

ALTIGEN COMMUNICATIONS INC  
Form 10-Q  
May 15, 2006

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

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FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

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

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ALTIGEN COMMUNICATIONS, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

94-3204299  
(I.R.S. Employer  
Identification Number)

4555 Cushing Parkway  
Fremont, CA  
(Address of principal executive offices)

94538  
(Zip Code)

Registrant's telephone number, including area code: (510) 252-9712

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of our common stock outstanding as of May 11, 2006 was: 14,976,633 shares.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

**ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share and per share amounts)

	March 31, 2006	September 30, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 4,867	\$ 3,963
Short-term investments	4,388	5,459
Accounts receivable, net of allowances of \$36 and \$40 at March 31, 2006 and September 30, 2005, respectively	2,158	1,957
Inventories	1,614	965
Prepaid expenses and other current assets	253	148
Total current assets	13,280	12,492
Property and equipment:		
Furniture and equipment	1,634	1,405
Computer software	920	920
	2,554	2,325
Less: Accumulated depreciation and amortization	(1,904)	(1,803)
Net property and equipment	650	522
Other non-current assets:		
Long-term investments	223	247
Long-term deposit	74	74
Total other non-current assets	297	321
Total assets	\$ 14,227	\$ 13,335
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 972	\$ 653
Accrued liabilities:		
Payroll and related benefits	331	317
Warranty (Note 2)	276	264
Marketing	57	58
Accrued expense	248	272
Other	325	288
Deferred revenue	764	507
Total current liabilities	2,973	2,359
Deferred Rent	219	258
Stockholders' equity:		
Convertible preferred stock, \$0.001 par value; Authorized - 5,000,000 shares; Outstanding - none at March 31, 2006 and September 30, 2005	—	—
Common stock, \$0.001 par value; Authorized - 50,000,000 shares; Outstanding - 16,018,849 shares at	16	16

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March 31, 2006 and 15,782,071 shares at September 30, 2005

Treasury stock at cost - 1,063,895 shares at March 31, 2006 and September 30, 2005	(1,014)	(1,014)
Additional paid-in capital	63,515	62,863
Accumulated other comprehensive income (loss)	1	(1)
Accumulated deficit	(51,483)	(51,146)
Total stockholders' equity	11,035	10,718
Total liabilities and stockholders' equity	\$ 14,227	\$ 13,335

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

**ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
<b>Net revenue:</b>				
Hardware	\$ 3,828	\$ 2,354	\$ 7,923	\$ 5,918
Software	346	447	654	1,158
Total net revenue	4,174	2,801	8,577	7,076
<b>Cost of revenue:</b>				
Hardware	1,909	1,227	3,906	2,842
Software	26	33	47	85
Total cost of revenue	1,935	1,260	3,953	2,927
Gross profit	2,239	1,541	4,624	4,149
<b>Operating expenses:</b>				
Research and development	895	935	1,922	1,757
Sales and marketing	999	988	2,090	1,989
General and administrative	527	529	1,085	1,004
Total operating expenses	2,421	2,452	5,097	4,750
Loss from operations	(182)	(911)	(473)	(601)
Equity in net loss of investee	(14)	—	(24)	—
Interest and other income, net	85	53	168	94
Net loss before tax	(111)	(858)	(329)	(507)
Income taxes	9	—	9	10
Net loss	\$ (120)	\$ (858)	\$ (338)	\$ (517)
Basic and diluted net loss per share	\$ (0.01)	\$ (0.06)	\$ (0.02)	\$ (0.04)
<b>Weighted average shares used in computing basic and diluted net loss per share</b>				
	14,937	14,575	14,889	14,516

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

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

	Six Months Ended March 31,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (338)	\$ (517)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	100	47
Stock based compensation	436	—
Equity in net loss of investee	24	—
Changes in operating assets and liabilities:		
Accounts receivable	(201)	165
Inventories	(649)	(73)
Prepaid expenses and other current assets	(105)	(56)
Accounts payable	319	(103)
Accrued liabilities	38	(127)
Deferred revenue	257	218
Deferred rent	(38)	(17)
Net cash used in operating activities	(157)	(463)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of short-term investments	(6,404)	(12,226)
Proceeds from sale of short-term investments	7,476	12,797
Changes in long-term investments	—	(90)
Purchases of property and equipment	(229)	(63)
Net cash provided by investing activities	843	418
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuances of common stock, net of issuance costs	218	264
Net cash provided by financing activities	218	264
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>904</b>	<b>219</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>3,963</b>	<b>2,898</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 4,867</b>	<b>\$ 3,117</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Income taxes	\$ (1)	—
Interest	\$ (9)	—

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

**ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**BASIS OF PRESENTATION**

AltiGen Communications, Inc. (“we or the Company”) is a pioneer in Internet protocol telephony systems. We design, manufacture and market next generation, Internet protocol phone systems and contact centers that use both the Internet and the public telephone network to take advantage of the convergence of voice and data communications. Unlike traditional proprietary phone systems, our systems are designed with open architecture and are built on an industry standard platform. This adherence to industry standards allows our products to play an important role in the small-to-medium sized business market by delivering phone systems that can integrate with other technologies and provide integrated voice and data solutions. We believe this enables our customers, small-to medium-sized businesses, to implement communication systems that provide competitive return on investment versus alternative technology investments.

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with (i) generally accepted accounting principles (GAAP) for interim financial information; (ii) the instructions for Form 10-Q and (iii) Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP 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.

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2005, included in the Company’s 2005 Annual Report on Form 10-K filed with the SEC on December 28, 2005. AltiGen’s 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.

During the quarter ended March 31, 2006, the Company determined that certain items as reported in the December 31, 2005 income statement were improperly classified. The Company reclassified \$13,000 from hardware revenue to software revenue.

**CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS**

We consider 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 are in highly liquid financial instruments with original maturities greater than three-months but less than one year and are classified as “available-for-sale” investments. Investments are reported at their fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders’ equity. As of March 31, 2006, our cash and cash equivalents consisted of commercial paper and cash deposited in checking and money market accounts.

Unrealized gains from short-term investments were \$1,000 at March 31, 2006 and unrealized losses from short-term investments were \$1,000 at September 30, 2005.

