230	--	--	103,
Compensation expense on option and warrant grants	54,259	--	46,282	100,
Stockholder repayment per indemnification agreement	348,068	--	--	348,068
Net loss	--	(5,380,664)	--	(5,380,
Balance, December 31, 2000 (unaudited)	$ 49,687,070	$(37,589,468)	$ (264,101)	$ 11,845,

The accompanying notes are an integral part of these statements.

MindArrow Systems, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

	Three Months Ended December 31, 2000	December 31 1999
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (5,380,664)	$ (2,252,58
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	668,531	157,99
Non-cash charges due to stock issuances	--	237,86
Non-cash charges due to contract settlements	1,191,701	--
Non-cash charges due to investment write-down	100,000	--
Non-cash charges due to stock option and warrant grants	100,541	119,79
Increase in accounts receivable	(305,198)	(27,04
(Increase) decrease in prepaid expenses	67,025	(75,78
Increase in due from related parties	(7,052)	--
(Increase) decrease in other current assets	581,788	(42
Decrease in deposits	10,174	27,63
Increase (decrease) in accounts payable and accrued liabilities	(392,125)	107,69
Decrease in accounts payable from acquired companies	--	(81,60
Increase in customer deposits	574,950	25,00
Net cash used in operations	(2,790,329)	(1,761,46
Cash flows from investing activities:		
(Increase) decrease in cash-pledged	33,420	(29,93
Purchases of fixed assets	(434,773)	(653,02
Proceeds from sale of assets	17,050	--
Purchases of patents and trademarks	(32,242)	(32,60
Net cash used in investing activities	(416,545)	(715,56
Cash flows from financing activities:		

Proceeds from issuance of preferred stock	--	2,392,98
Proceeds from option and warrant exercises	3,333	52
Net cash provided by financing activities	3,333	2,393,50
Net decrease in cash	(3,203,541)	(83,52
Cash, beginning of period	10,613,897	4,744,74
Cash, end of period	$ 7,410,356	$ 4,661,21
Cash paid for income taxes	$ --	$ --
Cash paid for interest	$ --	$ --

The accompanying notes are an integral part of these statements.

MindArrow Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note A--The Company and Summary of Significant Accounting Policies

1. Basis of Presentation

The accompanying consolidated financial statements have been prepared by MindArrow Systems, Inc. and subsidiaries (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair presentation of the balance sheets, operating results, and cash flows for the periods presented. Operating results for the three months ended December 31, 2000 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2001. Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, and accompanying notes, included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2000. The consolidated balance sheet at September 30, 2000 has been derived from the audited consolidated financial statements at that date.

2. Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

3. Basic and Diluted Net Loss Per Share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of the incremental common shares issuable upon conversion of convertible preferred

stock (using the if-converted method) and shares issuable upon the exercise of stock options and warrants (using the treasury stock method). Common equivalent shares were excluded from the computation as their effect was anti-dilutive. The Discrepant Shares (see Note F) have not been included in the calculation of basic and diluted net loss per share.

4. Use of Estimates

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

5. Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash, cash equivalents, and accounts receivable. Substantially all of the Company's cash and cash equivalents are held in one financial institution. As of December 31, 2000 and September 30, 2000, the carrying amounts of cash were $7,525,756 and $10,762,717, respectively, and the bank balances were $7,336,277 and $11,239,780, respectively, of which $100,000 was FDIC insured. Accounts receivable are typically unsecured and derived primarily from customers located in the United States and Hong Kong.

MindArrow Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)

The Company performs ongoing credit evaluations of its customers and will maintain reserves for potential credit losses as the need arises.

6. Segments

The Company has adopted Statement of Financial Accounting Standards No. 131 "Disclosures about Segments of an Enterprise and Related Information" (SFAS 131). SFAS 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected financial information for those segments to be presented in interim financial reports. SFAS 131 also establishes standards for related disclosures about products and services, and geographic areas. To date the Company has viewed their operations as principally one segment. The Company has not yet determined if, as the result of the acquisition of Fusionactive.com, Ltd., it will operate in more than one segment. The following is a summary of significant geographic markets:

	North America	Asia Pacific
For the quarter ended December 31, 1999:		
Net revenues	$ 29,390	$ -
Long lived assets	2,474,659	-

For the quarter ended December 31, 2000:		
Net revenues	616,604	382,122
Long lived assets	5,066,580	2,627,647

Note B--Investments

In January 2000, the Company made an equity investment of $100,000 into eContributor.com, Inc., an Internet-based fundraising management and donation processing firm. During the quarter ended December 31, 2000 the Company determined that the investment had no fair market value and wrote the asset value down to zero.

Note C--Commitments and Contingencies

1. Operating Leases

In January 2001, the Company signed an amendment to the lease for its primary facilities in Aliso Viejo, California, which will result in an increase in rent expense of $12,170 per month. The lease expires December 31, 2004.

2. Legal Proceedings

From time to time the Company is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights. Except as described below, the Company is not currently aware of any legal proceedings or claims that the Company believes will have, individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

The Company was named as a defendant in an action seeking damages (the "Voxel Claim") in connection with an Asset Purchase Agreement, dated as of November 25, 1998, pursuant to which Wireless Netcom, Inc. had proposed to acquire the assets of Voxel, Inc. Wireless Netcom, Inc. had accrued $1.8 million in estimated damages, a liability the Company assumed in the recapitalization. In October 1999, the court ruled in favor of the plaintiffs and awarded them $1.8 million in damages. In January 2000 the Company appealed the judgment and pledged a $2 million certificate of deposit with the court. In July

2000, the bankruptcy trustee accepted the Company's offer to settle the dispute for $1.5 million. The bankruptcy judge approved the settlement in August 2000 and the $500,000 balance of the deposit made with the court, included in other current assets on the accompanying Consolidated Balance Sheet, was returned to the Company in October 2000.

Pursuant to an indemnity agreement, a significant stockholder who is also a director, agreed to indemnify the Company for the $1.5 million paid to the plaintiffs, plus $202,947 in legal fees on or before March 2001, by either refunding the amounts in cash, or by tendering up to 500,000 shares of common stock, at his option. As of December 31, 2000, $1,354,879 remained due under the indemnity agreement. On February 4, 2001, the Company entered into an addendum to the indemnity agreement pursuant to which the shareholder agreed to contribute 102,170 shares of the Company's common stock for cancellation

immediately, and up to 198,915 to be cancelled by June 30, 2001, in full satisfaction of the shareholder's indemnification obligation under the indemnity agreement.

