MINDARROW SYSTEMS INC
Form 10-Q
August 14, 2001

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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 June 30, 2001

[_] 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:

11,456,666

(as of June 30, 2001)

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MindArrow Systems, Inc.

Quarterly Report on Form 10-Q

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MindArrow Systems, Inc. and Subsidiaries
Consolidated Balance Sheets

	June 30, 2001 (unaudited)	September 30, 2000
ASSETS		
Current Assets:		
Cash	$ 2,424,635	$ 10,613,897
Cash, pledged	115,400	148,820
Accounts receivable, net	747,307	704,862
Prepaid expenses	43,867	289,536
Due from related parties	471,231	586,522
Other current assets	-	581,788
Total current assets	3,802,440	12,925,425
Fixed Assets, net	2,378,678	2,891,808
Intangible Assets, net	2,794,760	2,615,288
Investments	-	100,000
Deposits	124,886	74,865
Total assets	$ 9,100,764	$ 18,607,386
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	$ 1,427,084	$ 1,356,410
Deferred revenue	1,364,259	576,336
Due to related parties	268,670	-
Total current liabilities	3,060,013	1,932,746
Stockholders' Equity:		
Series B Convertible Preferred Stock, $0.001 par value; 1,750,000 shares authorized; 1,004,949 and 1,476,698 shares issued and outstanding as of June 30, 2001 and September 30, 2000; $8,039,592 and $11,813,584 aggregate liquidation preference as of June 30, 2001 and September 30, 2000	1,005	1,477
Series C Convertible Preferred Stock, $0.001 par value; 3,000,000 shares authorized; 779,775 and 725,775 shares issued and outstanding as of June 30, 2001 and September 30, 2000; $19,494,375 and $18,144,375 aggregate liquidation preference as of June 30, 2001 and September 30, 2000	780	726
Common Stock, $0.001 par value; 30,000,000 shares authorized; 11,456,666 and 10,110,760 shares issued and outstanding as of June 30, 2001 and September 30, 2000	11,457	10,111
Additional paid-in capital	70,149,571	49,181,513
Accumulated deficit	(64,012,440)	(32,208,804
Unearned stock-based compensation	(109,622)	(310,383
Total stockholders' equity	6,040,751	16,674,640
Total liabilities and stockholders' equity	$ 9,100,764	$ 18,607,386

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The accompanying notes are an integral part of these statements.

MindArrow Systems, Inc. and Subsidiaries
Consolidated Statements of Operations

	Three Months Ended June 30, 2001	June 30, 2000	Jun 2
	(uanaudited)		
Revenues	$ 822,729	$ 606,076	$ 2,7
Operating expenses:			
Development	621,786	595,070	2,1
Production	431,082	442,256	1,3
Sales and marketing	1,205,964	1,632,781	4,9
General and administration	1,022,201	1,438,209	4,6
Depreciation and amortization	698,005	534,115	2,0
	3,979,038	4,642,431	15,0
Operating loss	(3,156,309)	(4,036,355)	(12,3
Interest income	31,054	207,620	2
Provision for income taxes	-	(28)	
Minority interest	-	14,949	
Other income (expense)	2,580	-	(
Loss on transfer agent fraud	(169,957)	-	(19,6
Net loss	(3,292,632)	(3,813,814)	(31,8
Beneficial conversion feature on preferred stock	-	-	
Net loss available to common stockholders	$(3,292,632)	$(3,813,814)	$(31,8
Basic and diluted loss per share	$ (0.30)	$ (0.38)	$
Shares used in computation of basic and diluted loss per share	10,867,313	9,987,160	10,6

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	$ 726
Conversion of preferred stock to common stock	(471,749)	(472)	(6,000)	(6)
Issuance of common stock pursuant to exercise of options	--	--	--	--
Compensation expense on option and warrant grants	--	--	--	--
Stockholder repayment per indemnification agreement	--	--	--	--
Adjustment for Discrepant Shares	--	--	--	--
Share contribution and cancellation	--	--	--	--
Exchange of Discrepant Shares	--	--	--	--
Shares cancelled pursuant to indemnification agreement	--	--	--	--
Issuance of common stock for acquisition of Control Commerce, Inc.	--	--	60,000	60
Net loss	--	--	--	--
Balance, June 30, 2001 (unaudited)	1,004,949	$ 1,005	779,775	$ 780