**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 (which approximates actual cost on first-in, first-out method) or market. Provisions, when required, are made to reduce excess and obsolete inventories to their estimated net realizable values.

We regularly monitor inventory quantities on hand and record a provision for excess and obsolete inventories based primarily on our estimated forecast of product demand and production requirements for the next six months. We did not record any provision for excess and obsolete inventories for the six months ended March 31, 2006 and 2005. The components of inventories include (in thousands):

	<b>March 31,</b>	<b>September</b>
	<b>2006</b>	<b>30,</b>
		<b>2005</b>
Raw materials	\$ 412	\$ 144
Work-in-progress	192	84
Finished goods	1,010	737
	\$ 1,614	\$ 965

### LONG-TERM INVESTMENTS

As of March 31, 2006, we held an investment of common stock in a private Taiwanese telecommunication company valued at approximately \$195,000 accounted for using the cost method. Our interest in the company is approximately 2%, which interest does not allow us to exercise significant influence.

In July 2004, we purchased common stock of a private Korean telecommunications company for \$79,000. As a result of this investment, we acquired approximately 23% of the voting power of the company and have the right to nominate and have elected one of the three members of the company's current board of directors. We are accounting for this investment using the equity method and record our minority interest in our results of operations. As of March 31, 2006, our investment in the Korean company had a remaining book value of approximately \$29,000.

We perform a periodic review of our investments for impairment. Our investments are considered impaired when a review of the corporate operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. As of March 31, 2006, we did not record any investment impairments.

### REVENUE RECOGNITION

We account for the recognition of software license revenue in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition." Revenue consists of sales to end-users, including resellers, and to distributors. Revenue 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. 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, we defer recognition of distributor revenue until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as "deferred revenue" in the accompanying consolidated balance sheets. The related cost of revenue is also deferred and reported in the consolidated balance sheets as inventory.

Software components are generally not sold separately from our hardware components. Software revenue consists of license revenue that are recognized upon the delivery of application products. We provide limited post-contract customer support ("PCS"), consisting primarily of technical 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 we provide 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 and enhancements, are accrued for at the time of delivery.

### **STOCK-BASED COMPENSATION**

Commencing October 1, 2005 we adopted the provisions of Statement of Financial Accounting Standard (“SFAS”) No. 123(R), “Share Based Payment” (“SFAS No. 123(R)”), which requires all share-based compensation, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair market values. For the six months ended March 31, 2006, stock compensation was accounted under SFAS No. 123(R) while for the six months ended March 31, 2005, stock-based compensation was accounted under Accounting Principles Board (APB), Opinion No. 25 APB (25).

Prior to adopting SFAS No. 123(R), we accounted for stock-based employee compensation under Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” as amended by SFAS No. 148, “Accounting for Stock-Based Compensation-Transition and Disclosures.” We have applied the modified prospective method in adopting SFAS No. 123(R) and, accordingly, we recorded compensation costs as the requisite service was rendered for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption. Periods prior to the adoption of SFAS No. 123(R) have not been restated.

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The following table summarizes the total stock-based compensation expense for the three and six months ended March 31, 2006 and is included in the Unaudited Condensed Consolidated Statements of Operations (in thousands):

	<b>Three Months Ended March 31, 2006</b>	<b>Six Months Ended March 31, 2006</b>
Cost of goods sold	\$ 8	\$ 20
Research and development	59	159
Selling, general and administrative	109	257
Pre-tax stock-based compensation expense	176	436
Income tax	—	—
Net stock-based compensation expense	\$ 176	\$ 436

The following table illustrates the effects on net income and earnings per share if the fair value based method had been applied to the prior periods as required under SFAS No. 123(R). The reported net income and earnings per share for the three and six months ended March 31, 2005 have been presented below to reflect the impact had the Company been required to include the amortization of the Black-Scholes option value as an expense (in thousands, except for per share data):

	<b>Three Months Ended March 31, 2005</b>	<b>Six Months Ended March 31, 2005</b>
Net loss	\$ (858)	\$ (517)
Add: stock-based employee compensation expense included in reported net loss under APB No. 25	—	—
Deduct: Total stock-based compensation determined under fair value based method prior to adoption of SFAS No. 123R, net of related tax effects	(409)	(815)
Net loss - pro forma	\$ (1,267)	\$ (1,332)
Basic and diluted net loss per share:		
As reported	\$ (0.06)	\$ (0.04)
Pro forma	\$ (0.09)	\$ (0.09)

The fair value of each option grant during the six months ended March 31, 2006 and 2005 were estimated at the date of grant using the Black-Scholes option pricing model, and is not subject to revaluation as a result of subsequent stock price fluctuations. The following weighted-average assumptions are used:

	<b>Employee Stock Option Plan for Three Months Ended March 31,</b>		<b>Employee Stock Option Plan for Six Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Expected Life (in years)	5	5	5	5
Risk-free interest rate	4.4%	3.7%	4.4%	3.7%
Volatility	96%	102%	96%	102%
Expected dividend	0.0%	0.0%	0.0%	0.0%

The fair value of each purchase rights granted under the Company's Employee Stock Purchase Plan during the six months ended March 31, 2006 and 2005 were estimated at the date of grant using the Black-Scholes option pricing

model, and is not subject to revaluation as a result of subsequent stock price fluctuations. The following weighted-average assumptions are used:

	<b>Employee Stock Purchase Plan for Three Months Ended March 31,</b>		<b>Employee Stock Purchase Plan for Six Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	Expected Life (in years)	0.5	0.5	0.5
Risk-free interest rate	4.3%	3.1%	4.3%	3.1%
Volatility	98%	100%	98%	100%
Expected dividend	0.0%	0.0%	0.0%	0.0%

The following table summarizes the Company's stock option plan as of March 31, 2006, and changes during the three months ended March 31, 2006:

	Number of Shares	Weighted- average Exercise Price	Weighted- average Remaining Contractual Term
Outstanding at January 1, 2005	3,781,316	\$ 3.79	
Granted	4,000	1.80	
Exercised	(46,056)	0.77	
Forfeitures and cancellations	(114,570)	7.20	
Outstanding at March 31, 2006	3,624,690	\$ 3.72	6.01
Vested and expected to vest at March 31, 2006	3,545,858	\$ 3.73	0.19
Exercisable at March 31, 2006	2,866,781	\$ 3.92	5.45

During the three months ended March 31, 2006, 2.9 million shares of options are exercisable with a weighted-average exercise price of \$3.92. The weighted-average remaining contractual term for outstanding options at March 31, 2006 was 6.0 years.