Note D--Stockholders' Equity

1. Preferred Stock Conversions

During the quarter ended December 31, 2000, 294,499 shares of Series B preferred stock were converted into 294,499 shares of common stock pursuant to the conversion rights of the Series B preferred stockholders.

2. Warrants

During the quarter ended December 31, 2000, the Company issued to consultants warrants to purchase 40,000 shares of common stock. The warrants are exercisable at prices ranging from $6 per share to $8 per share, vest over a period of up to 3 years, and expire in November 2005.

The Company recognizes compensation expense based on the fair value of the warrants, as computed using the Black-Scholes option pricing model. The Company recognized compensation expense of $58,238 for the quarter ended December 31, 2000.

3. Options

During the quarter ended December 31, 2000, the Company granted options to purchase 402,100 shares of common stock to employees and directors of the Company under the 2000 Stock Option Plan at a weighted average exercise price of $7 per share.

Note E--Employment Contracts

The Company terminated, effective December 31, 2000, an employment agreement with a former executive officer resulting in a charge to the Company of approximately $483,000. The transaction has been recorded on the accompanying consolidated balance sheet as the forgiveness of a $100,000 note receivable plus interest, payment of the exercise price on 175,000 options at $1 per share, and the balance payable in the form of cash plus a $120,000 one year, non-interest bearing note payable. The note payable is due in monthly installments of $10,000. All unpaid amounts as of December 31, 2000 are included in "Due to related parties" on the accompanying consolidated balance sheet.

The Company terminated, effective December 31, 2000, a consulting contract with a former executive officer, current director, and significant stockholder resulting in a charge to the Company of approximately $442,000. The amount will be paid out as follows: $44,167 in cash, payable in two monthly installments through February 28, 2001, the exchange of fixed assets with a net book value of $49,432, and the forgiveness of $348,068 due under the terms of an indemnity agreement (see Note C2). All unpaid amounts as of December 31, 2000 are included in "Due to related parties" on the accompanying consolidated balance sheet.

The Company terminated, effective December 31, 2000, a consulting contract with a former executive officer, current director, and significant stockholder resulting in a charge to the Company of $267,250. The transaction has been recorded as a non-interest bearing note payable with payments due through March 2002, and is included in "Due to related parties" on the accompanying consolidated balance sheet as of December 31, 2000. Additionally, in January 2001, 57,000 options to purchase common stock at an exercise price of $5 per share were granted in connection with this contract cancellation.

Note F--Subsequent Events

In January 2001, the Company announced the signing of a non-binding letter of intent to acquire Twelve Horses, Ltd., a privately-held company based in Dublin, Ireland, that provides innovative messaging solutions through strategic literature-distribution processes. Under the proposed terms of the acquisition, shareholders and option holders of Twelve Horses would receive common stock and/or options to purchase common stock of the Company representing approximately 29% of the outstanding common stock of the Company on a fully diluted basis, after giving effect to the proposed acquisition. Completion of the acquisition is subject to entering into a definitive agreement with Twelve Horses and its shareholders and to the satisfactory completion of due diligence and other conditions to closing, including, but not limited to, approval by MindArrow's shareholders, and regulatory approvals, including regulatory approval in Ireland.

In February 2001, the Company determined that between May 21, 1999 and March 8, 2000 stock certificates representing 1,108,051 shares (the "Discrepant Shares") were illegally authenticated by the Company's prior transfer agent or others acting on its behalf without the Company's authorization or knowledge. The Discrepant Shares were not recorded in the stock ledger records kept by the former transfer agent. Following the discovery of potential criminal activity, the Company contacted law enforcement officials, Nasdaq and the Securities and Exchange Commission and has assisted law enforcement in the investigation of this matter. On February 5, 2001, Nasdaq halted trading of MindArrow's stock on the Nasdaq SmallCap Market. The Company is working on this matter with Nasdaq in an effort to permit trading to resume as soon as possible. Because the Discrepant Shares were illegally authenticated, the Company does not consider them to be validly outstanding at any time, and no restatement of historical financial statements is necessary.

In order to offset the potential impact of recognizing additional shares that may be in the hands of innocent purchasers, the Company's co-chairmen, who were the EVP/corporate secretary and CEO at the time the Discrepant Shares were issued, have entered into an agreement with the Company pursuant to which the two co-chairmen have agreed to contribute or transfer 1,108,051 of their personal shares in replacement or substitution for wrongly authenticated certificates. The agreement provides that in the event that any of the Discrepant Shares are recovered by the Company, an equivalent number of shares shall be issued to the Company's co-chairmen. In the event that the Company recovers cash or property other than the Discrepant Shares, then the Company shall issue shares of its common stock to the Company's co-chairmen at a rate of one share of common stock for every $4.50 in property or cash recovered. In no event shall the Company be obligated to issue more than 1,108,051 shares pursuant to the agreement.

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

The following discussion should be read together with our consolidated financial statements and related notes included elsewhere in this quarterly report on Form 10-Q.

Overview

Our business was founded in March 1999. We were a development-stage company until December 31, 1999. Principal operations commenced in January 2000. On April 24, 2000, we acquired 90% of Fusionactive.com, Ltd. in exchange for 150,000 shares of our common stock. The results of operations of Fusionactive.com have been included in the consolidated financial statements commencing April 1, 2000. The results of operations of Fusionactive.com from April 1 through April 23 are immaterial to our consolidated results.

Through December 31, 2000, our revenues were derived from the production and delivery of eBrochures as well as reseller fees and software license fees. eBrochure production services include theme development, eBrochure design and layout, video production, special effects, hyperlink recommendations, hyperlink page design and creation, reporting and sales cycle consultation.

Revenues are recognized when the consulting or production services are rendered and eBrochures are delivered. We recognize software license fee revenue when persuasive evidence of an agreement exists, the product has been delivered, we have no remaining significant obligations with regard to implementation, the license fee is fixed or determinable and collection of the fee is probable. Fusionactive.com's revenue from media sales is recognized upon placing advertisements. Revenue from consulting is recognized as the services are rendered.

We record cash receipts from clients and billed amounts due from clients in excess of revenue recognized as deferred revenue. The timing and amount of cash receipts from clients can vary significantly depending on specific contract terms and can therefore have a significant impact on the amount of deferred revenue in any given period.