	Additional Paid-in Capital	Accumulated Deficit	Unear Stock- Compen
Balance, September 30, 2000	$ 49,181,513	$(32,208,804)	$ (3
Conversion of preferred stock to common stock	(6)	--	
Issuance of common stock pursuant to exercise of options	357,976	--	
Compensation expense on option and warrant grants	43,786	--	2
Stockholder repayment per indemnification agreement	348,068	--	
Adjustment for Discrepant Shares	18,682,398	--	

Share contribution and cancellation	1,108	--	
Exchange of Discrepant Shares	(1,108)	--	
Shares cancelled pursuant to indemnification agreement	296	--	
Issuance of common stock for acquisition of Control Commerce, Inc.	1,535,540	--	
Net loss	--	(31,803,636)	
Balance, June 30, 2001 (unaudited)	$ 70,149,571	$(64,012,440)	$ (1

The accompanying notes are an integral part of these statements.

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

	Nine Months Ended	
	June 30, 2001	June 200
	(unaudited)	
Cash flows from operating activities:		
Net loss	$(31,803,636)	$(11,48
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	2,031,804	93
Non-cash charges due to stock option and warrant grants	244,547	3,22
Minority interest	-	(1
Non-cash charges due to contract settlements	1,191,701	
Non-cash charge due to investment write-down	100,000	
Non-cash charge for discrepant share adjustment	18,682,398	
Non-cash charge for trade shows	49,145	
Non-cash forgiveness of amount due from related party	28,333	
Increase in accounts receivable	(42,445)	(27
(Increase) decrease in prepaid expenses	222,786	(1
(Increase) decrease in other current assets	584,288	(69
Increase in deposits	(19,771)	(1
Increase (decrease) in accounts payable and accrued liabilities	(365,351)	1,09
Decrease in accounts payable from acquired companies	-	(17
Increase in deferred revenue	787,923	18
Net cash used in operations	(8,308,278)	(7,23
Cash flows from investing activities:		
(Increase) decrease in cash-pledged	33,420	(2,02
Purchases of fixed assets	(717,706)	(2,30
Proceeds from sale of assets	21,051	
Increase in investments	-	(10
Net cash acquired in acquisitions	938,536	12
Decrease in due from related parties	(17,722)	
Purchases of patents and trademarks	(76,046)	(10

Net cash (used in) provided by investing activities	181,533	(4,42
Cash flows from financing activities:		
Proceeds from issuance of preferred stock	-	21,53
Proceeds from issuance of common stock	183,334	31
Decrease in due to related parties	(245,851)	
Net cash (used in) provided by financing activities	(62,517)	21,85
Net increase (decrease) in cash	(8,189,262)	10,19
Cash, beginning of period	10,613,897	4,74
Cash, end of period	$ 2,424,635	$ 14,93
Cash paid for income taxes	$ -	$
Cash paid for interest	$ -	$
Supplemental disclosure of noncash investing activities: In June 2001, the Company acquired Control Commerce, Inc. for 800,000 shares of common stock and 60,000 shares of Series C preferred stock. In April 2000, the Company acquired Fusionactive, Ltd. for 150,000 shares of common stock.	$ 1,536,400	$ 2,62

The accompanying notes are an integral part of these statements.

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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 and nine months ended June 30, 2001 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 if dilutive, 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.

4. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States 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 June 30, 2001 and September 30, 2000, the carrying amounts of cash were $2,540,035 and $10,762,717, respectively, and the bank balances were $2,497,373 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. 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, Ltd., it will operate in more than one segment. The following is a summary of significant geographic markets:

	North	Asia

	America	Pacific
For the nine months ended June 30, 2000:		
Net revenues	$ 761,968	$ 159,180
Long lived assets	4,173,565	2,693,499
For the nine months ended June 30, 2001:		
Net revenues	1,966,413	772,840
Long lived assets	6,317,797	2,639,279

7. Recent Accounting Pronouncements

On July 20, 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141, Business Combinations, and SFAS 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001 and the effective date of SFAS 142. Major provisions of these Statements and their effective dates for the Company are as follows:

- All business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest method of accounting is prohibited except for transactions initiated before July 1, 2001.

- Intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability.

- Goodwill, as well as intangible assets with indefinite lives, acquired after June 30, 2001, will not be amortized. Effective October 1, 2002, all previously recognized goodwill and intangible assets with indefinite lives will no longer be subject to amortization.

- Effective October 1, 2002, goodwill and intangible assets with indefinite lives will be tested for impairment annually and whenever there is an impairment indicator.