As of March 31, 2006, approximately \$767,000 represents the estimated unamortized expense remaining. This expense is to be recognized over a weighted average period of approximately 4 years.

Under the 1999 Employee Stock Purchase Plan, 875,038 shares of common stock are reserved for issuance at September 30, 2005 to eligible employees at a price of 85% of the lower of the fair market value of the common stock on the first day of the offering period or a specified exercise date (last trading day in April or October). During the six months ended March 31, 2006, 48,913 shares were purchased by and distributed to employees at a price of \$1.31 per share.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions, including the expected stock price volatility. We use projected volatility rates, which are based upon historical volatility rates since our initial public offering, trended into future years. We also use historical data to estimate option forfeitures. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our options.

#### COMPUTATION OF BASIC AND DILUTED NET LOSS PER SHARE

Historical net income (loss) per share has been calculated under SFAS No. 128, "Earnings per Share." SFAS No. 128 requires companies to compute earnings per share under two methods (basic and diluted). Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the three and six months ended March 31, 2006 and 2005, respectively, basic and diluted net loss per share numbers were identical as potential common shares resulting from the exercise of stock options were antidilutive.

#### COMPREHENSIVE INCOME

Comprehensive loss for the six months ended March 31, 2006 and 2005, respectively, were as follows (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Net loss	\$ (120)	\$ (858)	\$ (338)	\$ (517)
Unrealized gain (loss )	1	1	(2)	1
	\$ (119)	\$ (857)	\$ (340)	\$ (516)

**SEGMENT REPORTING**

We are organized and operate as one operating segment. We operate primarily in one geographic area, the Americas, which is comprised of the United States, Canada, Mexico, Central America and the Caribbean.

Net revenue by geographic region based on customer location for the three and six months ended March 31, 2006 and 2005, respectively, were as follows:

	<b>Three Months Ended March 31,</b>		<b>Six Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Americas	93%	92%	92%	88%
International	7%	8%	8%	12%
	100%	100%	100%	100%

International is comprised of revenue primarily from China, the United Kingdom and Norway. All significant long-lived assets are located in the United States for all periods presented.

Net revenue by customers that individually accounted for more than 10% of our revenue for the three and six months ended March 31, 2006 and 2005, respectively, were as follows:

	<b>Three Months Ended March 31,</b>		<b>Six Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
AltiSys	15%	23%	16%	15%
Synnex	52%	58%	55%	52%
Graybar	17%	8%	15%	9%

**2. WARRANTY**

The Company provides a one year warranty for hardware products starting upon shipment to end users. We historically have experienced minimal warranty costs. Factors that affect our warranty liability include the number of installed units, historical experience and management's judgment regarding anticipated rates of warranty claims and cost per claim. We assess the adequacy of our recorded warranty liability every quarter and make adjustments to the liability if necessary.

Changes in our warranty liability for the three and six months ended March 31, 2006 and 2005, respectively, are as follows (in thousands):

	<b>Three Months Ended March 31,</b>		<b>Six Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Beginning balance	\$ 252	\$ 407	\$ 264	\$ 424
Provisions for warranty liability	56	20	79	43
Warranty cost including labor, components and scrap	(33)	(41)	(68)	(81)
Ending balance	\$ 275	\$ 386	\$ 275	\$ 386

**3. COMMITMENTS AND CONTINGENCIES***Commitments*

We lease our facilities under several operating lease agreements expiring on various dates through February 2009. In December 2003, we leased approximately 32,000 square feet to serve as our headquarters for corporate administration, research and development, manufacturing, and sales and marketing in Fremont, California. The lease for our headquarters expires on February 21, 2009. Rent expense for all operating leases totaled approximately \$132,000 and \$258,000 for the three and six months ended March 31, 2006, respectively as compared to \$126,000 and \$252,000 for the three and six months ended March 31, 2005, respectively. The increase from \$252,000 to \$258,000 for the six months ended March 31, 2005 and 2006, respectively, was related to the renewal of our building lease agreement for the Beijing office starting in the second quarter of fiscal 2006. In addition, we lease certain equipment under capital lease arrangements. Minimum future lease payments under all noncancellable capital and operating leases as of March 31, 2006 are as follows (in thousands):

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Fiscal Year Ending September 30,	Capital Leases	Operating Leases
Remainder of 2006	\$ 26	\$ 258
2007	52	446
2008	48	286
2009	44	92
2010	33	—
Total minimum lease payment	\$ 203	\$ 1,082
Amount representing interest	\$ 34	
Present value of minimum lease payment	169	
Total minimum lease payment	\$ 203	
Current portion plus current portion of interest	\$ 52	
Long-term portion plus long-term portion of interest	151	
Total capital lease commitments	\$ 203	

### *Contingencies*

We may become party 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.

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks' U.S. Patents Nos. 6,266,341; 6,289,025; 6,292,482; 6,389,009; and 6,396,849. On October 28, 2002, Vertical Networks amended its complaint to add allegations of infringement of U.S. Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a second amended complaint on November 20, 2002 to identify our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. We filed an answer and counterclaims for declaratory relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its answer to our counterclaims. Vertical Networks served its preliminary infringement contentions on us on April 9, 2003 and we served Vertical Networks our preliminary invalidity contentions on June 3, 2003 and July 14, 2003. To date, the parties have exchanged some discovery, but no depositions have been taken, and no motions are currently pending. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the U.S. Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously defend our position. Management's view is that any loss from this litigation is currently not probable or estimable; therefore, the Company has not established a reserve on its balance sheet as to any liability related to the outcome of this action.

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

### **FORWARD-LOOKING INFORMATION**

This report contains certain forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended) and information relating to us that are based on the beliefs of our management as well as assumptions made by and information currently available to our management. Additional forward-looking statements may be identified by the words "anticipate," "believe," "expect," "intend," "plan," or the negative of such terms, or similar expressions, as they relate to us or our management.

