ALTIGEN COMMUNICATIONS INC
Form 10-Q
August 14, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITY EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

OR

/ / 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 000-27427

ALTIGEN COMMUNICATIONS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Delaware	94-3204299
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
47427 Fremont Boulevard Fremont, CA	94538
(address of principal executive offices)	(zip code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (510) 252-9712

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

AS OF AUGUST 12, 2002, 13,479,711 SHARES OF THE REGISTRANT'S COMMON STOCK WERE OUTSTANDING.

Table of Contents

	Page
PART I FINANCIAL INFORMATION	
Item 1. Unaudited Condensed Consolidated Financial Statements	3
Unaudited Condensed Consolidated Balance Sheets as of June 30, 2002 and September 30, 2001	3
Unaudited Condensed Consolidated Statements of Operations for the Three and Nine Months Ended June 30, 2002 and 2001	4
Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended June 30, 2002 and 2001	5
Notes to Unaudited Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures about Market Risk	23
PART II OTHER INFORMATION	
Item 1. Legal Proceedings	24
Item 2. Changes in Securities and Use of Proceeds	24
Item 4. Submission of Matters to a Vote of Security Holders	24
Item 6. Exhibits and Reports on Form 8-K	24
SIGNATURES	25

2

PART I. FINANCIAL INFORMATION
Item 1. Unaudited Condensed Consolidated Financial Statements

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2002
ASSETS	
Current assets:	
Cash and cash equivalents	$ 4,213,448
Short-term investments	8,797,497
Accounts receivable, net of allowances of $283,805 and $403,423 at June 30, 2002 and September 30, 2001, respectively	1,441,961
Inventories	1,589,241
Prepaid expenses and other current assets	345,289
Promissory note from officer / stockholder (Note 3)	350,012

Total current assets	16,737,448
Property and equipment:	
Leasehold improvements	297,922
Furniture and equipment	1,733,372
Computer software	913,253
	2,944,547
Less: Accumulated depreciation and amortization	(2,191,916)
Net property and equipment	752,631
Long-term investment	397,826
	$ 17,887,905
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$ 696,130
Accrued liabilities:	
Payroll and related benefits	305,303
Warranty	538,795
Marketing	538,724
Other	524,270
Deferred revenue	614,603
Total current liabilities	3,217,825
Contingencies	
Stockholders' equity:	
Common stock, $0.001 par value; Authorized - 50,000,000 shares; Outstanding - 14,543,606 shares at June 30, 2002 and 13,772,488 shares at September 30, 2001	14,544
Treasury stock at cost - 1,063,895 shares at June 30, 2002 and 114,900 shares at September 30, 2001	(1,014,499)
Additional paid-in capital	61,801,895
Deferred stock compensation	(176,709)
Accumulated other comprehensive gain	4,649
Accumulated deficit	(45,959,800)
Total stockholders' equity	14,670,080
	$ 17,887,905

The accompanying notes are an integral part of these condensed consolidated financial statements.

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30,		Nine Mo
	2002	2001	2002

Revenues, net	$ 2,764,539	$ 2,695,850	$ 6,735,
Cost of revenues	1,205,849	2,672,082	3,206,
Gross profit	1,558,690	23,768	3,529,
Operating expenses:			
Research and development	1,038,686	1,386,322	3,090,
Sales and marketing	1,490,926	3,082,496	4,490,
General and administrative	547,338	665,924	1,622,
Deferred stock compensation (Note 4)	92,757	133,209	278,
Total operating expenses	3,169,707	5,267,951	9,481,
Loss from operations	(1,611,017)	(5,244,183)	(5,951,
Interest and other income, net	61,138	243,535	229,
Net loss	$ (1,549,879)	$ (5,000,648)	$ (5,722,
Basic and diluted net loss per share	$ (0.12)	$ (0.36)	$ (0
Shares used in computing basic and diluted net loss per share	13,390,331	13,722,266	13,334,

The accompanying notes are an integral part of these condensed consolidated financial st

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months
	2002
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$ (5,722,622)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	458,559
Amortization of deferred stock compensation	278,274
Provision for accounts receivable allowance	(115,973)
Provision for excess and obsolete inventories	--
Changes in operating assets and liabilities	
Accounts receivable	(51,673)
Inventories	954,074
Prepaid expenses and other current assets	(75,847)
Accounts payable	228,588
Accrued liabilities	122,618
Deferred revenue	(184,254)
Net cash used in operating activities	(4,108,256)
CASH FLOWS FROM INVESTING ACTIVITIES:	

Purchases of short-term investments.................	(26,366,939)
Proceeds from sale and maturities of short-term investments	23,197,762
Purchases of property and equipment.................	(85,981)
Net cash (used in) provided by investing activities	(3,255,158)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from issuances of common stock.............	209,216
Purchase of treasury stock	(909,490)
Collection of promissory note from officer/stockholder	372,733
Unrealized gain on short term investments	4,649
Net cash (used in) provided by financing activities	(322,892)
NET DECREASE IN CASH AND CASH EQUIVALENTS.......................	(7,686,306)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD..................	11,899,754
CASH AND CASH EQUIVALENTS, END OF PERIOD........................	$ 4,213,448

The accompanying notes are an integral part of these condensed consolidated financial statem

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

AltiGen Communications, Inc. ("AltiGen" or the "Company") designs, manufactures and markets integrated, multifunction telecommunications systems that allow businesses to use data networks, such as the Internet, and the traditional telephone network interchangeably and seamlessly to carry voice and data communications.

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited condensed consolidated financial statements reflect the operations of the Company and its wholly-owned subsidiary. All significant intercompany transactions and balances have been eliminated. In our opinion, these unaudited condensed consolidated financial statements include all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the Company's financial position, results of operations and cash flows for the periods presented.

The condensed consolidated balance sheet as of September 30, 2001 has been derived from the audited consolidated financial statements as of that date. Certain amounts from the prior period have been reclassified to conform to the current period presentation. Such reclassifications have no effect on net income as previously reported.

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2001, included in the Company's 2001 Annual Report on Form 10-K. Our results of

operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

The Company considers all highly liquid investments with an original maturity of three months or less from the date of purchase to be cash equivalents. Short-term investments primarily consist of high-grade debt securities with original maturities greater than three months but less than one year and are classified as "available-for-sale" investments. As of June 30, 2002, the Company's cash and cash equivalents consisted of commercial paper and cash deposited in checking and money market accounts. For the third quarter of fiscal years 2002 and 2001, the Company did not make any cash payments for interest or income taxes.