We currently sell our products and services through a direct sales force and a small network of resellers.

Results of operations

For the quarters ended December 31, 2000 and 1999, revenues totaled $998,726 and $29,390, respectively. The increase from the previous year was due to the commencement of principal operations in January 2000, the release of our Virtual Prospector product in May 2000, the overall growth of our customer base, and the acquisition of our Hong Kong subsidiary in April 2000. During the quarters ended December 31, 2000 and 1999, we obtained new contracts, referred to as "bookings," totaling nearly $1.9 million and $51,000, respectively. We track bookings upon receiving an order for products or services, and recognize revenue according to our revenue recognition policy as described above. Accordingly, our production backlog at December 31, 2000, was approximately $2.3 million.

For the quarters ended December 31, 2000 and 1999, our net loss was $5,380,664, or $0.53 per share, and $2,252,585, or $0.23 per share, respectively. The loss for both periods can be attributed to development, marketing and selling, and general and administrative expenses incurred to expand our operations.

Development expenses consist primarily of salaries and related expenses for design engineers and other technical personnel, including consultants, and were focused on continued advancements in multimedia

communication technology and development of our proprietary network. Total development costs for the quarters ended December 31, 2000 and 1999 amounted to $814,241 and $385,651. Included in the amount for the quarter ended December 31, 2000 are non-recurring consulting charges of $68,750 related to a cancelled contract with a former executive officer, current director, and significant stockholder.

We charge all research and development expenses to operations as incurred. We believe that continued investment in research and development is critical to our long-term success. We expect development expenses to remain constant in absolute dollars but decrease as a percentage of revenues.

Production efforts focused on building a team of creative, client service focused people and producing eBrochures and related Web sites. Total production costs for the quarters ended December 31, 2000 and 1999 amounted to $434,386 and $90,064, respectively.

Sales and marketing expenses for the quarters ended December 31, 2000 and 1999 amounted to $2,158,432 and $789,840, respectively, and consisted primarily of salaries and related expenses for developing our direct and reseller organizations, as well as marketing expenses designed to create and promote brand awareness. Included in the amount for the quarters ended December 31, 2000 and 1999, is a non-cash charge of $42,966 and $77,877, respectively, which represents compensation expense related to the issuance of stock options and warrants. Additionally, included in the amount for the quarter ended December 31, 2000, are non-recurring salary and consulting charges of $128,750 related to cancelled contracts with one former executive officer and another former executive officer, current director, and significant stockholder. We have invested in a sales and marketing organization that we believe will help add customers and expand revenues. We intend to leverage this investment while aggressively managing our costs of selling. Accordingly, we expect cash-based sales and marketing expenses to remain constant in absolute dollars but decrease as a percentage of revenues.

General and administrative costs of $2,324,509 and $909,091 for the quarters ended December 31, 2000 and 1999, respectively, primarily included salaries and related expenses for administrative, finance and human resources personnel, professional fees and other corporate expenses related to establishing and expanding our operations. Included in these amounts are non-cash charges of $54,229 and $38,576 for the quarters ended December 31, 2000 and 1999, respectively, which represent compensation expense related to the issuance of stock options and warrants. Additionally, included in the amount for the quarter ended December 31, 2000 is a one time charge of approximately $1.2 million related to the termination of one employment contract and two consulting contracts with former executive officers. We expect to experience increased legal and related expenses associated with our investigation of the Discrepant Shares. We expect cash-based general and administrative expenses to both decrease in absolute dollars and as a percentage of revenues beginning in January 2001.

Stock-based compensation decreased to $100,540 for the quarter ended December 31, 2000 from $119,790 for the quarter ended December 31, 1999. This decrease was attributable to the fair value of warrants as calculated using the Black-Scholes option pricing model. Amortization of unearned stock-based compensation represents the difference between the exercise price of stock option grants and the deemed fair value of our stock at the time of such grants. Such amounts are amortized over the vesting period for such grants, which is typically three years. At December 31, 2000 we had $264,101 in unearned stock-based compensation scheduled to be amortized as follows: $126,901 in the fiscal year ending September 30, 2001, and $137,200 in the fiscal year ending September

30, 2002. We do not anticipate recording significant stock-based compensation in the future.

Recent financings

In December 1999, we completed a private placement offering of 1,388,073 shares of Series B preferred stock at $8 per share and issued an option to purchase an additional 125,000 shares of Series B preferred at $8.00 per share, which was exercised on March 24, 2000. These shares are convertible into shares of common stock on a one-for-one basis. Gross proceeds amounted to $11,104,584. The shares were sold to approximately 185 accredited investors. Net proceeds to us, after selling commissions of $829,242 and direct offering costs of $121,869, totaled $10,153,473, of which $7,760,492 was received prior to September 30, 1999, and $2,392,981 was received after September 30, 1999. On the initial closing date, the trading price of our common stock was $9.44 per share.

In April 2000, we completed a private placement offering of 725,775 shares of Series C preferred stock at $25 per share. Gross proceeds amounted to $18,144,375. On the initial closing date, the trading price of our common stock was $51.25 per share. When originally issued, the shares of Series C preferred

were convertible into common stock on a one-for-one basis. However, in response to a decline in the market price of our common stock in August 2000, we adjusted the conversion ratio to two-for-one. Accordingly, the 725,775 shares of Series C preferred are convertible into 1,451,550 shares of common stock.

Liquidity and sources of capital

Since our inception, we have funded our operations by selling stock. As of December 31, 2000, our cash position reduced short-term liquidity problems. We do not anticipate that monthly revenues will be sufficient to offset expected expenditures until summer 2001, however, we do anticipate that we have sufficient cash to fund our operations until then.

As of December 31, 2000 and September 30, 2000, we had current assets of $9,234,521 and $12,925,425, respectively, and current liabilities of $2,705,092 and $1,932,746, respectively. This represents working capital of $6,529,429 at December 31, 2000 and $10,992,679 at September 30, 2000.

For the quarter ended December 31, 2000, we used $2,790,329 of cash for operating activities, compared to $1,761,460 used for operations in the quarter ended December 31, 1999, which were primarily focused on growing our organizational infrastructure to be able to service our clients. During the same periods, $416,545 and $715,564, respectively, was used in investing activities, primarily for acquisitions of fixed assets used to expand our technology infrastructure and network. During the quarters ended December 31, 2000 and 1999, $3,333 and $2,393,502 was provided by financing activities, respectively, primarily from issuance of preferred stock in the prior year.