The forward-looking statements contained herein reflect our good faith judgment, based on the information available to us as of the date of this report. Actual results may differ materially from those anticipated in our forward looking statements due to certain risks, including risks described below, which risks may have a significant impact on our business or financial condition. You are cautioned that forward-looking statements are inherently uncertain. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should carefully review the cautionary statements contained in this Form 10-Q, including those found in “Certain Factors Affecting Business, Operating Results, and Financial Condition” below.

## OVERVIEW

We are a pioneer in Internet protocol telephony systems. We believe that we are a market leader in providing products and services to small and medium sized businesses. We design, manufacture and market next generation, Internet protocol phone systems and contact centers that use both the Internet and the public telephone network to take advantage of the convergence of voice and data communications. Unlike traditional proprietary phone systems, our systems are designed with open architecture and are built on an industry standard platform. This adherence to industry standards allows our products to play an important role in the small-to-medium sized business market by delivering phone systems that can integrate with other technologies and provide integrated voice and data solutions. We believe this enables our customers to implement communication systems that provide competitive return on investment versus alternative technology investments. We generated net revenue of \$4.2 million and \$8.6 million for the three and six months ended March 31, 2006, respectively, compared to net revenue of \$2.8 million and \$7.0 million for the three and six months ended March 31, 2005, respectively. As of March 31, 2006, we had an accumulated deficit of \$51.5 million. Net cash used in operating activities was \$157,000 for the six month ended March 31, 2006.

We derive our revenue from sales of our AltiServ telephone systems. Product revenue consists of sales to end-users (including dealers) and to distributors. Revenue from product sales to end users and resellers are recognized upon shipment. We defer recognition of revenue for sales to distributors until they resell our products to their customers. Upon shipment, we also provide a reserve for the estimated cost that may be incurred for product warranty. Under our distribution contracts, a distributor has the right, in certain circumstances, to return products it determines are overstocked, so long as it provides 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 revenue consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to the manufacturing of our products. Several factors that have affected and will continue to affect our revenue growth are the state of the economy, the market acceptance of our products, our ability to add new resellers and our ability to design, develop, and release new products. We engage third-party assemblers, including All Quality Services and Bestronics, to insert the hardware components into the printed circuit board of our products. We select our manufacturing partners with the goals of ensuring a reliable supply of high-quality finished products and lowering per unit product costs as a result of manufacturing economies of scale. We cannot assure you that we will maintain the volumes required to realize these economies of scale or when or if such cost reductions will occur. The failure to obtain such cost reductions could materially adversely affect our gross margins and operating results.

We continue to focus on (i) developing enhancements to our current products to provide greater functionality and increased capabilities, based on market research, customer feedback and our competitors' product offerings and (ii) creating new product offerings. In particular, we are developing products in an effort to enhance our position in our target market segment and seeking to enter new geographical markets. Additionally, we intend to continue to focus on selling our products to small-to-medium sized businesses and branch offices of larger corporations. Also, we plan to continue to recruit additional resellers and distributors that focus on selling phone systems to our target customers. We believe that the adoption rate for Internet telephony is much faster with small-to-medium sized businesses because they have no significant investment on their books for traditional phone systems. Also we believe that small-to-medium sized businesses are looking for call center-type administration to increase the productivity and efficiency of their contacts with customers. Assuming that current market trends, including the continuing acceptance of the call center products, continuing growth in the marketplaces of Asia, Latin America, the Caribbean, and the status quo of the North American economy continues and that we are successful in enhancing our products, we expect to see continued revenue growth for fiscal year 2006.

## CRITICAL ACCOUNTING POLICIES

*Revenue recognition.* Revenue consist of sales to end-users, including resellers, and to distributors. Revenue 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. We provide for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenue consists of product revenue 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 our products held by our distributors. Upon termination, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled without cause by either party following a specified notice period. As a result of the above provisions, we defer recognition of distributor revenue until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as “deferred revenue” in the accompanying consolidated balance sheets. The related cost of revenue is also deferred and reported in the consolidated balance sheets as inventory. Our total deferred revenue was \$764,000 and \$736,000 as of March 31, 2006 and March 31, 2005, respectively.

Software components are generally not sold separately from our hardware components. Software revenue consists of license revenue that are recognized upon the delivery of application products. We provide limited post-contract customer support (“PCS”), consisting primarily of technical 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 we provide 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 and enhancements are accrued for at the time of delivery.

*Allowance for Doubtful Accounts.* The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there were a deterioration of a major customer’s creditworthiness, or actual defaults were higher than our historical experience, we could be required to increase our allowance and our earnings could be adversely affected. Our allowance for doubtful accounts was \$36,000 and \$29,000 as of March 31, 2006 and 2005, respectively.

*Inventory.* Inventory is stated at the lower of cost (first-in, first-out method) or market. Our inventory balance was \$1.6 million as of March 31, 2006. We regularly review value of inventory in detail, with consideration given to future customer demand for our products, obsolescence from rapidly changing technology, and other factors. If actual market conditions are less favorable than those projected by management, and our estimates prove to be inaccurate, we could be required to increase our inventory provision and our gross margins could be adversely affected. As of December 2001, we had established a reserve to write off \$3.5 million of excess inventory which management believed would not be sold. During 2002 through 2005, we reversed a portion of the reserve related to inventory which was sold. The amounts of such reversals were \$167,000, \$293,000 and \$401,000 in fiscal years ending 2005, 2004 and 2003, respectively. Our inventory allowance was \$2.3 million as of March 31, 2006 compared to \$2.5 million as of March 31, 2005.

*Warranty.* We accrue for warranty costs based on estimated product return rates and the expected material and labor costs to provide warranty services. If actual return rates and repair and replacement costs differ significantly from our estimates, our gross margin could be adversely affected. The liability for product warranties was \$276,000 and \$386,000 as of March 31, 2006 and March 31, 2005, respectively.