INVENTORIES

Inventories (which include costs associated with components assembled by third party assembly manufacturers, as well as internal labor and allocable overhead) are stated at the lower of cost (first-in, first-out) or market. Provisions, when required, are made to write down excess and obsolete inventories to their estimated net realizable values. The components of inventories include:

	June 30, 2002	September 30, 2001
Raw materials............................	$ 253,873	$ 585,131
Work-in-progress.........................	247,698	88,711
Finished goods...........................	1,087,670	1,869,474
	$ 1,589,241	$ 2,543,316

LONG-TERM INVESTMENT

The Company has an approximately $380,000 equity investment in a private China based telecommunications company. AltiGen's interest in the company is approximately 2% and AltiGen does not have the ability to exercise significant influence. Accordingly, this investment is carried at cost. If this investment declined in fair value on an other than temporary basis, the Company would record an adjustment to the carrying value. To date, no such impairment has been recognized.

Revenue Recognition

Revenues consist of sales to end-users, including resellers, and to distributors. Revenues from sales to end-users are recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. The Company provides for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenues consist of product revenues reduced by estimated sales returns and allowances.

Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company's products held by its distributors. Upon termination, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled by either party based on a specified notice. As a result of the above provisions, the Company

defers recognition of revenues and the proportionate costs of revenues derived from sales to distributors until such distributors resell the Company's products to their customers. The amounts deferred as a result of this policy are reflected as "deferred revenue" in the accompanying consolidated balance sheets.

Software components are generally not sold separately from the Company's hardware components. The Company accounts for the recognition of software revenues in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition". Software revenues consist of license revenues that are recognized upon the delivery of application products. The Company provides limited post-contract customer support ("PCS"), consisting primarily of technically support and "bug" fixes. In accordance with SOP 97-2, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. Although the Company provides PCS, the revenue allocated to this element is recognized together with the initial licensing fee on delivery of the software because: (1) the PCS fee is included with the initial licensing fee; (2) the PCS included with the initial license fee is for one year or less; (3) the estimated cost of providing PCS during the arrangement is insignificant; and (4) unspecified upgrades/enhancements offered for minimal or no cost during PCS arrangements historically have been and are expected to continue to be minimal and infrequent. All estimated costs of providing the services, including upgrades/enhancements are accrued for at the time of delivery.

BASIC AND DILUTED NET LOSS PER SHARE

Historical net loss per share has been calculated under Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." SFAS No. 128 requires companies to compute earnings per share under two methods (basic and diluted). Basic net loss per share is calculated by dividing net loss by the weighted average shares of common stock outstanding during the period. Basic and diluted net loss per share numbers are the same, as potential common shares resulting from the exercise of stock options are antidilutive. Options to purchase 3,536,886 shares of common stock were outstanding at June 30, 2002.

7

COMPREHENSIVE INCOME

SFAS No. 130, "Reporting Comprehensive Income" establishes standards for reporting and presentation of comprehensive income. Comprehensive loss for the Company consists of net loss plus the effect of foreign currency translation adjustments and other unrealized gains and losses.

	Three Months Ended June 30,		Nine
	2002	2001	2002
Net loss	($ 1,549,879)	($ 5,000,648)	($ 5,722,62
Other comprehensive income-			
Change in net unrealized gain on investments	4,649	--	4,64
	($ 1,545,230)	($ 5,000,648)	($ 5,717,97

SEGMENT REPORTING

The Company is organized and operates as one operating segment. The Company operates primarily in one geographic area, North America.

Net revenue by geographic region based on customer location for the three month and nine month periods ended June 30, 2002 and 2001 were as follows:

	Three Months Ended June 30,		Nine
	2002	2001	2002
Net Revenue			
North America.......................	94%	97%	95%
International	6%	3%	5%
	100%	100%	100%

Net revenue by certain customers individually that account for more than 10% of revenue for the three month and nine month periods ended June 30, 2002 and 2001 were as follows:

	Three Months Ended June 30,		Nine
	2002	2001	2002
Customer A	28%	55%	30%
Customer B	20%	22%	27%
Customer C	28%	20%	26%
Others	24%	3%	17%
	100%	100%	100%

Nearly all long-lived assets are located in the United States for all periods presented.

8

Note 2. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, FASB issued SFAS No.'s 141 and 142, "Business Combinations" and "Goodwill and Other Intangibles". SFAS No. 141 require all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS No. 142, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill is subject to at least an annual assessment for impairment applying a fair-value based test. Additionally, an acquired intangible asset should be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if

the intangible asset can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. The Company will follow SFAS No. 141 for any future business acquisitions. The Company adopted SFAS No. 142 on October 1, 2001 and this adoption did not have a material impact on its consolidated financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS No. 144 establishes one accounting model to be used for long-lived assets to be disposed of by sale, and broadens the presentation of discontinued operations to include more disposal operations. SFAS No. 144 supersedes both SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of", and the accounting and the reporting provisions of Accounting Principles Board ("APB") Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Unfrequently Occurring Events and Transactions". SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. The Company does not expect the adoption of SFAS No. 144 will have a material impact on its consolidated financial position or results of operations.

In June 2002, the FASB issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities", which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. The Company will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

Note 3. PROMISSORY NOTE TO OFFICER / STOCKHOLDER:

On August 31, 2000, the Company granted a $1 million loan to its Chief Executive Officer and significant stockholder in exchange for a secured promissory note with a one-year term, bearing interest at 6.88%. During fiscal 2001, the Company received approximately $277,000 of payment against the note.

On September 17, 2001, the Company entered into a new note, replacing the previous note, for the then unpaid principal amount of $800,000. The new note requires two principal payments of $400,000 each, due on September 30, 2001 and 2002, respectively, with interest of 6.125% per annum due monthly. The note and related interest is full recourse and is secured by a security interest in the borrower's personal assets. During the nine month period ended June 30, 2002, approximately $373,000 was paid against the note.