Recent accounting pronouncements

In June 1998, the Financial Accounting Standards Board, or FASB, issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," which was later amended by SFAS No. 137 "Accounting for Derivative Instruments and Hedging Activities--Deferral of the Effective Date of FASB Statement No. 133." SFAS No. 133 established standards for the accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities. The statement generally requires

recognition of gains and losses on hedging instruments, based on changes in fair value or the earnings effect of a forecasted transaction. SFAS No. 133, as amended by SFAS No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. We do not believe that SFAS No. 133 or SFAS No. 137 will have a material impact on our consolidated financial statements.

In December 1999, the SEC issued Staff Accounting Bulletin No. 101, or SAB 101, entitled "Revenue Recognition," which outlines the basic criteria that must be met to recognize revenue and provides guidance for the presentation of revenue and for disclosure related to revenue recognition policies in financial statements filed with the SEC. The implementation date of SAB 101 has been deferred until no later than the fourth quarter of fiscal years beginning after December 31, 1999. We do not believe that SAB 101 will have a material impact on our financial position or results of operations.

In March 2000, the FASB issued Interpretation No. 44, or FIN 44, entitled "Accounting for Certain Transactions Involving Stock Compensation," which is an interpretation of Accounting Principles Board No. 25, or APB 25. This interpretation clarifies:

- the definition of an employee for purposes of applying APB 25;
- the criteria for determining whether a plan qualifies as a noncompensatory plan;
- the accounting consequences of various modifications to the terms of a previously fixed stock option or award; and
- the accounting for an exchange of stock compensation awards in a business combination.

This interpretation is effective July 1, 2000. We believe that the adoption of FIN 44 will not have a material impact on our financial position or results of operations.

Certain of the matters and subject areas discussed in this quarterly report on Form 10-Q contain "forward-looking statements" that are subject to a number of risks and uncertainties, many of which are beyond our control. All statements, other than statements of historical fact included in this report regarding our business strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives of management as well as third parties are forward-looking statements. Generally, when used in this report, the words "anticipate," "intend," "estimate," "expect," "project," and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words. Specific examples of forward-looking statements include the expectations that (i) our development and cash-based sales and marketing expenses will remain constant in absolute dollars but decrease as a percentage of revenues, (ii) our cash-based general and administrative expenses will decrease both in absolute dollars and as a percentage of revenues beginning in January 2001, (iii) we will not record significant stock-based compensation in the future, (iv) we have sufficient cash to fund our operations until summer 2001 and (v) the application of Statement of Financial Accounting Standards Nos. 133 and 137 and Interpretation No. 44, as well as the SEC's Staff Accounting Bulletin No. 101, will not have a material impact on our consolidated financial statements or our financial condition or results of operations. All forward-looking statements speak only as of the date of this report. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be

correct. Important factors that could cause our actual results to differ materially from our expectations are described below and in our other filings with the Securities and Exchange Commission.

Risk Factors

If our stock does not resume trading on Nasdaq or fails to meet Nasdaq's continued listing requirements, the liquidity of our shares may be adversely affected

On February 5, 2001, Nasdaq halted trading in our common stock on the Nasdaq SmallCap Market. We are working to permit trading to resume as soon as possible. Nevertheless, we cannot assure you when, or if, trading in our common stock on the Nasdaq SmallCap Market will resume. In addition, we cannot predict what short-term or long-term effects the halt in trading will have on the market price of our common stock if and when trading resumes. Moreover, after trading resumes we must meet Nasdaq's continued listing requirements. However, we cannot assure you that we will always be able to meet the continued listing requirements in the future. Failure to meet these requirements could result in the delisting of our common stock from the Nasdaq SmallCap Market, which may adversely affect the liquidity of our shares.

Our limited operating history makes evaluation of our business difficult

Our business was formed as eCommercial.com in March 1999 and we were a development-stage company through December 31, 1999. In January 2000, principal operations commenced. We have recorded a cumulative loss of $24,199,886 through December 31, 2000 and anticipate recording losses in the near term. Accordingly, we have a limited operating history on which to base our evaluation of current business and prospects. Our short operating history makes it difficult to predict future results, and there are no assurances that our revenues will increase, or that we will achieve or maintain profitability or generate sufficient cash from operations in future periods.

Our ability to achieve and sustain profitability would be adversely affected if we:

- fail to effectively market and sell our services;
- fail to develop new and maintain existing relationships with clients;
- fail to continue to develop and upgrade our technology and network infrastructure;
- fail to respond to competitive developments;

- fail to introduce enhancements to our existing products and services to address new technologies and standards; or
- fail to attract and retain qualified personnel.

Our operating results are also dependent on factors outside of our control, such as strength of competition and the growth of the market for our services. There is no assurance that we will be successful in addressing these risks, and failure to do so could have a material adverse effect on our financial performance.

We expect to incur losses in the near term, and if we are unable to

generate sufficient cash flow or raise the capital necessary to allow us to continue to meet all of our obligations as they come due, our business could suffer.

Our future revenues are not predictable, and our results could vary significantly

Because of our limited operating history and the emerging nature of our markets, we are unable to reliably forecast our revenues.

Our fixed expenses, which generally are comprised of the costs of personnel and facilities have been averaging approximately $800,000 per month. Our expected expense levels are based, in part, on planned revenues and our ability to raise additional funding. If we are unsuccessful in generating significant revenues or raising additional funds, we may be unable to adjust spending in time to compensate for a shortfall or we may have to forego potential revenue-generating activities, either of which could hurt our financial performance.

Our quarterly operating results may fluctuate significantly in the future as a result of a variety of factors. These factors include:

- the demand for our services;
- the addition or loss of individual clients;
- the amount and timing of capital expenditures and other costs relating to the expansion of our operations;
- the introduction of new products or services by us or our competitors; and
- general economic conditions and economic conditions specific to the Internet, such as electronic commerce and online media.

Any one of these factors could cause our revenues and operating results to vary significantly. In addition, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing, service or marketing decisions or acquisitions that could significantly hurt our operating results in a given period.

Due to all of the foregoing factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Furthermore, it is possible that our operating results in one or more quarters will fail to meet the expectations of securities analysts or investors. In such event, the market price of our common stock could drop.