## Results of Operations

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
<b>Consolidated Statements of Operations Data:</b>				
Net revenue:				
Hardware	91.7%	84.0%	92.4%	83.6%
Software	8.3	16.0	7.6	16.4
Total net revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Hardware	45.7	43.8	45.6	40.2
Software	0.6	1.2	0.5	1.2
Total cost of revenue	46.3	45.0	46.1	41.4
Gross profit	53.7	55.0	53.9	58.6
Operating expenses:				
Research and development	21.4	33.3	22.4	24.8
Sales and marketing	24.0	35.3	24.4	28.1
General and administrative	12.7	18.9	12.6	14.2
Total operating expenses	58.1	87.5	59.4	67.1
Income (loss) from operations	(4.4)	(32.5)	(5.5)	(8.5)
Equity in net loss of investee	(0.3)	—	(0.3)	—
Interest and other income, net	2.0	1.9	2.0	1.3
Net income (loss) before taxes	(2.7)	(30.6)	(3.8)	(7.2)
Provision for income taxes	0.2	—	0.1	0.1
Net income (loss)	(2.9)%	(30.6)%	(3.9)%	(7.3)%

**Revenue, net.** Revenue consist of sales to end users (including resellers) and distributors.

International is comprised of revenue primarily from China, the United Kingdom and Norway. All significant long-lived assets are located in the United States for all periods presented.

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Americas	93%	92%	92%	88%

International	7%	8%	8%	12%
	100%	100%	100%	100%

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Net revenue by customers that individually accounted for more than 10% of our revenue for the three and six months ended March 31, 2006 and 2005, respectively, were as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
AltiSys	15%	23%	16%	15%
Synnex	52%	58%	55%	52%
Graybar	17%	8%	15%	9%

Revenue generated in the Americas accounted for \$3.9 million or 93% and \$7.9 million or 92%, for the three and six months ended March 31, 2006, respectively, as compared to \$2.6 million, or 92%, and \$6.2 million, or 88%, for the three and six months ended March 31, 2005, respectively. Net revenue increased 49% to \$4.2 million for the three months ended March 31, 2006 as compared to \$2.8 million for the three months ended March 31, 2005. This increase was largely attributable to increased sales of telephone systems of 44% in the Americas. Net revenue increased 21% to \$8.6 million for the six months ended March 31, 2006 from \$7.1 million for the six months ended March 31, 2005 primarily due to higher sales of telephone systems of 44% in the Americas which was offset in part from a price reduction on our smaller telephone system bundle in the second quarter of fiscal 2005 and lower international revenue as compared with the same period last year.

For the three and six months ended March 31, 2006, we incurred a net loss of \$120,000 and \$338,000, respectively. However, for such periods, we recognized \$176,000 and \$436,000, respectively, of non-cash stock based-compensation expense and as a result of the adoption of SFAS No. 123(R). We generated a modest net profit in each period when the SFAS No. 123(R) expense is excluded.

**Cost of revenue.** Cost of revenue for the three months ended March 31, 2006 increased \$675,000 or 54% to \$1.9 million from approximately \$1.3 million for the three months ended March 31, 2005 primarily due to an increase in volume of sales of our products over the prior year quarter and an increase in operating cost for the period. Cost of revenue as a percentage of net revenue increased from 45% and 41% for the three and six months ended March 31, 2005, respectively, as compared to 46% for both the three and six months ended March 31, 2006. This increase in the six month comparison was caused primarily by a lower profit margin as a result of a price reduction on our smaller telephone system bundles. No provision for excess or obsolete inventory was necessary in the three and six months ended March 31, 2006.

**Research and development expenses.** 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. Research and development expenses decreased to \$895,000 for the three months ended March 31, 2006 from \$935,000 for the same period in fiscal 2005. This decrease was primarily the result of lower legal expenses of \$34,000, headcount-related costs of \$55,000 resulting from decrease in salary and other related payroll expenses, offset in part by an increase of \$59,000 due to non-cash stock-based compensation required by SFAS No.123(R) in the current period. Research and development expenses as a percentage of revenue decreased to 21% for the three months ended March 31, 2006 from 33% for the same period in fiscal 2005. Research and development expenses increased to \$1.9 million for the six months ended March 31, 2006 from \$1.8 million for the same period in fiscal 2005. This increase was primarily the result of an increase of \$159,000 of non-cash stock-based compensation expense required by SFAS No. 123(R). Research and development expenses as a percentage of revenue decreased slightly from 24% for the six months ended March 31, 2005 to 22% for the six months ended March 31, 2006. We believe that research and development expenses will increase in the future periods over the long term due to development of new products and continued efforts in the improvement of the current products. In the short term, we expect research and development expenses to remain consistent as management continues to monitor expenses and plans to keep them in line with expected revenue opportunities.

**Sales and marketing expenses.** Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales and customer support functions, as well as trade shows, advertising, and promotional expenses. Sales and marketing expenses increased to \$999,000 for the three months ended March 31, 2006 from approximately \$988,000 for the same period in fiscal 2005. This increase was due to a \$49,000 increase of non-cash stock-based compensation expense required by SFAS No. 123(R), offset in part by lower head count related expenses in the marketing organization. Sales and marketing expenses as a percentage of revenue decreased to 24% for the three months ended March 31, 2006 from 35% for the same period in fiscal 2005. For the six months ended March 31, 2006, sales and marketing expenses increased to \$2.1 million from approximately \$2.0 million for the same period in fiscal 2005. This was primarily attributable to \$111,000 increase of non-cash stock-based compensation expense required by SFAS No. 123(R). Sales and marketing expenses as a percentage of revenue decreased to 24% for the six months ended March 31, 2006 from 28% for the same period in fiscal 2005. We anticipate sales and marketing expenses to remain consistent; however, some expenses vary with revenue, such as commissions. If we are successful in enhancing our products, we expect to see continued revenue growth for fiscal year 2006 and, consequently, expect an increase in sales and marketing expenses.