9

Note 4. DEFERRED STOCK COMPENSATION

The amortization of deferred stock compensation relates to the following items in the accompanying unaudited condensed consolidated statements of operations:

	Three Months Ended June 30,		Nine
	2002	2001	2002

Research and development..........	$ 36,026	$ 53,360	$ 108,078
Sales and marketing...............	28,654	48,895	85,962
General and administrative........	28,077	30,954	84,234
	$ 92,757	$ 133,209	$ 278,274

Note 5. STOCK REPURCHASE PROGRAMS

On April 24, 2001, the Company's Board of Directors authorized a stock repurchase program to buy back up to $1.0 million of the Company's outstanding common stock in the open market. As of June 30, 2002, all $1.0 million had been used to repurchase 1,063,895 shares of the Company's common stock.

10

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

FORWARD-LOOKING INFORMATION

Certain statements in this Form 10-Q contain "forward-looking" information (as defined in Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended) that involve risks and uncertainties, which may cause actual results to differ materially from those predicted in the forward-looking statements. Forward-looking statements can be identified by their use of such verbs as "expects," "anticipates," and "believes" or similar verbs or conjugations of such verbs. If any of our assumptions on which the statements are based prove incorrect or should unanticipated circumstances arise, our actual results could materially differ from those anticipated by such forward-looking statements. The differences could be caused by a number of factors or combination of factors, including, but not limited to, the "Certain Factors Affecting Business, Operating Results and Financial Conditions " described herein and the Risk Factors described in our Securities and Exchange Commission filings.

OVERVIEW

We are a leading provider of integrated, multi-function telecommunications systems. We began operations in July 1994 and we first recognized revenues from product sales of our Quantum board and AltiWare software in July 1996. We generated net revenues of $2.8 million and $6.7 million for the third quarter and the first nine months of fiscal 2002, respectively, compared to net revenues of $2.7 million and $8.0 million for the third quarter and the first nine months of fiscal 2001. As of June 30, 2002, we had an accumulated deficit of $46.0 million.

We derive our revenues from sales of our AltiServ system, which includes Quantum boards, Triton boards and AltiWare software. We generally do not sell software separately from our hardware products. Software sales were $680,000 and $1.2 million for the third quarter and the first nine months of fiscal 2002, respectively, compared to software sales of $376,000 and $1.4 million for the same periods of fiscal 2001, respectively. Product revenues consist of sales to end users (including dealers) and to distributors. Revenues from product sales to end users are recognized upon shipment. We defer recognition of sales to distributors until they resell our products to their customers. Under our distribution contracts, a distributor has the right in certain circumstances to

return products the distributor determines are overstocked, so long as they provide an offsetting purchase order for products in an amount equal to or greater than the dollar value of the returned products. In addition, we provide distributors protection from subsequent price reductions.

Our cost of revenues consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to manufacturing our products. Software sales typically carry a higher gross margin than hardware sales.

We have experienced operating losses and negative cash flows from operations in each quarterly and annual period since our inception and we currently expect to continue to incur losses and negative cash flows for the foreseeable future. We have not recognized any future tax benefits of our cumulative net operating losses due to uncertainty as to future realizability.

11

Results of Operations

The following table sets forth consolidated statements of operations data for the periods indicated as a percentage of net revenues.

	Three Months Ended June 30,		Ni
	2002	2001	2002
	(unaudited)		
Revenues, net.........................	100.0%	100.0%	100.0%
Cost of revenues.....................	43.6	99.1	47.6
Gross margin.........................	56.4	0.9	52.4
Operating expenses :			
Research and development.........	37.6	51.4	45.9
Sales and marketing	53.9	114.4	66.7
General and administrative.......	19.8	24.7	24.1
Deferred stock compensation......	3.4	4.9	4.1
Total operating expenses ...	114.7	195.4	140.8
Loss from operations	(58.3)	(194.5)	(88.4)
Interest and other income, net	2.2	9.0	3.4
Net loss	(56.1)%	(185.5)%	(85.0)

Revenues, net. Revenues consist of sales to end users (including dealers) and to distributors. Net revenues increased 3% from $2.7 million for the third quarter of fiscal 2001 to $2.8 million for the third quarter of fiscal 2002. Net revenues decreased 16% from $8.0 million for the first nine months of fiscal 2001 to $6.7 million for the first nine months of fiscal 2002 as a result of decreased or delayed capital spending by existing and prospective customers and the slowdown of U.S. economy. Sales through our main distributors, AltiSys, Synnex, and Ingram Micro, accounted for approximately 19.6%, 27.8%, and 28.4%, respectively, of our revenues for the third quarter of fiscal 2002 as compared to 21.7%, 54.5%, and 20.4%, respectively, of our revenues for the same period of

fiscal 2001. Approximately 12% of our revenues for the quarter ended June 30, 2002 were derived from a promotional program in which we sold upgrades of the latest software release to our installed base. The increase in software revenues also contributed to the higher gross margin for the quarter ended June 30, 2002.

Cost of revenues. Cost of revenues were $1.2 million and $3.2 million for the third quarter and the first nine months of fiscal 2002, respectively, decreases of 55% and 42% from $2.7 million and $5.6 million for the same periods of fiscal 2001. Cost of revenues consists primarily of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to manufacturing our products. Cost of revenues as a percentage of net revenues decreased from 99.1% and 69.7% for the third quarter and the first nine months of fiscal 2001, respectively, to 43.6% and 47.6% for the same periods of fiscal 2002. The year-over-year decreases were primarily due to the fact that our inventory balance as of June 30, 2002 did not require additional write down for excess and obsolete inventory. Management continues to monitor our inventory levels in line with forecasted future shipment.

Gross margin. Gross profit increased to $1.6 million and $3.5 million for the third quarter and the first nine months of fiscal 2002, respectively, from $24,000 and $2.4 million for the same periods of fiscal

12

2001. As a percentage of revenue, gross margin increased to 56.4% and 52.4% for the third quarter and the first nine months of fiscal 2002, respectively, from 0.9% and 30.3% for the same periods of fiscal 2001. The increase in gross profit as a percentage of net revenues was primarily due to the previously mentioned write down for excess and obsolete inventory.

Research and development expenses. Research and development expenses decreased to $1.0 million and $3.1 million for the third quarter and the first nine months of fiscal 2002, respectively, from $1.4 million and $3.8 million for the same periods of fiscal 2001. Research and development expenses consist principally of salaries and related personnel expenses, consultant fees and prototype expenses related to the design, development and testing of our products and enhancement of our converged telephone system software. The year-over-year decreases were primarily due to a reduction in consulting fees, equipment and recruiting expenses.