Possible need for additional financing

The capital requirements associated with developing our network and corporate infrastructure have been and will continue to be significant. We have been substantially dependent on the

private placements of our equity securities to fund such requirements. These private placements have raised approximately $30 million in gross proceeds. We do not anticipate that monthly revenues will be sufficient to offset expected expenditures until summer 2001, however, we do anticipate that we have sufficient cash to fund our operations until then. Although we believe our assumptions to be reasonable, we lack the operating history of a more seasoned

company and there can be no assurance that our forecasts will prove accurate. In the event that our plans change, our assumptions change or prove inaccurate, or if future private placements, other capital resources and projected cash flow otherwise prove to be insufficient to fund operations, we could be required to seek additional financing sooner than currently anticipated. We have no current arrangements with respect to sources of additional financing if and when needed, or that, if available, such additional financing would be on terms acceptable to us. To the extent that any such financing involves the sale of our equity securities, the interests of our shareholders could be substantially diluted.

We are not sure if the market will accept our systems

Our ability to succeed will depend on the following, none of which can be assured:

- the effectiveness of our marketing and sales efforts;
- market acceptance of our current and future offerings;
- the reliability of our networks and services; and
- the extent to which end users are able to receive eBrochures at tolerable download speeds.

We operate in a market that is at a very early stage of development, is rapidly evolving, and is characterized by an increasing number of competitors and risk surrounding market acceptance of new technologies and services. Potential customers must accept eBrochures as a viable alternative to traditional commercial advertising and brochure distribution. Because this market is so new, it is difficult to predict its size and growth rate. If the market fails to develop as we expect, our growth will be slower than expected.

Our success also depends on the market acceptance of our technology. For example, congestion over the Internet may interrupt eBrochure broadcasts, resulting in unsatisfying user experiences. Some users may block reception of executable email attachments such as eBrochures or be unwilling to download them due to the large size of the files. Through December 31, 2000, 81% of the eBrochures we've sent have been delivered successfully; however, widespread adoption of eBrochure technology depends on overcoming these obstacles, improving audio and video quality and educating clients and users. If our technology fails to achieve broad commercial acceptance, our growth will be slower than expected.

If we are unable to manage or sustain our growth our operating results could be impaired

We may be required to rapidly expand our operations in the near future to address market opportunities. Such growth, if it occurs, will place a significant strain on our managerial, operational and financial resources and systems. To manage this growth, we must implement, improve and effectively utilize operational, management, marketing and financial systems, and train and manage our employees. There can be no assurance that we will be able to manage effectively the expansion of operations or that our personnel, systems, procedures and controls will be adequate to support operations. Any failure to manage our growth effectively could hurt our financial performance.

We may make acquisitions of complementary technologies or businesses, which may disrupt our business and be dilutive to our existing stockholders.

In January 2001, we announced the signing of a non-binding letter of intent to acquire Twelve Horses, Ltd., a privately-held company based in Dublin, Ireland, that provides innovative messaging solutions through strategic

literature-distribution processes. We intend to consider this and other acquisitions of businesses and technologies on an opportunistic basis. Acquisitions of businesses and technologies involve numerous risks, including the diversion of management attention, difficulties in

assimilating the acquired operations, loss of key employees from the acquired company, and difficulties in transitioning key customer relationships. In addition, these acquisitions may result in dilutive issuances of equity securities, the incurrence of additional debt, large one-time expenses and the creation of goodwill or other intangible assets that result in significant amortization expense. Any acquisition may not provide the benefits originally anticipated, and there may be difficulty in integrating the service offerings and customer and supplier relationships gained through acquisitions with our own. Although we attempt to minimize the risk of unexpected liabilities and contingencies associated with acquired businesses through planning, investigation and negotiation, such unexpected liabilities nevertheless may accompany such acquisitions. We cannot guarantee that we will successfully identify attractive acquisition candidates, complete and finance additional acquisitions on favorable terms, or integrate the acquired businesses or assets into our own. Any of these factors could materially harm our business or our operating results in a given period.

Network and system failures could adversely impact our business

The performance, reliability and availability of our Web sites and network infrastructure is critical to our reputation and ability to attract and retain clients. Our systems and operations are vulnerable to damage or interruption from earthquake, fire, flood, power loss, telecommunications failure, Internet breakdowns, break-ins, tornadoes and similar events. We carry business interruption insurance to compensate for losses that may occur, but insurance is not guaranteed to remove all risk of loss. Services based on sophisticated software and computer systems often encounter development delays and the underlying software may contain errors that could cause system failures. Any system failure that causes an interruption could result in a loss of clients and could reduce the attractiveness of our services.

We are also dependent upon Web browsers, Internet service providers and online service providers to provide Internet users access to our clients, users and Web sites. Users may experience difficulties due to system failures or delays unrelated to our systems. These difficulties may hurt audio and video quality or result in intermittent interruptions in broadcasting and thereby slow our growth.

Circumvention of our security measures and viruses could disrupt our business

Despite the implementation of security measures, our networks may be vulnerable to unauthorized access, computer viruses and other disruptive problems. Anyone who is able to circumvent security measures could steal proprietary information or cause interruptions in our operations. Service providers have occasionally experienced interruptions in service as a result of the accidental actions of users or intentional actions of hackers. We may have to spend significant capital to protect against security breaches or to fix problems caused by such breaches. Although we have implemented security measures, there can be no assurance that such measures will not be circumvented in the future. Eliminating computer viruses and alleviating other security problems may require interruptions, delays or cessation of service to users, which could hurt our business.

Our dependence on short-term contracts could make future revenues volatile

Although some clients enter into multi-year agreements, 78% of our revenues through December 31, 2000 have been derived from contracts with fewer than three months duration. Consequently, our clients can generally stop using our systems quickly and without penalty, thereby increasing our exposure to competitive pressures. There can be no assurance that current clients will continue to be clients, or that we will be able to attract new clients.

We need to be scalable in the number of users we serve

Our success depends on our ability to deliver and track a large of number of eBrochures. At our current capacity, we can deliver and track approximately three million eBrochures per week. During the quarter ended December 31, 2000, we delivered an average of 105,000 eBrochures per week. If demand for our services exceeds capacity, we may not be able to add to our extensive network capability quickly enough to serve clients.

We depend on continued growth in use of the Internet

Rapid growth in use of the Internet is a recent phenomenon and there can be no assurance that use of the Internet will continue to grow or that a sufficient base of users will emerge to support our business. The Internet may not be accepted as a viable medium for broadcasting advertising and brochure distribution, for a number of reasons, including:

- inadequate development of the necessary infrastructure;
- inadequate development of enabling technologies;
- lack of acceptance of the Internet as a medium for distributing rich media advertising; and
- inadequate commercial support for Web-based advertising.