**General and administrative expenses.** General and administrative expenses consist of salaries and related expenses for (i) executive, finance, human resources and administrative personnel, (ii) facilities, (iii) allowance for doubtful accounts, (iv) legal, and (v) other general corporate expenses. General and administrative expenses decreased to \$527,000 for the three months ended March 31, 2006 from \$529,000 in the same period in the prior year. The decrease is primarily the result of a lower insurance expense of \$52,000, and a decrease in other general expenses, offset by an increase of \$60,000 for non-cash stock-based compensation expense required by SFAS No. 123(R). General and administrative expenses for the six months ended March 31, 2006 increased to \$1.1 million from \$1.0 million as compared with the same period in the prior year fiscal. This was mainly the result of a \$146,000 non-cash stock-based compensation expense required by SFAS No. 123(R). General and administrative expenses as a percentage of revenue decreased to 13% for the three months ended March 31, 2006 from 19% for the same period in fiscal 2005. For the six months ended March 31, 2006, general and administrative expenses as a percentage of revenue decreased to 13% as compared to 19% during the same period in the prior year. We expect general and administrative expenses to remain consistent as we continue to focus on controlling costs.

**Equity in net loss of investee.** In July 2004, we purchased common stock of a private Korean telecommunications company for \$79,000. As a result of this investment, we acquired approximately 23% of the voting power of the company and have the right to nominate and have elected one of the three members of the company's current board of directors. We are accounting for this investment using the equity method. The total equity in net losses of the Korea investee was approximately \$105,000 of which 23%, or \$24,000, is recognized in the six months ended March 31, 2006.

**Interest and other income, net.** Net interest and other income increased to \$85,000 and \$168,000 for the three and six months ended March 31, 2006, respectively, from \$53,000 and \$94,000 for the same periods in fiscal 2005. The increase in net interest and other income for the three and six months ended March 31, 2006 was primarily a result of higher interest rates on investments. We expect net interest and other income to remain relatively flat as we have limited cash reserves to invest.

### Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the sale of equity securities. As of March 31, 2006, we had cash and short-term investments totaling \$9.3 million consisting of cash and cash equivalents of \$4.9 million and \$4.4 million of short-term investment with a maturity of greater than 90 days.

	Six Months Ended March 31,	
	(in thousands)	
	2006	2005
Cash and cash equivalents	\$ 4,867	\$ 3,117
Short-term investments	4,388	6,565
Total cash, cash equivalents and short-term investments	\$ 9,255	\$ 9,682
Cash used in operating activities	\$ (157)	\$ (463)
Cash provided by investing activities	\$ 843	\$ 418
Cash provided by financing activities	\$ 218	\$ 264
Net increase in cash and cash equivalents	\$ 904	\$ 219

### Changes in Cash Flows

During the six months ended March 31, 2006, net cash used in operating activities of was \$157,000, which was approximately \$306,000 lower than the cash used in operating activities during the same period in fiscal 2005. This was primarily due to a lower net loss of \$338,000, an increase in accounts payable and non-cash stock-based

compensation expense of \$436,000. The stock-based compensation expense is the result of our adoption of SFAS No. 123(R) starting on October 1, 2005. The lower loss was partially offset by an increase in inventory of \$649,000 as well as an increase in accounts receivable of \$201,000. Factors that helped to reduce the net cash used in operations were an increase of \$257,000 in deferred revenue and depreciation and amortization of approximately \$100,000.

For the six months ended March 31, 2006, net cash provided by investing activities was \$843,000, which was primarily attributable to proceeds from maturities of short-term investments.

Net accounts receivable increased to \$2.2 million at March 31, 2006 from \$2.0 million at September 30, 2005. The increase in net accounts receivable was primarily due to higher deferred revenue and increases in days sales outstanding (DSO) at 47 days as of March 31, 2006 from 41 days as of September 30, 2005.

We ended the second quarter of fiscal 2006 with a cash conversion cycle of 76 days as compared to 87 days for the second quarter of fiscal 2005. The cash conversion cycle is the duration between purchase of inventories and services and the collection of the cash from the sale of our products and services and is a metric on which we have focused as we continue to try to efficiently manage our assets. The cash conversion cycle results from the calculation of DSO added to days of supply in inventories (DOS), reduced by days of payable outstanding (DPO).

Inventories increased to \$1.6 million at March 31, 2006 from \$965,000 at September 30, 2005 and our inventory turn rate decreased to 4.8 times at March 31, 2006 from 6.8 times at September 30, 2005. Our annualized inventory turn rate represents the number of times inventory is replenished during the year. The increase in inventory is the result of higher finished goods and work in process. Inventory management will continue to be an area of focus as we balance the need to maintain strategic inventory levels to help ensure competitive lead times with the risk of inventory obsolescence due to rapidly changing technology and customer requirements.

Accounts payable increased to \$972,000 at March 31, 2006 from \$653,000 at September 30, 2005. This increase was primarily attributable to an increase in product purchased in fiscal 2006. Accrued payroll-related liabilities increased to \$331,000 at March 31, 2006 from \$317,000 at September 30, 2005, primarily as a result of an increase of \$8,000 in accrued commission and an increase of \$6,000 in accrued vacation.

During the six months ended March 31, 2006, our net cash provided by financing activities was primarily attributable to the \$218,000 of proceeds from the exercise of employee stock options and stock purchases through our employee stock purchase plan.

#### *Liquidity and Capital Resources*

We intend to continue to invest our cash in excess of current operating requirements in short-term, interest bearing investment-grade securities.

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 enhancements to existing products, the 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 need and are unable to raise additional capital or if sales from our new products or enhancements 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.

Additional financing, if required, may not be available on acceptable terms, or at all. We also may require additional capital to acquire or invest in complementary businesses or products, or obtain the right to use complementary technologies. If we need and cannot raise funds on acceptable terms, we may not be able to further develop or enhance our products, take advantage of future opportunities, or 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 we 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 our risk or perceived risk.

We do not have any material commitments for capital expenditures as of March 31, 2006. We have commitments under our noncancellable operating lease in the amount of \$1.3 million as of March 31, 2006. The following table represents our future commitments as of March 31, 2006 (in thousands):

Contractual Obligations	Total	Payment Due by Period			
		Less than	1 - 3 Years	3 - 5 Years	More than

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	1 Year				5 Years	
Operating leases obligation	\$ 1,082	\$ 258	\$ 732	\$ 92	\$ —	—
Capital leases obligation	203	26	100	77	—	—
Total	\$ 1,285	\$ 284	\$ 832	\$ 169	\$ —	—

We believe we have sufficient cash reserves to allow us to continue operations for at least the next twelve months.