Sales and marketing expenses. Sales and marketing expenses decreased to $1.5 million and $4.5 million for the third quarter and the first nine months of fiscal 2002, respectively, from $3.1 million and $7.6 million for the same periods of fiscal 2001, respectively. Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in sales and marketing functions, trade show expenses, promotional and marketing programs and related expenses. The year-over-year decreases were primarily due to significantly lower sales forces expenses in the first nine months of fiscal 2002 resulting from headcount reduction and cutback in the promotional and advertising activities.

General and administrative expenses. General and administrative expenses decreased to $547,000 and $1.6 million for the third quarter and the first nine months of fiscal 2002, respectively, from $666,000 and $2.2 million for the same periods of fiscal 2001. The year-over-year decreases were primarily due to reduction in legal fees as a result of the settlement of litigation with Sonoma Systems, Inc.

Deferred stock compensation expense. Deferred stock compensation expense was $93,000 and $278,000 for the third quarter and the first nine months of fiscal 2002, respectively, as compared to $133,000 and $656,000 for the same period of

fiscal 2001, respectively. Deferred stock compensation expense reflects the amortization of stock compensation charges resulting from granting stock options at exercise prices below the deemed fair value of our common stock on the dates the options were granted. The Company amortizes these amounts using the straight-line method over the vesting period of the related stock options. The Company expects to amortize approximately $93,000 of the remaining balance of this deferred stock compensation in fiscal year 2002 and $84,000 in fiscal year 2003.

Interest and other income, net. Net interest and other income decreased to $61,000 and $229,000 for the third quarter and the first nine months of fiscal 2002, respectively, from $244,000 and $1.1 million for the same period of fiscal 2001, respectively. The Company invested the proceeds from our initial public offering in October 1999 in highly liquid, short-term investments. The decreases were due to reductions in invested principal and declines in interest rates.

Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the sale of equity securities. As of June 30, 2002, we had cash and short-term investments totaling $13.0 million consisting of cash and cash equivalents of $4.2 million and $8.8 million of highly liquid short-term investments.

Net cash used in our operating activities was $4.1 million and $10.3 million for the nine months ended June 30, 2002 and 2001, respectively. Net cash used in operating activities primarily reflected the impact of the net loss for each of the periods reported.

Net cash used in investing activities was $3.3 million for the nine months ended June 30, 2002, which was primarily a result of purchases of short-term investments. Net cash provided by investing activities

for the nine months ended June 30, 2001 was $6.7 million, which was primarily a result of redemption of short-term investments.

Net cash used in financing activities was $323,000 for the nine months ended June 30, 2002, consisting primarily of funds used in the repurchase of our common stock. Cash provided by financing activities was $308,000 for the nine months ended June 30, 2001, consisting primarily of proceeds from issuances of common stock under our employee stock options and stock purchase plans.

Our cash needs depend on numerous factors, including market acceptance of and demand for our products, our ability to develop and introduce new products and product enhancements, prices at which we can sell our products, the resources we devote to developing, marketing, selling and supporting our products, the timing and expense associated with expanding our distribution channels, increases in manufacturing costs and the prices of the components we purchase as well as other factors.

If we are unable to raise additional capital or if sales from our new products are lower than expected, we will be required to make additional reductions in operating expenses and capital expenditures to ensure that we will have adequate cash reserves to fund operations.

Additionally, there may be other financial alternatives, such as but not limited to, private placements, strategic partnerships, mergers, and the issuance of equity or debt securities, which may be explored.

In January 2002, we restructured our organization and reduced overall headcount

by 6% to reduce our ongoing cash expenditures. Based on our current revenue projections, and recent cost savings, we believe that our cash reserves and working capital will be adequate to finance our operations for the next twelve months.

Our management intends to invest our cash in excess of current operating requirements in short-term, interest-bearing investment-grade securities. Additional financing, if required, may not be available on acceptable terms, or at all. We may also require additional capital to acquire or invest in complementary businesses or products, or obtain the right to use complementary technologies. If we can not raise funds, if needed, on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities, or to respond to competitive pressures or unanticipated requirements, which could seriously harm our business. Even if additional financing is available, we may be required to obtain the consent of our stockholders, which may or may not be able to obtain. In addition, the issuance of equity or equity-related securities will dilute the ownership interest of our stockholders and the issuance of debt securities could increase the risk or perceived risk of AltiGen.

AltiGen's common stock was transferred to the Nasdaq SmallCap Market at the opening of business on June 12th, 2002. Pursuant to a letter received from the Nasdaq staff on June 10, 2002, we must now demonstrate compliance with a requirement involving a minimum bid price of $1.00 per share by August 26, 2002. Staff will provide written notification that compliance is achieved once our common stock closes at $1.00 per share or more for a minimum of 10 consecutive trading days. If compliance with this rule cannot be demonstrated by August 26, 2002, Staff will determine whether AltiGen meets the initial listing criteria for this market under Marketplace Rule 4310(c)(2)(A). If it meets the initial listing criteria, Staff will notify us that it has been granted an additional 180 calendar day grace period to demonstrate compliance. Otherwise, Staff will provide written notification that our securities will be delisted. At that time, we may appeal the Staff's determination to delist our securities to a Listing Qualifications Panel.

The result of delisting from the Nasdaq SmallCap Market would be a reduction in the liquidity of any investment in our common stock and a material adverse effect on the price of our common stock. Delisting would reduce the ability of holders of our common stock to purchase or sell shares as quickly and as inexpensively as they could have done in the past. This lack of liquidity would make it more difficult for us to raise capital in the future. Although we are working to comply with all continued listing requirements of the Nasdaq SmallCap Market, there can be no assurance that we will be able to satisfy such requirements.

CERTAIN FACTORS AFFECTING BUSINESS, OPERATING RESULTS, AND FINANCIAL CONDITION

RISKS RELATED TO ALTIGEN

WE HAVE A HISTORY OF LOSSES AND EXPECT TO INCUR FUTURE LOSSES, WHICH MAY PREVENT US FROM BECOMING PROFITABLE.

We have experienced operating losses since our inception. As of June 30, 2002, we had an accumulated deficit of $46.0 million. We expect to incur operating losses for the foreseeable future, and these losses may be substantial. Further, we expect our operating cash flows to be negative for the foreseeable future. Because we expect continued expenditures for product development, and sales and marketing activities, we will need to increase revenues significantly to achieve profitability and positive operating cash flows. Even if we do achieve profitability and positive operating cash flows, we may not be able to sustain

or increase profitability or positive operating cash flows on a quarterly or annual basis.