To the extent that Internet use continues to increase, there can be no assurance that the Internet infrastructure will be able to support the demands placed upon it, and especially the demands of delivering high-quality video content.

Furthermore, user experiences on the Internet are affected by access speed. There is no assurance that broadband access technologies will become widely adopted. In addition, the Internet could lose its viability as a commercial medium due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet activity, or due to increased government regulation. Our business could suffer if use of the Internet grows more slowly than expected, or if the Internet infrastructure does not effectively support the growth that does occur.

If we do not respond to technological change, we could lose or fail to develop customers

The development of our business entails significant technical and business risks. To remain competitive, we must continue to enhance and improve the functionality and features of our technology. The Internet and the ecommerce industry are characterized by:

- rapid technological change;
- changes in client requirements and preferences;

. frequent new product and service introductions embodying new technologies; and

. the emergence of new industry standards and practices.

The evolving nature of the Internet could render our existing systems obsolete. Our success will depend, in part, on our ability to:

. develop and enhance technologies useful in our business;

. develop new services and technology that address the increasingly sophisticated and varied needs of our current and prospective clients; and

. adapt to technological advances and emerging industry and regulatory standards and practices in a cost-effective and timely manner.

Future advances in technology may not be beneficial to, or compatible with, our business. Furthermore, we may not use new technologies effectively or adapt our systems to client requirements or emerging industry standards on a timely basis. Our ability to remain technologically competitive may require substantial expenditures and lead time. If we are unable to adapt to changing market conditions or user requirements in a timely manner, we will lose clients.

We could face liability for Internet content

As a distributor of Internet content, we face potential liability for negligence, copyright, patent or trademark infringement, defamation, indecency and other claims based on the content of our broadcasts. Such claims have been brought, and sometimes successfully pressed, against Internet content distributors. Our general liability insurance may not be adequate to indemnify us for all liability that may be imposed. Although we generally require our clients to indemnify us for such liability, such indemnification may be inadequate. Any imposition of liability that is not covered by insurance or by an indemnification by a client could harm our business.

Our operating results could be impaired if we become subject to burdensome government regulations and legal uncertainties concerning the Internet

Due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may be adopted with respect to the Internet, relating to:

. user privacy;

. pricing, usage fees and taxes;

. content;

. copyrights;

. distribution;

. characteristics and quality of products and services; and

. online advertising and marketing.

The adoption of any additional laws or regulations may decrease the popularity or impede the expansion of the Internet and could seriously harm our

business. A decline in the popularity or growth of the Internet could decrease demand for our products and services, reduce our revenues and margins and increase our cost of doing business. Moreover, the applicability of existing laws to the Internet is uncertain with regard to many important issues, including property ownership, intellectual property, export of encryption technology, libel and personal privacy. The application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and other online services, could also harm our business.

Our stock price has been and may continue to be volatile

The trading price of our common stock has been and is likely to continue to be highly volatile. For example, on March 14, 2000, our common stock closed at $51.25 per share, and on February 2, 2001, our common stock closed at $4.50 per share. Our stock price could be subject to wide fluctuations in response to factors such as:

- actual or anticipated variations in quarterly operating results;
- announcements of technological innovations, new products or services by us or our competitors;
- the addition or loss of strategic relationships or relationships with our key customers;
- conditions or trends in the Internet, streaming media, media delivery, and online commerce markets;

- changes in the market valuations of other Internet, online service, or software companies;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures, or capital commitments;
- legal or regulatory developments;
- additions or departures of key personnel;
- sales of our common stock; and
- general market conditions.

The historical volatility of our stock price may make it more difficult to resell shares at prices you find attractive. See also "Risk Factors - If our stock does not resume trading on Nasdaq or fails to meet Nasdaq's continued listing requirements, the liquidity of our shares may be affected".

In addition, the stock market in general, the Nasdaq SmallCap Market, the market for Internet and technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of these companies. These broad market and industry factors may reduce our stock price, regardless of our operating performance.

A prolonged decline in the price of our stock may make it difficult for us to obtain additional financing on favorable terms.

Our efforts to protect our intellectual property rights may not sufficiently

protect us and we may incur costly litigation to protect our rights

We have filed nineteen patent applications and we plan to file additional patent applications in the future with respect to various additional aspects of our technologies. We mark our software with copyright notices, and intend to file copyright registration applications where appropriate. We have also filed several federal trademark registration applications for trademarks and service marks we use. There can, however, be no assurance that any patents, copyright registrations, or trademark registrations applied for by us will be issued, or if issued, will sufficiently protect our proprietary rights.

We also rely substantially on certain technologies that are not patentable or proprietary and are therefore available to our competitors. In addition, many of the processes and much of our technology are dependent upon our technical personnel, whose skill, knowledge and experience are not patentable. To protect our rights in these areas, we require all employees, significant consultants and advisors to enter into confidentiality agreements under which they agree not to use or disclose our confidential information as long as that information remains proprietary. We also require that our employees agree to assign to us all rights to any inventions made during their employment relating to our activities, and not engage in activities similar to ours during the term of their employment. There can be no assurance, however, that these agreements will provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure of such trade secrets, know-how or proprietary information. Further, in the absence of patent protection, we may be exposed to competitors who independently develop substantially equivalent technology or otherwise gain access to our trade secrets, knowledge or other proprietary information.

Despite our efforts to protect our intellectual property, a third party or a former employee could copy, reverse-engineer or otherwise obtain and use our intellectual property or trade secrets without authorization or could develop technology competitive to ours.

Our intellectual property may be misappropriated or infringed upon. Consequently, litigation may be necessary in the future to enforce our intellectual property rights, to protect our confidential information or trade secrets, or to determine the validity or scope of the rights of others. Litigation could result in

substantial costs and diversion of management and other resources and may not successfully protect our intellectual property. Additionally, we may deem it advisable to enter into royalty or licensing agreements to resolve such claims. Such agreements, if required, may not be available on commercially reasonable or desirable terms or at all.

Our technology may infringe on the rights of others

Even if the patents, copyrights and trademarks we apply for are granted, they do not confer on us the right to manufacture or market products or services if such products or services infringe on intellectual property rights held by others. If any third parties hold conflicting rights, we may be required to stop making, using, or marketing one or more of our products or to obtain licenses from and pay royalties to others, which could have a significant and material adverse effect on us. There can be no assurance that we will be able to obtain or maintain any such license on acceptable terms or at all.