- All acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

The Company will continue to amortize goodwill and intangible assets recognized prior to July 1, 2001, under its current method until October 1, 2002, at which time annual and quarterly goodwill amortization of $719,790 and $282,380, respectively, will no longer be recognized. By September 30, 2003 the Company will have completed a transitional fair value based impairment test of goodwill as of October 1, 2002. By December 31, 2002, the Company will have completed a transitional impairment test of all intangible assets with indefinite lives. Impairment losses, if any, resulting from the transitional testing will be recognized in the quarter ended December 31, 2002, as a cumulative effect of a change in accounting principle.

Note B--Liquidity

Since inception, the Company has funded operations by selling stock. While revenues have increased significantly over the prior year, expenses continue to exceed revenues. During the quarter ended June 30, 2001, the Company continued to implement cost-savings measures designed to reduce net cash expenditures in future quarters. Even so, the Company does not anticipate that monthly revenues will be sufficient to offset expected expenditures until late calendar 2001. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Need for additional financing."

Note C--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 D--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 resulted in an increase in rent expense of $12,170 per month. The lease expires December 31, 2004.

As a result of the acquisition of Control Commerce, Inc. the Company assumed two leases for office space in New York City and Encinitas, California. The New York office lease requires monthly rent payments of $11,500 per month and expires in July 2002. The Company is in the process of closing its existing facility in New York and moving into a portion of these facilities. Furthermore, the Company is negotiating to return unused space to the landlord in exchange for extending the lease term until July 2003. The Encinitas space requires monthly rent payments of $7,834 per month through April 2002, and $8,064 per month through May 2003, when the lease expires. Effective July 1, 2001 the Company entered into a sublease for the Encinitas space which provides for rental income of $8,064 per month through April 2002, and $8,525 per month through May 2003, when the lease expires.

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.

In October 2000, the Company received a refund in the amount of $500,000 resulting from excess amounts deposited with the court in connection with a lawsuit that was settled in September 2000.

During the nine months ended June 30, 2001, 296,177 shares of common stock were contributed to the Company and cancelled pursuant to an indemnity agreement with a significant stockholder, in full settlement of an amount due under the indemnity agreement.

In January 2001, 800 America, Inc. brought an action against Control Commerce, Inc., which was acquired by MindArrow in June 2001, in state court in New York relating to discussions of a proposed acquisition of Control Commerce by 800 America. The complaint alleged, among other things, a breach of contract by Control Commerce and tortious interference with a contractual relationship by unnamed third parties. In March 2001, the case was removed to the U.S. District Court for the Southern District of New

York. In April 2001, MindArrow was added as a defendant to the litigation. 800 America has alleged that MindArrow wrongfully interfered with its business relationship with Control Commerce and has alleged contractual damages of $2 million and punitive damages of $10 million against Control Commerce and MindArrow. MindArrow and Control Commerce believe the claims against them are without merit and intend to vigorously defend themselves in these matters. In August 2001, MindArrow filed a motion for summary judgment to dismiss the claims against it.

3. Acquisitions

In June 2001, the Company completed its acquisition of Control Commerce, Inc. ("Control Commerce"), a privately-held Delaware corporation. Under the terms of the merger agreement, a wholly-owned subsidiary of the Company was merged with and into Control Commerce, with Control Commerce surviving the merger and becoming a wholly-owned subsidiary of the Company.

In the merger, the shareholders of Control Commerce received in exchange for all of their issued and outstanding capital stock of Control Commerce an aggregate of 60,000 shares of the Company's Series C preferred stock, 800,000 shares of the Company's common stock and warrants to purchase 12,000 shares of the Company's common stock at a price of $12.50 per share (collectively, the "Merger Consideration"). In addition, in the event the Company closes a round of financing on or before December 15, 2001 involving the issuance of shares of a series of the Company's preferred stock with a liquidation preference senior to that of the Company's Series C preferred stock (or a liquidation preference equal to the Series C preferred stock if fifty percent or more of the new series is sold to existing holders of the Company's Series B or Series C preferred stock), the merger agreement permits the Control Commerce shareholders to exchange the Merger Consideration for consideration consisting of a combination of shares of the new series of stock and the Company's common stock, up to a maximum of one million equivalent shares of common stock.