IF WE ARE UNABLE TO COMPLY WITH NASDAQ'S CONTINUED LISTING REQUIREMENTS, OUR COMMON STOCK COULD BE DELISTED FROM THE NASDAQ SMALLCAP MARKET.

AltiGen's common stock was transferred to the Nasdaq SmallCap Market at the opening of business on June 12th, 2002. Pursuant to a letter received from the Nasdaq staff on June 10, 2002, we must now demonstrate compliance with a requirement involving a minimum bid price of $1.00 per share by August 26, 2002. Staff will provide written notification that compliance is achieved once our common stock closes at $1.00 per share or more for a minimum of 10 consecutive trading days. If compliance with this rule cannot be demonstrated by August 26, 2002, Staff will determine whether AltiGen meets the initial listing criteria for this market under Marketplace Rule 4310(c)(2)(A). If it meets the initial listing criteria, Staff will notify us that it has been granted an additional 180 calendar day grace period to demonstrate compliance. Otherwise, Staff will provide written notification that our securities will be delisted. At that time, we may appeal the Staff's determination to delist our securities to a Listing Qualifications Panel.

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THE CURRENT ECONOMIC DOWNTURN MAY CONTINUE TO ADVERSELY AFFECT OUR REVENUES, GROSS MARGINS AND EXPENSES.

Our quarterly revenue and operating results have and may continue to fluctuate due to the effects of general economic conditions in the United States and globally, and, in particular, market conditions in the telecommunications industry. In recent quarters, our operating results have been adversely affected as a result of the economic slowdown and reduced capital spending, particularly in the United States. The downturn has also contributed to the decline in revenue during the first three quarters of 2002 compared to the same period in 2001. We have experienced gross margin declines, reflecting the effect of competitive pressures as well as write-downs for inventories as a result of the downturn. We are uncertain about the extent, severity, and length of the economic downturn. If the economic conditions in the United States and globally do not improve, or if we experience a worsening in the global economic slowdown, we may continue to experience material negative effects on our business, operating results, and financial condition.

WE HAVE A LIMITED OPERATING HISTORY, WHICH MAKES IT DIFFICULT TO EVALUATE OUR BUSINESS AND OUR FUTURE PROSPECTS.

We shipped our first products in July 1996. As a result of our limited operating history, we have limited financial data that you can use to evaluate our business. You must consider our prospects in light of the risks, expenses and challenges we might encounter because we are at an early stage of development in a new and rapidly evolving market. To address these risks and achieve profitability and increased sales levels, we must:

o establish and increase market acceptance of our technology, products and systems;

- expand our network of distributors, dealers and companies that buy our products in bulk, customize them for particular applications or customers, and resell them under their own names;
- introduce products and systems incorporating our technology and enhancements to our product applications on a timely basis;
- respond effectively to competitive pressures; and
- successfully market and support our products and systems.

We may not successfully meet any of these challenges, and our failure to do so will seriously harm our business and results of operations. In addition, because of our limited operating history, we have limited insight into trends that may emerge and harm our business.

OUR OPERATING RESULTS VARY, MAKING FUTURE OPERATING RESULTS DIFFICULT TO PREDICT.

Our quarterly and annual operating results have varied significantly in the past and will likely vary significantly in the future. A number of factors, many of which are beyond our control, may cause our operating results to vary, including:

- our sales cycle, which may vary substantially from customer to customer;
- unfavorable changes in the prices and delivery of the components we purchase;
- the size and timing of orders for our products, which may vary depending on the season, and the contractual terms of those orders;
- the size and timing of our expenses, including operating expenses and expenses of developing new products and product enhancements;
- deferrals of customer orders in anticipation of new products, services or product enhancements introduced by us or by our competitors; and
- our ability to attain and maintain production volumes and quality levels for our products.

Our budgets and commitments that we have made for the future are based in part on our expectations of future sales. If our sales do not meet expectations, it will be difficult for us to reduce our expenses quickly, and consequently our operating results may suffer.

Our dealers often require immediate shipment and installation of our products. As a result, we have historically operated with limited backlog, and our sales and operating results in any quarter depend primarily on orders booked and shipped during that quarter.

Any of the above factors could harm our business, financial condition and results of operations. We believe that period-to-period comparisons of our results of operations are not meaningful, and you should not rely upon them as indicators of our future performance.

OUR MARKET IS HIGHLY COMPETITIVE, AND WE MAY NOT HAVE THE RESOURCES TO COMPETE ADEQUATELY.

The market for our integrated, multifunction telecommunications systems is new, rapidly evolving and highly competitive. We expect competition to intensify in the future as existing competitors develop new products and new competitors enter the market. We believe that a critical component to success in this market is the ability to establish and maintain strong partner and customer relationships with a wide variety of domestic and international providers. If we fail to establish or maintain these relationships, we will be at a serious competitive disadvantage.

We face competition from companies providing traditional private telephone systems. Our principal competitors that produce traditional private telephone systems are Avaya Communications, NEC and Nortel Networks. We also compete against providers of multifunction telecommunications systems, including 3Com Corporation, Artisoft, Inc., Cisco System, Inc. and Shoreline Teleworks, Inc., as well as any number of future competitors. Many of our competitors are substantially larger than we are and have significantly greater name recognition, financial, sales and marketing, technical, customer support, manufacturing and other resources. These competitors may also have more established distribution

16

channels and stronger relationships with service providers. These competitors may be able to respond more rapidly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sale of their products. These competitors may enter our existing or future markets with solutions that may be less expensive, provide higher performance or additional features or be introduced earlier than our solutions. If any technology that is competing with ours is more reliable, faster, less expensive or has other advantages over our technology, then the demand for our products and services could decrease and harm our business.

We expect our competitors to continue to improve the performance of their current products and introduce new products or new technologies. If our competitors successfully introduce new products or enhance their existing products, this could reduce the sales or market acceptance of our products and services, increase price competition or make our products obsolete. To be competitive, we must continue to invest significant resources in research and development, sales and marketing and customer support. We may not have sufficient resources to make these investments or to make the technological advances necessary to be competitive, which in turn will cause our business to suffer.

LOSING ANY OF OUR KEY DISTRIBUTORS WOULD HARM OUR BUSINESS. WE ALSO NEED TO ESTABLISH AND MAINTAIN RELATIONSHIPS WITH ADDITIONAL DISTRIBUTORS AND ORIGINAL EQUIPMENT MANUFACTURERS.