We may also be subject to litigation to defend against claims of infringement of the rights of others or to determine the scope and validity of

the intellectual property rights of others. If third parties hold trademark, copyright or patent rights that conflict with our business, then we may be forced to litigate infringement claims that could result in substantial costs to us. In addition, if we were unsuccessful in defending such a claim, it could have a negative financial impact. If third parties prepare and file applications in the United States that claim trademarks used or registered by us, we may oppose those applications and be required to participate in proceedings before the United States Patent and Trademark Office to determine priority of rights to the trademark, which could result in substantial costs to us. An adverse outcome in litigation or privity proceedings could require us to license disputed rights from third parties or to cease using such rights. Any litigation regarding our proprietary rights could be costly, divert management's attention, result in the loss of certain of our proprietary rights, require us to seek licenses from third parties and prevent us from selling our services, any one of which could have a negative financial impact. In addition, inasmuch as we broadcast content developed by third parties, our exposure to copyright infringement actions may increase because we must rely upon such third parties for information as to the origin and ownership of such licensed content. We generally obtain representations as to the origin and ownership of such licensed content and generally obtain indemnification to cover any breach of such representations; however, there can be no assurance that such representations will be accurate or given, or that such indemnification will adequately protect us.

Our officers and directors control a significant percentage of our outstanding common stock which will enable them to exert control over many significant corporate actions and may prevent a change in control that would otherwise be beneficial to our stockholders

Our officers and directors beneficially own approximately 26% of our outstanding stock. This level of ownership could have a substantial impact on matters requiring the vote of the stockholders, including the election of our directors and most of our corporate actions. This control could delay, defer or prevent others from initiating a potential merger, takeover or other change in our control, even if these actions would benefit our stockholders and us. This control could adversely affect the voting and other rights of our other stockholders and could depress the market price of our common stock.

The length of our sales cycle increases our costs

Many of our potential customers conduct extensive and lengthy evaluations before deciding whether to purchase or license our products. In our experience to date we've seen the sales cycle range anywhere up to six months. While the potential customer is making this decision, we continue to incur salary, travel and other similar costs of following up with these accounts. Therefore, the risk associated with our lengthy sales cycle is that we may expend substantial time and resources over the course of the sales cycle only to realize no revenue from such efforts if the customer decides not to purchase from us. Any significant change in customer buying decisions or sales cycles for our products could have a material adverse effect on our business, results of operations, and financial conditions.

We have a limited operating history in international markets

We have only limited experience in operating in international markets. Although we have distributed our products and services internationally since August 1999, we had no experience in international operations prior to the acquisition of our Hong Kong-based subsidiary, Fusionactive.com, Ltd., in April 2000. To date, we have recognized approximately $800,000 of revenue related to our international operations in eastern Asia. There can be no assurance that our

international operations will be successful.

There are risks inherent in conducting international operations

There are many risks associated with our international operations in eastern Asia, including, but not limited to:

- difficulties in collecting accounts receivable and longer collection periods;
- changing and conflicting regulatory requirements;
- potentially adverse tax consequences;
- tariffs and general export and customs restrictions;
- difficulties in staffing and managing foreign operations;
- political instability;
- fluctuations in currency exchange rates;
- the need to develop localized versions of our products;
- national standardization and certification requirements;
- seasonal reductions of business activity; and
- the impact of local economic conditions and practices.

Any of the above-listed risks could have a material adverse effect on our future business, financial condition, or results of operations.

International markets for online marketing are in their very early stages of development

We distribute our eBrochures globally. To date, we have developed or modified into foreign language text and delivered eBrochures to recipients in the United Kingdom, France, Switzerland, Austria, Norway, Sweden, Iceland, Finland, Denmark, Greece, Lebanon, Mexico, Panama, Peru, Philippines, Australia, Singapore, Hong Kong, China, and Taiwan. The markets for online advertising and direct marketing in these countries are generally in earlier stages of development than in the United States, and we cannot assure you that the market for, and use of online advertising and direct marketing in international markets such as these and others will be significant in the future. Factors that may account for slower growth in the online advertising and direct marketing markets include, but are not limited to:

- slower growth in the number of individuals using the Internet internationally;
- privacy concerns;
- a lower rate of advertising spending internationally than in the United States; and

- a greater reluctance to use the Internet for advertising and direct marketing.

Any of the above-listed risks could have a material adverse effect on our future business, financial condition, or results of operations.

We are subject to risks associated with governmental regulation and legal uncertainties

We are subject to general business laws and regulations. These laws and regulations, as well as new laws and regulations that may be adopted in the United States and other countries with respect to the Internet, may impede the growth of the Internet. These laws may relate to areas such as advertising, taxation, personal privacy, content issues (such as obscenity, indecency, and defamation), copyright and other intellectual property rights, encryption, electronic contracts and "digital signatures," electronic commerce liability, email, network and information security, and the convergence of traditional communication services with Internet communications, including the future availability of broadband transmission capability. Other countries and political organizations are likely to impose or favor more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments may impose regulations in addition to, inconsistent with, or stricter than, federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, applicability, and enforcement, may affect the available distribution channels for and costs associated with our products and services, and may affect the growth of the Internet. Such laws or regulations may therefore harm our business.

We do not know for certain how existing laws governing issues such as privacy, property ownership, copyright and other intellectual property issues, taxation, illegal or obscene content, retransmission of media, and data protection, apply to the Internet. The vast majority of such laws were adopted before the advent of the Internet and related technologies and do not address the unique issues associated with the Internet and related technologies. Most of the laws that relate to the Internet have not yet been interpreted. Changes to or the interpretation of these laws could:

- limit the growth of the Internet;
- create uncertainty in the marketplace that could reduce demand for our products and services;
- increase our cost of doing business;
- expose us to significant liabilities associated with content distributed or accessed through our products or services, and with our provision of products and services, and with the features or performance of our products;
- lead to increased product development costs, or otherwise harm our business; or
- decrease the rate of growth of our user base and limit our ability to effectively communicate with and market to our user base.

Any of the above-listed consequences could have a material adverse effect on our future business, financial condition, or results of operations.