The total purchase price of the acquisition was $1,536,400 for which the Company issued warrants to purchase 12,000 shares of the Company's common stock at a price of $12.50 per share, 800,000 shares of common stock, and 60,000 shares of Series C preferred stock, convertible into 120,000 shares of common stock, at a value of $1.67 per share. The purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values. Goodwill has resulted from the excess costs over fair value of net assets acquired.

Goodwill..	$930,177
Tangible assets acquired............................	1,025,268
Liabilities assumed.................................	(419,045)

$ 1,536,400
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On August 1, 2001, the Company announced the signing of a non-binding letter of intent to acquire privately-held Radical Communication, Inc. ("Radical"). Under the proposed terms of the transaction, the Company would acquire substantially all of the assets of Radical in exchange for 1,980,000 shares of common stock, 135,000 shares of Series C preferred stock and an unsecured subordinated promissory note in the aggregate principal amount of $1,000,000. The promissory note would be payable in two annual installments of $500,000, with the first installment due October 1, 2002. It is also contemplated that upon the close of the proposed transaction, Radical will designate a representative to join the Company's Board of Directors. Completion of the acquisition is subject to entering into a definitive agreement with Radical and to the satisfactory completion of due diligence and other conditions to closing, including but not limited to, approval by both companies' Board of Directors and approval by Radical's stockholders. The acquisition is expected to close in fall 2001 if it proceeds.

4. Transfer Agent Fraud

In February 2001, the Company determined that between May 21, 1999 and April 7, 2000 stock certificates representing 1,107,951 shares (the "Discrepant Shares") were illegally authenticated by the Company's prior transfer agent or others acting on its behalf. 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 SEC and has assisted law enforcement in the investigation of this matter. On February 5, 2001, Nasdaq halted trading of MindArrow's common stock on the Nasdaq SmallCap Market. On May 1, 2001 trading resumed.

In order to offset the impact of recognizing additional shares in the hands of innocent purchasers, two significant shareholders entered into an agreement with the Company pursuant to which they agreed to contribute for cancellation by the Company 1,107,951 shares owned by them. This contribution of shares was made concurrent with the exchange of new shares for the 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 two contributing shareholders. 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 contributing shareholders 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 1,107,951 shares pursuant to the agreement.

On March 30, 2001, the Company issued new shares in exchange for the Discrepant Shares and the 1,107,951 shares agreed to be contributed by the two significant shareholders were contributed to the Company and cancelled. No gain or loss has been recognized by the Company as a result of the share contribution.

The Discrepant Shares entered the public float over a period of approximately eleven months. In connection with the exchange, the Company

determined that under generally accepted accounting principles it should record a non-recurring, non-cash charge of $18,682,398 at the time the exchange of new shares for the Discrepant Shares occurs. Accordingly, this non-cash charge is reflected in the accompanying consolidated financial statements for the nine months ended June 30, 2001. This amount represents the estimated market value of the Discrepant Shares at the time they entered the public float. The charge had no impact on total stockholders' equity, as the Company concurrently recorded an $18,682,398 increase to additional paid-in capital. Any amounts recovered by the Company from the perpetrators of the fraud will be recorded as non-operating income at the time of the recovery. The loss on transfer agent fraud of $19,609,090 on the accompanying consolidated statement of operations includes legal and other costs associated with investigating the fraud, implementing the share exchange, pursuing resolution of the trading halt, and recovery of assets.

On June 25, 2001, the former transfer agent and her accomplice were convicted of crimes arising out of their fraudulent issuance of shares, and have agreed as part of their plea agreement to pay restitution. Authorities have seized $4.5 million in assets that may be distributed pursuant to civil forfeiture proceedings. The Company has made claim to these assets as partial recovery of the loss incurred by the Company as a result of the fraud. However, the Company can make no assurances as to when or whether it will obtain a recovery of the seized assets.

The following is a schedule of as reported and pro forma net loss and loss per share, illustrating the impact the Discrepant Shares would have had if the loss of $18,682,398 associated with the Discrepant Shares had been recorded in the periods in which the Discrepant Shares entered the public float:

MindArrow Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)

Period	Discrepant Shares	Value	Net Loss	
			As Reported	Pro Forma
Period from inception (March 26, 1999) to June 30, 1999	326,742	$ (3,880,061)	$ (799,762)	$ (4,679,823
Quarter ended September 30, 1999	237,000	(1,925,626)	(2,593,831)	(4,519,457
Period from inception (March 26, 1999) to September 30, 1999	563,742	$ (5,805,687)	$ (3,393,593)	$ (9,199,280
Quarter ended December 31, 1999	256,414	$ (4,827,209)	$ (2,252,585)	$ (7,079,794
Quarter ended March 31, 2000	274,810	(7,536,594)	(17,765,937)	(25,302,531
Quarter ended June 30, 2000	12,985	(512,908)	(3,813,814)	(4,326,722
Quarter ended September 30, 2000	-	-	(4,982,875)	(4,982,875
Year ended September 30, 2000	544,209	$(12,876,711)	$(28,815,211)	$(41,691,922

