

ALTIGEN COMMUNICATIONS INC  
Form 10-Q  
February 11, 2005

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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 DECEMBER 31, 2004**

**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 an accelerated filer. YES  NO

The number of shares of our common stock outstanding as of February 9, 2005 was: 14,563,687 shares

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**PART I. FINANCIAL INFORMATION**  
**Financial Statements**

**Item 1.**

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

	December 31, 2004	September 30, 2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 6,753	\$ 5,367
Short-term investments	3,261	4,667
Accounts receivable, net of allowances of \$30 and \$35 at December 31, 2004 and September 30, 2004, respectively	2,015	1,857
Inventories	890	1,058
Prepaid expenses and other current assets	168	67
Total current assets	13,087	13,016
Property and equipment:		
Furniture and equipment	1,004	987
Computer software	920	915
	1,924	1,902
Less: Accumulated depreciation and amortization	(1,772)	(1,750)
Net property and equipment	152	152
Other non-current assets:		
Long-term investment	255	274
Long-term deposit	74	74
Total other non-current assets	329	348
Total assets	\$ 13,568	\$ 13,516
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 724	\$ 798
Accrued liabilities:		
Payroll and related benefits	273	330
Warranty (Note 3)	407	424
Marketing	126	139
Other	424	493
Deferred revenue	295	518
Total current liabilities	2,249	2,702
Long-term deferred rent	134	145
Stockholders' equity:		
Convertible preferred stock, \$0.001 par value; Authorized - 5,000,000 shares; None issued and outstanding at December 31, 2004 and September 30, 2003	--	--
Common stock, \$0.001 par value; Authorized - 50,000,000 shares; Outstanding - 15,594,607 shares at December 31, 2004 and 15,462,506	15	15

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shares at September 30, 2004

Treasury stock at cost - 1,063,895 shares at December 31, 2004 and September 30, 2004	(1,014)	(1,014)
Additional paid-in capital	62,678	62,505
Accumulated other comprehensive loss	--	(2)
Accumulated deficit	(50,494)	(50,835)
Total stockholders' equity	11,185	10,669
Total liabilities and stockholders' equity	\$ 13,568	\$ 13,516

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

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

	<b>Three Months Ended</b>	
	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
Net revenue:		
Hardware	\$ 3,564	\$ 3,220
Software	711	410
Total net revenue	4,275	3,630
Cost of revenues:		
Hardware	1,615	1,406
Software	52	32
Total cost of revenues	1,667	1,438
Gross profit	2,608	2,192
Operating expenses:		
Research and development	822	828
Sales and marketing	1,001	1,013
General and administrative	475	422
Total operating expenses	2,298	2,263
Income (loss) from operations	310	(71)
Interest and other income, net	42	25
Net income (loss) before tax	352	(46)
Income taxes	10	--
Net income (loss)	\$ 342	\$ (46)
Basic and diluted net income (loss) per share	\$ 0.02	\$ (0.00)
Weighted average shares used in computing basic net income (loss) per share	14,459	14,116
Weighted average shares used in computing diluted net income (loss) per share	15,797	14,116

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)

	<b>Three Months Ended</b>	
	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Income (loss)	\$ 342	\$ (46)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	22	73
Changes in operating assets and liabilities		
Accounts receivable	(158)	(331)
Inventories	168	196
Prepaid expenses and other current assets	(101)	(21)
Accounts payable	(74)	(445)
Accrued liabilities	(156)	7
Deferred revenue	(223)	(144)
Deferred rent	(11)	--
Net cash used in operating activities	(191)	(711)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of short-term investments	(1,594)	(3,369)
Proceeds from sale and maturities of short-term investments	3,000	1,591
Changes in other non-current assets	19	(50)
Purchases of property and equipment	(22)	(7)
Net cash provided by (used in) investing activities	1,403	(1,835)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuances of common stock	174	109
Net cash provided by financing activities	174	109
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>1,386</b>	<b>(2,437)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>5,367</b>	<b>8,548</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 6,753</b>	<b>\$ 6,111</b>

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. designs, manufactures and markets next generation, time-tested 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.

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

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2004, included in the Company's 2004 Annual Report on Form 10-K filed with the SEC on December 29, 2004. 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.

**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 December 31, 2004, our cash and cash equivalents consisted of commercial paper and cash deposited in checking and money market accounts. For the three months ended December 31, 2004 and 2003, we did not make any cash payments for interest or income taxes.

Unrealized loss from short-term investments were \$0 at December 31, 2004 and \$2,000 at September 30, 2004, respectively.

**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 three months ended December 31, 2004 and 2003. The components of inventories include (in thousands):



	<b>December 31, 2004</b>	<b>September 30, 2004</b>
Raw materials	\$ 248	\$ 68
Work-in-progress	87	95
Finished goods	555	895
	\$ 890	\$ 1,058

### **LONG-TERM INVESTMENT**

As of December 31, 2004, 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 approximately \$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.

We perform a periodic review of our investments for impairment. Our investments are considered impaired when a review of the investees' 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.