Sales through our three key distributors, Altisys, Synnex, and Ingram Micro accounted for 75.8% of our net revenues in the third quarter of fiscal 2002. Our business and operating results will suffer if either of these distributors does not continue distributing our products, fails to distribute the volume of our products that it currently distributes or fails to expand our customer base. We also need to establish and maintain relationships with additional distributors and original equipment manufacturers. We may not be able to establish, or successfully manage, relationships with additional distribution partners. In addition, our agreements with distributors typically provide for termination by either party upon written notice to the other party. For example, our agreement with Synnex provides for termination, with or without cause, by either party upon 30 days' written notice to the other party, or upon insolvency or bankruptcy. Generally, these agreements are non-exclusive and distributors sell products that compete with ours. If we fail to establish or maintain

relationships with distributors and original equipment manufacturers, our ability to increase or maintain our sales and our customer base will be substantially harmed.

WE SELL OUR PRODUCTS THROUGH DEALERS AND DISTRIBUTORS, WHICH LIMITS OUR ABILITY TO CONTROL THE TIMING OF OUR SALES, AND THIS MAKES IT MORE DIFFICULT TO PREDICT OUR REVENUES.

We do not recognize revenue from the sale of our products to our distributors until these products are sold to either dealers or end users. We have little control over the timing of product sales to dealers and end users. Our lack of control over the revenue which we recognize from our distributors' sales to dealers and end users limits our ability to predict revenue for any given period. Our budgets and commitments that we have made for the future are based in part on our expectations of future sales. If our sales do not meet expectations, it will be difficult for us to reduce our expenses quickly, and consequently our operating results may suffer.

WE RELY ON SOLE-SOURCED COMPONENTS AND THIRD-PARTY TECHNOLOGY AND PRODUCTS; IF THESE COMPONENTS ARE NOT AVAILABLE, OUR BUSINESS MAY SUFFER.

We purchase technology from third parties that are incorporated into our products, including virtually all of our hardware products. We order sole-sourced components using purchase orders and do not have supply contracts for them. One sole-sourced component, a TI DSP chip, is particularly important to our business because it is included in virtually all of our Triton family products. If we were unable to purchase an adequate supply of these sole-sourced components on a timely basis, we would be required to develop alternative solutions. This could entail qualifying an alternative source or redesigning our products based on different components. Our inability to obtain these sole-sourced

components, especially the TI DSP chip, could significantly delay shipment of our products, which could have a negative effect on our business, financial condition and results of operations.

WE RELY ON DEALERS TO PROMOTE, SELL, INSTALL AND SUPPORT OUR PRODUCTS, AND THEIR FAILURE TO DO SO MAY SUBSTANTIALLY REDUCE OUR SALES AND THUS SERIOUSLY HARM OUR BUSINESS.

We rely on dealers who can provide high quality sales and support services. As with our distributors, we compete with other telecommunications systems providers for our dealers' business, as our dealers generally market competing products. If a dealer promotes a competitor's products to the detriment of our products or otherwise fails to market our products and services effectively, we could lose market share. In addition, the loss of a key dealer or the failure of dealers to provide adequate customer service could cause our business to suffer. If we do not properly train our dealers to sell, install and service our products, our business will suffer.

SOFTWARE OR HARDWARE ERRORS MAY SERIOUSLY HARM OUR BUSINESS AND DAMAGE OUR REPUTATION, CAUSING LOSS OF CUSTOMERS AND REVENUES.

Users expect telephone systems to provide a high level of reliability. Our products are inherently complex and may have undetected software or hardware errors. We have detected and may continue to detect errors and product defects in our installed base of products, new product releases and product upgrades. For example, a small number of our boards failed and were returned. We have replaced these boards and made certain design changes. We cannot be sure that

the problem has been fully addressed and that similar or different problems may not occur in existing or new boards in the future. In addition, end users may install, maintain and use our products improperly or for purposes for which they were not designed. These problems may degrade or terminate the operation of our products, which could cause end users to lose telephone service, cause us to incur significant warranty and repair costs, damage our reputation and cause significant customer relations problems. Any significant delay in the commercial introduction of our products due to errors or defects, any design modifications required to correct these errors or defects or any negative effect on customer satisfaction as a result of errors or defects could seriously harm our business, financial condition and results of operations.

Any claims brought because of problems with our products or services could seriously harm our business, financial condition and results of operations. We currently offer a one-year hardware guarantee to end users. If our products fail within the first year, we face replacement costs. Our insurance policies may not provide sufficient or any coverage should a claim be asserted. In addition, our introduction of products and systems with reliability, quality or compatibility problems could result in reduced revenues, uncollectible accounts receivable, delays in collecting accounts receivable, warranties and additional costs. Our customers, end users or employees could find errors in our products and systems after we have begun to sell them, resulting in product redevelopment costs and loss of, or delay in, their acceptance by the markets in which we compete. Further, we may experience significant product returns in the future. Any of these events could have a material adverse effect on our business, financial condition and results of operations.

WE MAY FACE INFRINGEMENT ISSUES THAT COULD HARM OUR BUSINESS BY REQUIRING US TO LICENSE TECHNOLOGY ON UNFAVORABLE TERMS OR TEMPORARILY OR PERMANENTLY CEASE SALES OF KEY PRODUCTS.

We may become parties to litigation in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex litigation are difficult to predict. We are not currently party to any material litigation.

More generally, litigation related to these types of claims may require us to acquire licenses under third-party patents which may not be available on acceptable terms, if at all. We believe that an increasing portion of our revenues in the future will come from sales of software applications for our hardware

products. The software market has traditionally experienced widespread unauthorized reproduction of products in violation of developers' intellectual property rights. This activity is difficult to detect, and legal proceedings to enforce developers' intellectual property rights are often burdensome and involve a high degree of uncertainty and substantial costs.

ANY FAILURE BY US TO PROTECT OUR INTELLECTUAL PROPERTY COULD HARM OUR BUSINESS AND COMPETITIVE POSITION.

Our success depends, to a certain extent, upon our proprietary technology. We currently rely on a combination of patent, trade secret, copyright and trademark law, together with non-disclosure and invention assignment agreements, to establish and protect the proprietary rights in the technology used in our products.