Quarter ended December 31, 2000	-	$ -	$ (5,380,664)	$ (5,380,664
Quarter ended March 31, 2001	(1,107,951)	18,682,398	(23,130,340)	(4,447,942
Quarter ended June 30, 2001	-	-	(3,292,632)	(3,292,632
Nine months ended June 30, 2001	(1,107,951)	$ 18,682,398	$(31,803,636)	$(13,121,238

The pro forma charges above would have no impact on total stockholders' equity, as the Company would concurrently record a corresponding increase to additional paid-in capital.

Note E--Stockholders' Equity

1. Preferred Stock Conversions

During the nine months ended June 30, 2001, 471,749 shares of Series B preferred stock were converted into 471,749 shares of common stock pursuant to the conversion rights of the Series B preferred stockholders. During the quarter ended June 30, 2001, 6,000 shares of Series C preferred stock were converted into 12,000 shares of common stock pursuant to the conversion rights of the Series C preferred stockholders.

2. Warrants

During the nine months ended June 30, 2001, the Company issued to consultants warrants to purchase 70,000 shares of common stock. The warrants are exercisable at prices ranging from $5 per share to $8 per share, vest over periods up to 3 years, and expire January 2002 through October 2005. Additionally, during the quarter ended June 30, 2001, the Company issued warrants to purchase 12,000 shares of common stock at a price of $12.50 per share, as partial consideration in the Control Commerce acquisition (see Note D3).

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 $74,302 for the nine months ended June 30, 2001.

3. Options

During the nine months ended June 30, 2001, the Company granted options to purchase 1,503,700 shares of common stock to employees and directors of the Company under the 1999 and 2000 Stock Option Plans at exercise prices from $1 to $7 per share. During the same period, options to purchase 972,514 shares were forfeited and 358,334 were exercised, resulting in outstanding options to purchase 3,174,686 shares at June 30, 2001.

Note F--Due to Related Parties

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 was recorded as the reduction 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 June 30, 2001 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 and significant stockholder resulting in a charge to the Company of approximately $442,000. The amount was paid 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 a reduction of $348,068 due under the terms of an indemnity agreement. All amounts were paid as of March 31, 2001.

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 was 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. Additionally, in January 2001, options to purchase 57,000 shares of common stock at an exercise price of $5 per share were granted in connection with this contract cancellation, resulting in compensation expense of $76,380.

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, Ltd. in exchange for 150,000 shares of our common stock. The results of operations of Fusionactive have been included in the consolidated financial statements commencing April 1, 2000. The results of operations of Fusionactive from April 1 through April 23 are immaterial to our consolidated results. In June 2001, we acquired Control Commerce, Inc. in exchange for 800,000 shares of our common stock, 60,000 shares of our Series C preferred stock and a warrant to purchase 12,000 shares of our common stock. The results of operations of Control Commerce have been included in the consolidated financial statements commencing June 1, 2001.

Through June 30, 2001, our revenues were derived from professional services, transaction charges and license fees for our software product, MindArrow Messenger. Professional services include Message production and design consultation, e-Marketing consulting and software implementation and training services. Transaction charges are for delivery and tracking of MindArrow Messages. The Control Commerce product Virtual Kiosk is an e-commerce enabling technology that will be integrated into our existing messaging and software products.

Revenues are recognized when the professional services are rendered and transaction charges are recognized when the MindArrow Messages 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's revenue from media sales is recognized upon placing advertisements.

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.

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 private placements of our equity securities to fund such requirements.

We do not anticipate that monthly revenues will be sufficient to offset expected expenditures until late calendar 2001. Based on our current operating plan and available cash, we anticipate that we will need to obtain additional financing before then. We have no current arrangements with respect to sources of additional financing and there is no certainty that we will be able to raise additional funds. We plan to seek additional financing but the market for privately placed equity securities of companies like ours is, at this time, very difficult. We also have made a claim to recover assets seized from our former transfer agent and an accomplice as partial restitution arising from the loss incurred by the Company as a result of the transfer agent fraud (see Note D4 to our Financial Statements) but we can not be certain when or whether we will obtain a recovery of the seized assets. If the Company is unsuccessful in raising additional funds or obtaining a recovery of the seized assets prior to September 30, 2001, the liquidity position of the Company will be materially and adversely effected and we could be required to make drastic cost reductions, which

could negatively impact our operations. All of the statements contained in this Report on Form 10-Q are qualified by these facts.