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*Recent Accounting Pronouncements*

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154") which replaces Accounting Principles Board Opinions No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28." SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 is required to be adopted by us in the first quarter of fiscal year 2007. We are currently evaluating the effect that the adoption of SFAS 154 will have on our consolidated results of operations and financial condition but do not expect it to have a material impact.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

*Interest Rate 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 a change in interest rates does not pose a material market risk to us.

*Foreign Currency Exchange Risk.* We face foreign exchange currency fluctuations with our subsidiary in China, however, due to the strength in China's economy, we do not foresee foreign exchange currency fluctuations to pose a material market risk to us.

**Item 4. Controls and Procedures.**

*(a) Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*(b) Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks' U.S. Patents Nos. 6,266,341; 6,289,025; 6,292,482; 6,389,009; and 6,396,849. On October 28, 2002, Vertical Networks amended its complaint to add allegations of infringement of U.S. Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a second amended complaint on November 20, 2002 to identify our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. We filed an answer and counterclaims for declaratory relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its answer to our counterclaims. Vertical Networks served its preliminary infringement contentions on us on April 9, 2003 and we served Vertical Networks our preliminary invalidity contentions on June 3, 2003 and July 14, 2003. To date, the parties have exchanged some discovery, but no depositions have been taken, and no motions are currently pending. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the U.S. Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously defend our position. Management's view is that any loss from this litigation is currently not probable or estimable; therefore, the Company has not established a reserve on its balance sheets as to any liability related to the outcome of this action.

From time to time, we may become party to litigation and subject to claims arising in the ordinary course of our business. To date, these actions have not had a material adverse effect on our financial position, result of operations or cash flows. Although the results of litigation and claims cannot be predicted with certainty, we believe that the final outcome of such matters would not have a material adverse effect on our business, financial position, results of operation and cash flows.

### Item 1A. Risk Factors

#### CERTAIN FACTORS AFFECTING BUSINESS, OPERATING RESULTS, AND FINANCIAL CONDITION

You should carefully consider the risks described below and all of the information contained in this Form 10-Q. If any of the following risks occur, our business, financial condition and result of operations could be harmed, the trading price of our common stock could decline and you may lose all or part of your investment in our common stock.

#### *Risks Related to Our Business*

*We have had a history of losses and may incur future losses, which may prevent us from maintaining profitability.*

We have had a history of operating losses since our inception, and as of March 31, 2006, we had an accumulated deficit of \$51.5 million. We may incur operating losses in the future, and these losses could be substantial and impact our ability to maintain profitability. We do not expect to increase expenditures for product development, general and administrative expenses, and sales and marketing expenses; however, if we cannot maintain current revenue or revenue growth, we will not achieve or sustain profitability or positive operating cash flows. Even if we 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.

*Our operating results vary, making future operating results difficult to predict.*

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

to vary, including:

our ability to respond effectively to competitive pricing pressures;

- our ability to respond effectively to competitive pricing pressures;
- our ability to establish or increase market acceptance of our technology, products and systems;
- our success in expanding 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;

market acceptance of products and systems incorporating our technology and enhancements to our product applications on a timely basis;

- our ability to respond effectively to competitive pressures;
- our success in supporting our products and systems;
- 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 the 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 future projected budgets and commitments 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 primarily depend 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 adequately compete.***

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 these telephone systems are Avaya Communications, NEC and Nortel Networks. We also compete against providers of multi-function telecommunications systems, including 3Com Corporation, and Cisco Systems, 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 resources, sales and marketing teams, technical and customer support, manufacturing capabilities and other resources. These competitors also may have more established distribution 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 to devote greater resources to the development, promotion and sale of their products. These competitors may enter our existing or future markets with products that may be less expensive, provide higher performance or additional features or be introduced earlier than our phone systems. We also expect that other companies may enter our market with better products and technologies. 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, our sales or market acceptance of our products and services could be reduced, price competition could be increased or make our products could become obsolete. To remain competitive, therefore, 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.

***We sell our products through dealers and distributors, which limits our ability to control the timing of our sales, and which makes it more difficult to predict our revenue.***

We do not recognize revenue from the sale of our products to our distributors until these products are sold to either resellers 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 that we recognize from our distributors' sales to resellers and end-users limits our ability to predict revenue for any given period. Our future projected budgets and commitments 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 resellers 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 resellers who can provide high quality sales and support services. As with our distributors, we compete with other telecommunications systems providers for our resellers' business as our resellers generally market competing products. If a reseller 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 reseller or the failure of resellers to provide adequate customer service could cause our business to suffer. If we do not properly train our resellers 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 revenue.***

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. 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 revenue, 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.

***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. In order to be competitive, therefore, we 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.

***We depend on attracting and retaining 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 revenue. Competition for highly trained personnel is intense, especially in the San Francisco Bay Area where most of our operations are located. 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.

***FASB's adoption of SFAS No. 123(R) will cause, and changes to existing accounting pronouncements or taxation rules or practices may cause, adverse revenue fluctuations, affect our reported results of operations or how we conduct our business.***

In December 2004, the FASB issued SFAS No. 123(R), Stock-Based Compensation, which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 - Stock-Based Compensation, which provides interpretive guidance related to SFAS No. 123(R). SFAS No. 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under APB Opinion No. 25. SFAS No. 123(R). We have adopted this standard starting October 1, 2005. This standard will have material impact on our results of operations.

Also, a change in accounting pronouncements or taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. Other new accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. This change to existing rules, future changes, if any, or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

***If, as of the end of our 2007 fiscal year, we are unable to assert that our internal control over financial reporting is effective, or if our auditors are unable to confirm our assessment, investors could lose confidence in our reported financial information, and the trading price of our stock price and our business could be adversely affected.***

We are in the process of documenting, and plan to test during the current fiscal year, our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act. Commencing on September 30, 2007, the end of our 2007 fiscal year, the Sarbanes-Oxley Act will require annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent registered public accounting firm addressing these assessments. During the course of our testing we may identify deficiencies which we may not be able to remediate in time to meet the deadline imposed by the Sarbanes-Oxley Act for compliance with the requirements of Section 404. In addition, if we fail to achieve and maintain the adequacy of our internal controls, as such standards are modified, supplemented, or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Effective internal controls are important to help produce reliable financial reports and to prevent financial fraud. If we are unable to assert that our internal control over financial reporting is effective as of the end of our 2007 fiscal year, or if our auditors are unable to attest that our management's report is fairly stated or they are unable to express an opinion on our management's evaluation or on the effectiveness of the internal controls, we could lose investor confidence in the accuracy and completeness of our financial reports, investors could lose confidence in our reported financial information, and the trading price of our stock and our business could be adversely affected.