Although we have filed patent applications, we are not certain that our patent

applications will result in the issuance of patents, or that any patents issued will provide commercially significant protection to our technology. In addition, others may independently develop substantially equivalent proprietary information not covered by patents to which we own rights, may obtain access to our know-how or may claim to have issued patents that prevent the sale of one or more of our products. Also, it may be possible for third parties to obtain and use our proprietary information without our authorization. Further, the laws of some countries, such as those in Japan, one of our target markets, may not adequately protect our intellectual property or may be uncertain. Our success also depends on trade secrets that cannot be patented and are difficult to protect. If we fail to protect our proprietary information effectively, or if third parties use our proprietary technology without authorization, our competitive position and business will suffer.

OUR PRODUCTS MAY NOT MEET THE LEGAL STANDARDS REQUIRED FOR THEIR SALE IN SOME COUNTRIES; IF WE CANNOT SELL OUR PRODUCTS IN THESE COUNTRIES, OUR RESULTS OF OPERATIONS MAY BE SERIOUSLY HARMED.

The United States and other countries in which we intend to sell our products have standards for safety and other certifications that must be met for our products to be legally sold in those countries. We have tried to design our products to meet the requirements of the countries in which we sell or plan to sell them. We have also obtained or are trying to obtain the certifications that we believe are required to sell our products in these countries. However, we cannot guarantee that our products meet all of these standards or that we will be able to obtain any certifications required. In addition, there is, and will likely continue to be, an increasing number of laws and regulations pertaining to the products we offer and may offer in the future. These laws or regulations may include, for example, more stringent safety standards, requirements for additional or more burdensome certifications or more stringent consumer protection laws.

If our products do not meet a country's standards or we do not receive the certifications required by a country's laws or regulations, then we may not be able to sell those products in that country. This may seriously harm our results of operation by reducing our sales or requiring us to invest significant resources to conform our products to these standards.

OUR MARKET IS SUBJECT TO CHANGING PREFERENCES; FAILURE TO KEEP UP WITH THESE CHANGES WOULD RESULT IN OUR LOSING MARKET SHARE, THUS SERIOUSLY HARMING OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our customers and end users expect frequent product introductions and have changing requirements for new products and features. Therefore, to be competitive, we will need to develop and market new products and product enhancements that respond to these changing requirements on a timely and cost-effective basis. Our failure to do so promptly and cost-effectively would seriously harm our business, financial condition and results of operations. Also, introducing new products could require us to write off existing inventory as obsolete, which could harm our results of operations.

IF WE DO NOT MANAGE OUR GROWTH EFFECTIVELY, OUR BUSINESS WILL SUFFER.

We may not be successful in managing any future growth. We have expanded our operations rapidly since our inception. In order to manage this expansion and to grow in the future, we will need to expand or enhance our management, manufacturing, research and development and sales and marketing capabilities. We may not be able to hire the management, staff or other personnel required to do so.

We may not be able to install adequate control systems in an efficient and timely manner, and our current or planned operational systems, procedures and controls may not be adequate to support our future operations. Difficulties in installing and implementing new systems, procedures and controls may significantly burden our management and our internal resources. Delays in the implementation of new systems or operational disruptions when we transition to new systems would impair our ability to accurately forecast sales demand, manage our product inventory and record and report financial and management information on a timely and accurate basis.

Lead times for materials and components used in the assembly of our products vary significantly, and depend on factors such as the supplier, contract terms and demand for a component at a given time. If orders do not match forecasts, we may have excess or inadequate inventory of certain materials and components, which may seriously harm our business, financial condition and results of operation.

OUR PLANNED EXPANSION IN INTERNATIONAL MARKETS WILL INVOLVE NEW RISKS THAT OUR PREVIOUS DOMESTIC OPERATIONS HAVE NOT PREPARED US TO ADDRESS; OUR FAILURE TO ADDRESS THESE RISKS COULD HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We intend to expand our international sales and marketing efforts. Our efforts are subject to a variety of risks associated with conducting business internationally, any of which could seriously harm our business, financial condition and results of operations. These risks include:

- tariffs, duties, price controls or other restrictions on foreign currencies or trade barriers, such as import or export licensing imposed by foreign countries, especially on technology;
- potential adverse tax consequences, including restrictions on repatriation of earnings;
- fluctuations in foreign currency exchange rates, which could make our products relatively more expensive in foreign markets; and
- conflicting regulatory requirements in different countries that may require us to invest significant resources customizing our products for each country.

WE NEED ADDITIONAL QUALIFIED PERSONNEL TO MAINTAIN AND EXPAND OUR BUSINESS; OUR FAILURE TO PROMPTLY ATTRACT AND RETAIN QUALIFIED PERSONNEL MAY SERIOUSLY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We depend, in large part, on our ability to attract and retain highly skilled personnel, particularly engineers and sales and marketing personnel. We need highly trained technical personnel to design and support our server-based telecommunications systems. In addition, we need highly trained sales and marketing personnel to expand our marketing and sales operations in order to increase market awareness of our products and generate increased revenues. In spite of the economy downturn, competition for highly trained personnel can be intense, especially in the San Francisco Bay Area where most of our operations are located. Volatility or lack of positive performance in our stock price may also adversely affect our ability to retain key employees, all of whom have been granted stock options. We cannot be certain that we will be successful in our recruitment and retention efforts. If we fail to attract or retain qualified personnel or suffer from delays in hiring required personnel, our business,

financial condition and results of operations may be seriously harmed.

OUR FACILITY IS VULNERABLE TO DAMAGE FROM EARTHQUAKES AND OTHER NATURAL DISASTERS; ANY SUCH DAMAGE COULD SERIOUSLY OR COMPLETELY IMPAIR OUR BUSINESS.

We perform final assembly, software installation and testing of our products at our facility in Fremont, California. Our facility is located on or near known earthquake fault zones and is vulnerable to damage from fire, floods, earthquakes, power loss, telecommunications failures and similar events. If such a disaster occurs, our ability to perform final assembly, software installation and testing of our products at our facility would be seriously, if not completely, impaired. If we were unable to obtain an alternative place or way to perform these functions, our business, financial condition and results of operations would suffer. The insurance we maintain may not be adequate to cover our losses against fires, floods, earthquakes and general business interruptions.

WE RELY ON A CONTINUOUS POWER SUPPLY TO CONDUCT OPERATIONS, AND CALIFORNIA'S CURRENT ENERGY CRISIS COULD DISRUPT OUR BUSINESS AND INCREASE OUR EXPENSES.