Results of operations

For the three and nine months ended June 30, 2001, revenues totaled $822,729 and $2,739,253, respectively, compared to $606,076 and $921,148 for the corresponding periods in fiscal 2000. The increase from the previous year was due to our expanded product and service offerings and the overall growth of our customer base.

For the three and nine months ended June 30, 2001, our operating loss was $3,156,309 and $12,352,538, respectively, compared to $4,036,355 and $11,799,899 for the corresponding periods in fiscal 2000. The reduction in the quarterly loss results from increased revenue and our efforts to reduce costs across the board. The increase in the operating loss for the nine months ended June 30, 2001 results primarily from increased depreciation and amortization expenses in the current year. Other cost increases were offset by the increase in revenue over the previous year.

In February 2001, the Company determined that between May 21, 1999 and

April 7, 2000 stock certificates representing 1,107,951 shares (the "Discrepant Shares") were illegally authenticated by the Company's prior transfer agent or others acting on its behalf. 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 SEC and has assisted law enforcement in the investigation of this matter. On February 5, 2001, Nasdaq halted trading of MindArrow's common stock on the Nasdaq SmallCap Market. On May 1, 2001 trading resumed.

In order to offset the impact of recognizing additional shares that may be in the hands of innocent purchasers, two significant shareholders entered into an agreement with the Company pursuant to which they agreed to contribute for cancellation by the Company 1,107,951 shares owned by them. This contribution of shares was made concurrent with the exchange of new shares for the 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 two contributing shareholders. 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 contributing shareholders 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 1,107,951 shares pursuant to the agreement.

On March 30, 2001, the Company issued new shares in exchange for the Discrepant Shares and the 1,107,951 shares agreed to be contributed by the two significant shareholders were contributed to the Company and cancelled. No gain or loss has been recognized by the Company as a result of the share contribution.

The Discrepant Shares entered the public float over a period of approximately eleven months. In connection with the exchange, the Company determined that under generally accepted accounting principles it should record a non-recurring, non-cash charge of $18,682,398 at the time the exchange of new shares for the Discrepant Shares occurs. Accordingly, this non-cash charge is reflected in the accompanying consolidated financial statements. This amount represents the estimated market value of the Discrepant Shares at the time they entered the public float. The charge had no impact on total stockholders' equity, as the Company concurrently recorded an $18,682,398 increase to additional paid-in capital. Any amounts recovered by the Company from the perpetrators of the fraud will be recorded as non-operating income at the time of the recovery. The loss on transfer agent fraud of $19,609,090 includes legal and other costs associated with investigating the fraud, implementing the share exchange and pursuing resolution of the trading halt.

On June 25, 2001, the former transfer agent and her accomplice were convicted of crimes arising out of their fraudulent issuance of shares, and have agreed as part of their plea agreement to pay restitution. Authorities have seized $4.5 million in assets that may be distributed pursuant to civil forfeiture proceedings. The Company has made claim to

these assets as partial recovery of the loss incurred by the Company as a result of the fraud. However, the Company can make no assurances as to when or whether it will obtain a recovery of the seized assets.

For the three and nine months ended June 30, 2001, our net loss available to common stockholders was $3,292,632, or $0.30 per share, and $31,803,636, or $3.00 per share, respectively, compared to $3,813,814, or $0.38 per share, and $23,832,336, or $2.44 per share, for the corresponding periods in fiscal 2000. On a pro forma basis, excluding the non-cash portion of the loss on transfer

agent fraud described above, net loss for the nine months was $13,121,238, or $1.24 per share.

Development expenses consist primarily of salaries and related expenses for software engineers and other technical personnel, including consultants, and were focused on continued advancements in multimedia communication technology and continued development of MindArrow Messenger, as well as integrating technology acquired in the Control Commerce acquisition. Total development costs for the three and nine months ended June 30, 2001 amounted to $621,786 and $2,144,665, compared to $595,070 and $1,440,723 for the corresponding periods in fiscal 2000. 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 design and client service people to produce MindArrow Messages and assist our clients to implement MindArrow Messenger. Total production costs for the three and nine months ended June 30, 2001 amounted to $431,082 and $1,301,044, respectively, compared to $442,256 and $664,785, for the corresponding periods of fiscal 2000.