We may be subject to legal liability in connection with the data collection capabilities of our products and services

Our products are interactive Internet applications that by their very nature require communication between a client and server to operate. To provide

better consumer experiences and to operate effectively, our products occasionally send information to servers at MindArrow. Many of the services we provide also require that users provide information to us. We post privacy policies concerning the use and disclosure of

our user data. Any failure by us to comply with our posted privacy policies could impact the market for our products and services, subject us to litigation, and harm our business.

In addition, the Child Online Privacy Protection Act ("COPPA") became effective as of April 21, 2000. COPPA requires operators of commercial Web sites and online services directed to children (under 13), and general audience sites that know that they are collecting personal information from a child, to:

- provide parents notice of their information practices;
- obtain verifiable parental consent before collecting a child's personal information, with certain limited exceptions;
- give parents a choice as to whether their child's information will be disclosed to third parties;
- provide parents access to their child's personal information and allow them to review it and/or have it deleted;
- give parents the opportunity to prevent further use or collection of information; not require a child to provide more information than is reasonably necessary to participate in an activity; and
- maintain the confidentiality, security, and integrity of information collected from children.

We do not knowingly collect and disclose personal information from such minors, and therefore believe that we are fully compliant with COPPA. However, the manner in which COPPA may be interpreted and enforced cannot be fully determined, and thus COPPA and future legislation such as COPPA could subject us to potential liability which in turn would harm our business.

Future sales of our common stock may depress our stock price

Sales of a substantial number of shares of our common stock in the public market, or the appearance that such shares are available for sale, could adversely affect the market price for our common stock. As of January 31, 2001, we had 10,695,717 shares of common stock outstanding. A significant number of these shares are not publicly traded but are available for immediate resale to the public, subject to certain volume limitations under the securities laws. We also have reserved shares of our common stock as follows:

- 1,070,074 shares are reserved for issuance upon the conversion of our outstanding shares of Series B preferred stock and 661,941 shares are reserved for issuance upon the exercise of warrants, all of which are eligible for immediate resale upon the effectiveness of our recently filed amendment to our registration statement (registration no. 333-91819);
- 1,451,550 shares are reserved for issuance upon the conversion of our outstanding shares of Series C preferred stock and 936,156 shares are reserved for issuance upon the exercise of warrants, all of which are eligible for immediate resale upon the effectiveness our recently filed registration statement (registration no. 333-52932);

- 409,533 shares are reserved for issuance upon the exercise of other warrants;
- 3,000,000 shares are reserved for issuance under our 1999 Stock Option Plan; and
- 1,000,000 shares are reserved for issuance under our 2000 Stock Option Plan.

Shares underlying vested options are generally eligible for immediate resale in the public market.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not believe that we currently have material exposure to interest rate, foreign currency exchange rate or other relevant market risks.

Interest Rate and Market Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment profile. As of December 31, 2000, our investment portfolio consisted primarily of cash and cash equivalents, substantially all of which were held at one financial institution. We do not use derivative financial instruments in our investment portfolio.

Foreign Currency Exchange Risk. We do not believe that we currently have material exposure to foreign currency exchange risk because of the relative insignificance of our foreign subsidiaries. We intend to assess the need to use financial instruments to hedge currency exposures on an ongoing basis.

We do not use derivative financial instruments for speculative trading purposes.

PART II-OTHER INFORMATION

Item 1. Legal Proceedings

Although we have not become a party to any material legal proceeding since MindArrow was founded, we were named as a defendant in a lawsuit filed on March 25, 1999 in the US Bankruptcy Court. The lawsuit arose from an Asset Purchase Agreement, dated November 25, 1998, pursuant to which our predecessor, Wireless Netcom, had proposed to acquire the assets of Voxel, Inc. for $5 million. A dispute about the terms of the agreement arose, and Wireless Netcom did not complete the acquisition. The Bankruptcy trustee then sold the assets of Voxel for $3.2 million and sued Wireless Netcom for the difference. We acquired this lawsuit when we subsequently merged with Wireless Netcom on April 19, 1999. The entire $1.8 million in dispute was recorded as a liability on the books of Wireless Netcom at the time we merged with them.

On October 27, 1999, the trial judge granted a summary judgment motion in favor of the plaintiffs in the amount of $1.8 million. In January 2000, we appealed the decision and pledged a $2 million certificate of deposit to the court. In July 2000, the bankruptcy trustee accepted our offer to settle this dispute for $1.5 million. In September 2000, the bankruptcy judge approved the settlement and subsequently refunded the balance of the deposit we made with the court. The $300,000 reduction in the liability was recorded as an increase to additional paid-in capital during the year ended September 30, 2000.

Pursuant to an indemnity agreement, Eric McAfee, one of our significant stockholders who is a director and is also a former officer, agreed to indemnify us for the $1.5 million settlement and $202,947 in attorney fees on or before March 2001, by either refunding the amounts in cash, or by tendering up to 500,000 shares of common stock, at his option. As of December 31, 2000, $1,354,879 remained due under the indemnity agreement. On February 4, 2001, we entered into an addendum to the indemnity agreement pursuant to which Mr. McAfee agreed to contribute 102,170 shares of our common stock for cancellation immediately and up to 198,915 to be cancelled by June 30, 2001, in full satisfaction of his indemnification obligation under the indemnity agreement.

Item 2. Changes in Securities and Use of Proceeds

During the quarter ended December 31, 2000, we issued to consultants warrants to purchase 40,000 shares of common stock. The warrants are exercisable at prices ranging from $6 per share to $8 per share, vest over a period of up to 3 years, and expire in November 2005. These warrants were issued without registration under the Securities Act of 1933, as amended (the "Securities Act"), in reliance upon the exemption from the registration requirements of the Securities Act set forth in Section 4(2) of the Securities Act.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

10.1 Settlement and Release of Claim Agreement - Thomas J. Blakeley
10.2 Settlement and Release of Claim Agreement - Eric A. McAfee
10.3 Settlement and Release of Claim Agreement - Mark Grundy
10.4 Share Cancellation Agreement
10.5 Addendum to Indemnification Agreement

Page 26

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.

MindArrow Systems, Inc.
(Registrant)

Date: February 14, 2001

/s/ Robert I. Webber

Robert I. Webber

Chief Executive Officer, President,
(Principal Executive Officer), and Director

Date: February 14, 2001

/s/ Michael R. Friedl

Michael R. Friedl
Chief Financial Officer, Treasurer,
(Principal Financial and Accounting Officer)