***If we do not manage our growth effectively, our business will suffer.***

We may not be successful in managing our future growth. We have expanded our operations rapidly since our inception. In order to manage this expansion and 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 operations.

***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, Graybar and Synnex, accounted for 84% and 86% for the three and six months end months ended March 31, 2006, respectively. Our business and operating results will suffer if any one

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 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 many of 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 Texas Instruments Digital Processing (TI DSP) chip, is particularly important to our business because it is included in virtually all of our hardware 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 products, which could entail qualifying an alternative source or redesigning our products based on different components. Our inability to obtain these sole-sourced components, especially the Texas Instruments Digital Processing (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

***Compliance with changing regulations of corporate governance and public disclosure may result in additional expenses.***

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act, new SEC regulations and Nasdaq National Market rules, are creating uncertainty for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. As a result, our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act and the related regulations regarding our required assessment of our internal controls over financial reporting and our external auditors' audit of that assessment has required the commitment of significant financial and managerial resources. We expect these efforts to require the continued commitment of significant resources. Further, our board members, chief executive officer, and chief financial officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which could harm our business. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed.

***Our facility is vulnerable to damage from earthquakes and other natural disasters and other business interruptions; 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 may be subject to rolling electrical blackouts and is vulnerable to damage or interruption from fire, floods, earthquakes, power loss, telecommunications failures and similar events. If such a disaster or interruption 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 engage third-party assemblers to insert the hardware components into the printed circuit board. We selected our manufacturing partners with the goals of ensuring a reliable supply of high-quality finished products and lowering per unit product costs as a result of manufacturing economies of scale.

***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 subcontractors were 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.

***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.*

For the three and six months ended March 31, 2006, approximately 7% and 8%, respectively and of our net revenue came from customers outside of the Americas. 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.

***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 of our technology. In addition, other individuals or companies 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 such protection 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.

***If we are unable to raise additional capital when needed, we may be unable to develop or enhance our products and services.***

We may seek additional funding in the future. If we cannot raise funds on acceptable terms, we may be unable to develop or enhance our products and services, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements. We also may be required to reduce operating costs through lay-offs or reduce our sales and marketing or research and development efforts. If we issue equity securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of our common stock.

***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.

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks' U.S. Patents Nos. 6,266,341; 6,289,025; 6,292,482; 6,389,009; and 6,396,849. On October 28, 2002, Vertical Networks amended its complaint to add allegations of infringement of U.S. Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a second amended complaint on November 20, 2002 to identify our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. We filed an answer and counterclaims for declaratory relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its answer to our counterclaims. Vertical Networks served its preliminary infringement contentions on us on April 9, 2003 and we served Vertical Networks our preliminary invalidity contentions on June 3, 2003 and July 14, 2003. To date, the parties have exchanged some discovery, but no depositions have been taken, and no motions are currently pending. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the U.S. Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously defend our position. Management's view is that any loss from this litigation is currently not probable or estimable. Therefore, we have not established a reserve on our balance sheets as to any liability related to the outcome of this action.

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

***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 where we sell or plan to sell them. We also have obtained or are trying to obtain the certifications that we believe are required to sell our products in these countries. We cannot, however, 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 our products in that country. This inability to sell our products 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.

***Risks Related to the Industry***

***Integrated, multifunction telecommunications systems may not achieve widespread acceptance.***

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 also may 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 also may experience these problems if the networks do not have sufficient capacity to carry all of these communications at the same time.

***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 also may 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.

***Future regulation or legislation could harm our business or increase our cost of doing business.***

The Federal Communications Commission (FCC) has 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, 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 of products and services. In February 2004, the FCC found that an entirely Internet based voice over Internet protocol service was an unregulated information service. At the same time, the FCC began a broader proceeding to examine what its role should be in this new environment of increased consumer choice and what can be done to meet its role of safeguarding the public interest. 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.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None

**Item 3. Defaults Upon Senior Securities.**

None

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

On February 9, 2006, we held our annual meeting of stockholders to seek their approval as to the following matters:

- The re-election of Kenneth Tai and Tacheng Chester Wang as Class I directors.

As to the re-election:

- Mr. Tai received 12,427,425 votes for re-election and 91,860 shares withheld.
- Mr. Wang received 12,421,575 votes for re-election and 97,710 shares withheld.

The ratification of the appointment of Deloitte & Touche LLP as our independent registered public accounting firm for the fiscal year ending September 30, 2006.

As to the ratification of the appointment of Deloitte & Touche LLP:

12,470,552 shares voted for the appointment, 23,614 shares voted against the appointment and 25,119 shares abstained from voting.

In addition, the terms of the following directors continued after the date of the meeting: Richard B. Black, Gilbert Hu and Mike Mon Yen Tsai.

There were 14,902,501 shares issued, outstanding and eligible to vote at the meeting.

**Item 5. Other Information.**

None

**Item 6. Exhibits.**

Please refer to the Exhibit Index of this report on Form 10-Q.

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**SIGNATURE**

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.

ALTIGEN COMMUNICATIONS, INC.

Date: May 15, 2006

By: /s/ Philip M. McDermott

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

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**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
3.1 (1)	Amended and Restated Certificate of Incorporation.
3.2 (2)	Second Amended and Restated Bylaws.
31.1	Certification of Principal Executive Officer, filed herewith.
31.2	Certification of Principal Financial Officer, filed herewith.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

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- (1) Incorporated by reference to exhibit filed with the Registrant's Registration Statement on Form S-1 (No. 333-80037) declared effective on October 4, 1999.
- (2) Incorporated by reference to exhibit filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.