Sales and marketing expenses for the three and nine months ended June 30, 2001 amounted to $1,205,964 and $4,969,565, respectively, a decrease from $1,632,781 and $5,241,520 from the previous year. The expenses 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. 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. 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 $1,022,201 and $4,644,713 for the three and nine months ended June 30, 2001, respectively, compared to $1,438,209 and $4,442,542 for the corresponding periods in fiscal 2000, primarily included salaries and related expenses for administrative, finance and human resources personnel, professional fees and other costs of operating as a public company. The decrease in costs from the quarter in the previous year primarily resulted from the elimination of certain positions and consultants.

Stock-based compensation decreased to $29,388 for the three months ended June 30, 2001 from $251,814 for the three months ended June 30, 2000. This decrease was attributable to a decrease in the quantity of warrants granted and vested, and 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 June 30, 2001 we had $109,622 in unearned stock-based compensation scheduled to be amortized as follows: $31,288 in the quarter ending September 30, 2001, and $78,334 in the fiscal year ending September 30, 2002. We do not anticipate recording significant stock-based compensation in the future.

Liquidity and sources of capital

In addition to the following see the preceding discussion regarding "Need for additional financing."

Since our inception, we have funded our operations by selling stock. While

our revenues have increased significantly over the prior year, our expenses continue to exceed revenues. During the quarter ended June 30, 2001, we continued to implement cost-savings measures designed to reduce net cash expenditures in future quarters. Even so, we do not anticipate that monthly revenues will be sufficient to offset expected expenditures until late calendar 2001.

As of June 30, 2001 and September 30, 2000, we had current assets of $3,802,440 and $12,925,425, respectively, and current liabilities of $3,060,013 and $1,932,746, respectively. This represents working capital of $742,427 at June 30, 2001 and $10,992,679 at September 30, 2000.

For the nine months ended June 30, 2001, we used $8,308,278 of cash for operating activities, compared to $7,239,124 used for operations in the nine months ended June 30, 2000, which were primarily focused on growing our organizational infrastructure to be able to service our clients.

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. SFAS No. 133 or SFAS No. 137 have not had 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. SAB 101 has not had 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. The adoption of FIN 44 has not had a material impact on our financial position or results of operations.

On July 20, 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141, Business Combinations,

and SFAS 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001 and the effective date of SFAS 142. Major provisions of these Statements and their effective dates for the Company are as follows:

. All business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest method of accounting is prohibited except for transactions initiated before July 1, 2001.

. Intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability.

. Goodwill, as well as intangible assets with indefinite lives, acquired after June 30, 2001, will not be amortized. Effective October 1, 2002, all previously recognized goodwill and intangible assets with indefinite lives will no longer be subject to amortization.

. Effective October 1, 2002, goodwill and intangible assets with indefinite lives will be tested for impairment annually and whenever there is an impairment indicator.

. All acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

The Company will continue to amortize goodwill and intangible assets recognized prior to July 1, 2001, under its current method until October 1, 2002, at which time annual and quarterly goodwill amortization of $719,790 and $282,380, respectively, will no longer be recognized. By September 30, 2003 the Company will have completed a transitional fair value based impairment test of goodwill as of October 1, 2002. By December 31, 2002, the Company will have completed a transitional impairment test of all intangible assets with indefinite lives. Impairment losses, if any, resulting from the transitional testing will be recognized in the quarter ended December 31, 2002, as a cumulative effect of a change in accounting principle.

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, and (ii) we will not record significant stock-based compensation in

the future. 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 SEC.

Risk Factors

Additional factors that may affect future results

In addition to the factors discussed in the "Need for additional financing" section of this Management's Discussion and Analysis of Financial Conditions and Results of Operations, the following additional risk factors may affect our future operating results.

We cannot assure you that our common stock will continue to be listed on the Nasdaq SmallCap Market

The Nasdaq Stock Market retains discretion over whether to continue listing our common stock on the Nasdaq SmallCap Market. Recently, the share price of our common stock has been less than $1.00. If our common stock does not maintain a required minimum bid price of $1.00 over a period of 30 consecutive trading days, we may be notified by Nasdaq that we need to regain compliance with this requirement. If we do not regain compliance with this requirement or if we do not meet other qualification listing standards, our common stock may be delisted from trading on the Nasdaq SmallCap market. If our common stock is delisted from the Nasdaq SmallCap Market, your shares may become significantly less liquid and may decline significantly in price.