California recently experienced an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage that is, when power reserves for California fall below 1.5%, California has on some occasions implemented, and may in the future continue to implement, rolling blackouts throughout California. We currently have only limited backup generators for emergency alternate sources of power in the event of blackout. If blackouts interrupt our power supply, we would be temporarily unable to continue operations at our facility. Any such interruption in our ability to continue operations at our facility could delay shipments of our products to customers, and could result in lost revenue, which could harm our business and results of operations.

OUR STRATEGY TO OUTSOURCE ASSEMBLY AND TEST FUNCTIONS IN THE FUTURE COULD DELAY DELIVERY OF PRODUCTS, DECREASE QUALITY OR INCREASE COSTS.

Based on volume or customer requirements, we may begin outsourcing some assembly and test functions. In addition, we may determine that we need to establish assembly and test operations overseas to better serve our international customers. Establishing overseas assembly and test operations may be more difficult or take longer than we anticipate. This outsourcing strategy involves certain risks, including the potential lack of adequate capacity and reduced control over delivery schedules, manufacturing yield, quality and costs. In the event that any significant subcontractor was to become unable or unwilling to continue to manufacture or test our products in the required volumes, we would have to identify and qualify acceptable replacements. Finding replacements could take time, and we cannot be sure that additional sources would be available to us on a timely basis. Any delay or increase in costs in the assembly and testing of products by third-party subcontractors could seriously harm our business, financial condition and results of operations.

RISKS RELATED TO THE INDUSTRY

INTEGRATED, MULTIFUNCTION TELECOMMUNICATIONS SYSTEMS MAY NOT ACHIEVE WIDESPREAD ACCEPTANCE, AND OUR FIXED COSTS IN THE SHORT RUN COULD CAUSE OUR OPERATING RESULTS AND BUSINESS TO SUFFER.

The market for integrated, multifunction telecommunications systems is relatively new and rapidly evolving. Businesses have invested substantial resources in the existing telecommunications infrastructure, including

traditional private telephone systems, and may be unwilling to replace these systems in the near term or at all. Businesses may also be reluctant to adopt integrated, multifunction telecommunications systems because of their concern about the current limitations of data networks, including the Internet. For example, end users sometimes experience delays in receiving calls and reduced voice quality during calls when routing calls over data networks. Moreover, businesses that begin to route calls over the same networks that currently carry only their data may also experience these problems if the networks do not have sufficient capacity to carry all of these communications at the same time. We incur many fixed costs in anticipation of a certain level of revenues. If businesses defer purchasing or decide not to purchase integrated, multifunction telecommunications systems and the market for our products does not grow or grows substantially more slowly than we anticipate, our operating results will suffer and our business will be harmed because we will be unable to reduce fixed costs in the short term to offset the reduced revenues.

FUTURE REGULATION OR LEGISLATION COULD HARM OUR BUSINESS OR INCREASE OUR COST OF DOING BUSINESS.

In April 1998, the Federal Communications Commission submitted a report to Congress stating that it may regulate certain Internet services if it determines that such Internet services are functionally equivalent to conventional telecommunications services. The increasing growth of the voice over data network market and the popularity of supporting products and services, however, heighten the risk that national governments will seek to regulate the transmission of voice communications over networks such as the Internet. In addition, large telecommunications companies may devote substantial lobbying efforts to influence the regulation of this market so as to benefit their interests, which may be contrary to our interests. These regulations may include, for example, assessing access or settlement charges, imposing tariffs or imposing regulations based on encryption concerns or the characteristics and quality

22

of products and services. Future laws, legal decisions or regulations, as well as changes in interpretations of existing laws and regulations, could require us to expend significant resources to comply with them. In addition, these future events or changes may create uncertainty in our market that could reduce demand for our products.

EVOLVING STANDARDS MAY DELAY OUR PRODUCT INTRODUCTIONS, INCREASE OUR PRODUCT DEVELOPMENT COSTS OR CAUSE END USERS TO DEFER OR CANCEL PLANS TO PURCHASE OUR PRODUCTS, ANY OF WHICH COULD ADVERSELY AFFECT OUR BUSINESS.

The standards in our market are still evolving. These standards are designed to ensure that integrated, multifunction telecommunications products from different manufacturers can operate together. Some of these standards are proposed by other participants in our market, including some of our competitors, and include proprietary technology. In recent years, these standards have changed, and new standards have been proposed, in response to developments in our market. Our failure to conform our products to existing or future standards may limit their acceptance by market participants. We may not anticipate which standards will achieve the broadest acceptance in our market in the future, and we may take a significant amount of time and expense to adapt our products to these standards. We may also have to pay additional royalties to developers of proprietary technologies that become standards in our market. These delays and expenses may seriously harm our results of operations. In addition, customers and users may defer or cancel plans to purchase our products due to concerns about the ability of our products to conform to existing standards or to adapt to new or changed standards, and this could seriously harm our results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in cash equivalents and short-term instruments. Due to the short-term nature of our cash equivalents and investments, we have concluded that there is no material market risk exposure. Therefore, no quantitative tabular disclosures are required.

23

PART II

Item1. Legal Proceedings

We may become parties to litigation in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex litigation are difficult to predict. We are not currently party to any material litigation.

Item 2. Changes in Securities and Use of Proceeds

For the three months ended June 30, 2002, we issued 299,463 shares of common stock pursuant to the exercise of stock options at exercise price of 0.23. All of the stock options were granted under our 1994 Stock Option Plan prior to our initial public offering. For the same period, 49,851 shares were purchased and distributed to employees at a price of $0.51 per share related to Employee Stock Purchase Plan. All of these stocks were granted under our 1999 Employee Stock Purchase Plan. Our issuance of shares of our common stock upon the exercise of these options was exempt from registrant pursuant to rule 701 promulgated under the Securities Act of 1933, as amended.

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

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Number	Exhibit Description
99.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

We filed a report on Form 8-K with the Securities and Exchange Commission on June 26, 2002 announcing a change in the Company's independent public accountants for the fiscal year ended September 30, 2002, from Arthur Andersen LLP to Deloitte & Touche LLP. An amended 8-K/A was filed on July 10, 2002.

24

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Fremont, State of California, on the 14th day of August, 2002.

ALTIGEN COMMUNICATIONS, INC.

By: /s/ Phillip M. McDermott

Philip M. McDermott,
Chief Financial Officer
(Principal Financial and Accounting Officer)