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 net loss of $50,622,858 through June 30, 2001 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 $700,000 per month, even after giving effect to our recent reductions in personnel. Our expected expense levels are based, in part, on our cash resources and planned revenues. If we are unsuccessful in generating significant revenues or raising additional funds, we will be unable to continue expenditures at current levels. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Need for additional financing."

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;
- fees for professional services associated with resolving issues related to the Discrepant Shares;
- 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 investors. In such event, the market price of our common stock could drop.

If we are unable to obtain funding, our customers and vendors may decide not to do business with us

If we are unable to continue funding our operations at our current levels, and if customers and vendors become concerned about our business prospects, they may decide not to conduct business with us, or may conduct business with us on terms that are less favorable than those customarily extended by them. In that event, our net sales would decrease and our business will suffer significantly.

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 be unwilling to download eBrochures due to the large size of the files. During the quarter ended June 30, 2001, 88% of the eBrochures we sent were 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.

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

We intend to consider acquisitions of businesses and technologies on an opportunistic basis, for example, our recent acquisition of Control Commerce, Inc. and our announced intent to acquire the assets of Radical Communications, Inc. 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, 65% of our revenues through June 30, 2001 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 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 August 13, 2001, our common stock closed at $0.78 per share. Our stock price could be subject to wide fluctuations in response to factors such as:

- the average daily trading volume of our common stock;
- actual or anticipated variations in quarterly operating results and our need for additional financing to fund our continuing operations;
- 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

- 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 - We cannot assure you that our common stock will continue to be listed on the Nasdaq SmallCap Market."

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.

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. In addition, we have received one patent on technology we obtained in the Control Commerce acquisition. 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 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 17% of our outstanding common stock and 25% of our Series B preferred 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 Ltd., in April 2000. To date, we have recognized approximately $1.2 million 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 MindArrow Messages 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 June 30, 2001, we had 11,456,666 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:

- 1,004,949 shares are reserved for issuance upon the conversion of our outstanding shares of Series B preferred stock;

- 1,559,550 shares are reserved for issuance upon the conversion of our outstanding shares of Series C preferred stock;

- 2,000,880 shares are reserved for issuance upon the exercise of 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 June 30, 2001, 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

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.

For a description of certain of these matters, see Note D2 to our consolidated financial statements, which is incorporated by reference in response to this item.

Item 2. Changes in Securities and Use of Proceeds

During the nine months ended June 30, 2001, we issued to consultants warrants to purchase 70,000 shares of common stock. The warrants are exercisable at prices ranging from $5 per share to $8 per share, vest over periods up to 3 years, and expire between January 2002 and October 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.

In May 2001, we acquired Control Commerce, Inc. in exchange for 800,000 shares of MindArrow common stock, 60,000 shares of MindArrow Series C preferred stock convertible into 120,000 shares of common stock, and a warrant to purchase 12,000 shares of MindArrow common stock pursuant to an exemption from registration provided by Rule 506 of Regulation D of the Securities Act of 1933, as amended. This transaction was made without general solicitation or advertising. The Company believes that each purchaser (i) was an accredited investor or a sophisticated investor (either alone or through its representative) with access to all relevant information necessary, (ii) was acquiring the MindArrow securities solely for his or her own account and for investment, and (iii) does not intend to offer, sell or dispose of such securities except in compliance with the Securities Act of 1933, as amended.

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

(a) Exhibits

3.1 MindArrow Systems, Inc. Restated Certificate of Incorporation
3.2 MindArrow Systems, Inc. Bylaws, as corrected

(b) Reports on Form 8-K

1. On June 18, 2001, MindArrow filed a report on Form 8-K relating to an announcement regarding the completion of an acquisition of Control Commerce, Inc.

2. On August 1, 2001, MindArrow filed a report on Form 8-K relating to an announcement regarding the signing of a letter of intent to acquire the assets of Radical Communication, Inc.

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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.

MindArrow Systems, Inc.

(Registrant)

Date: August 14, 2001

/s/ ROBERT I. WEBBER

Robert I. Webber
Chief Executive Officer, President,
(Principal Executive Officer), and
Director

Date: August 14, 2001

/s/ MICHAEL R. FRIEDL

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

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