## **REVENUE RECOGNITION**

We account for the recognition of software license revenues in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition." Revenues consist of sales to end-users, including resellers, and to distributors. Revenues from sales to end-users are recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. 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 revenues 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 revenues consist of license revenues 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**

We account for stock-based compensation in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and comply with the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosures." Deferred compensation recognized under APB Opinion No. 25 is amortized to expense using the graded vesting method. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") No. 96-18 under the fair value based method.

We adopted the disclosure-only provisions of SFAS No. 123, and accordingly, no expense has been recognized for options granted to employees under our various option plans. We amortize deferred stock-based compensation over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS

No. 123, the Company's pro forma net loss and net loss per share would be as follows (in thousands, except per share data):

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	Three Months Ended December 31,	
	2004	2003
Reported net income (loss)	\$ 342	\$ (46)
Add: Total 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 for all awards	(396)	(246)
Pro forma net loss under SFAS No. 123	\$ (54)	\$ (292)
Basic and diluted net income (loss) per share – as reported	\$ 0.02	\$ (0.00)
Basic and diluted net loss per share – pro forma	\$ (0.00)	\$ (0.02)

The fair value of each option grant is estimated on 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:

	Employee Stock Option Plan for Three Months Ended December 31,	
	2004	2003
Expected Life (in years)	5	5
Risk-free interest rate	3.5%	3.4%
Volatility	103%	113%
Expected dividend	0.0%	0.0%

	Employee Stock Purchase Plan for Three Months Ended December 31,	
	2004	2003
Expected Life (in years)	0.5	0.5
Risk-free interest rate	2.5%	1.1%
Volatility	102%	113%
Expected dividend	0.0%	0.0%

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.

#### COMPUTATION OF BASIC AND DILUTED NET INCOME (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 all periods but the quarter ended December 31, 2004, basic and diluted net loss per share numbers were identical as potential common shares resulting from the exercise of stock options were antidilutive

**Three Months  
Ended December 31,  
2004                      2003  
(in thousands, except per share data)**

Net Income (loss)	\$ 342	\$ (46)
Weighted average shares outstanding – basic	14,459	14,116
Add: Dilutive stock options	1,338	--
Weighted average shares outstanding – diluted	15,797	14,116
Basic and diluted earnings (loss) per share	\$ 0.02	\$ (0.00)

**COMPREHENSIVE INCOME**

Comprehensive income (loss) consists of net income (loss) plus the effect of foreign currency translation adjustments and other unrealized gains and losses, which were not material for each of the three months ended December 31, 2004 and 2003, respectively. Accordingly, comprehensive income (loss) closely approximates actual net income (loss).

**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 months ended December 31, 2004 and 2003, respectively, were as follows:

	<b>Three Months Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
Americas	85%	92%
International	15%	8%
	100%	100%

International is comprised of revenues 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 months ended December 31, 2004 and 2003, respectively, were as follows:

	<b>Three Months Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
AltiSys	10%	17%
Ingram Micro (see Note 5)	7%	18%
Synnex	49%	48%
Graybar	10%	--

Graybar became our distributor starting in June 2003 but did not generate any significant revenue for the three months ended December 31, 2003.

## 2. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2004, the EITF reached a consensus on Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock" ("EITF No. 02-14"). The consensus was that an investor should only apply the equity method of accounting when it has investments in either common stock (as already required by APB Opinion No. 18) or in-substance common stock of a corporation, provided that the investor has the ability to exercise significant influence over the operating and financial policies of the investee. EITF No. 02-14 defines in-substance common stock and provides guidance on determining whether an investment is substantially similar to the common stock of the investee. EITF No. 02-14 should be applied in the first reporting period beginning after September 15, 2004. The adoption of this standard did not have a material impact on our consolidated financial statements.

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, "Inventory Costs." The statement requires that abnormal amounts of idle facility expense, freight handling costs and wasted material be recognized as current-period expenses. In addition, the statement requires that the allocation of production overhead be based on normal capacity. The adoption of this standard in October 2004 did not have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have material impact on our consolidated financial statements.

Also in December 2004, the FASB issued SFAS No. 123, "Share-Based Payments (revised 2004)," (SFAS No. 123R). This statement eliminates the option to apply the intrinsic value measurement provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees", to stock compensation awards issued to employees. Rather the statement requires companies 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. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award – the requisite service period (usually the vesting period). SFAS No. 123R will also require enterprises to measure the cost of employee services received in exchange for employee stock purchase plan ("ESPP") awards and we will be required to expense the grant-date fair value of our ESPP awards. SFAS No. 123R will be effective for our fiscal quarter beginning July 1, 2005. We have not yet quantified the effect of the future adoption of SFAS No. 123R on a going forward basis.

## 3. WARRANTY

We provide 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 months ended December 31, 2004 and 2003, respectively, are as follows (in thousands):

<b>Three Months Ended</b>	
<b>December 31,</b>	
<b>2004</b>	<b>2003</b>



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Beginning balance	\$	424	\$	644
Provisions for warranty liability		23		60
Warranty cost including labor, components and scrap		(40)		(34)
Ending balance	\$	407	\$	670

#### 4. COMMITMENTS AND CONTINGENCIES

##### *Commitments*

We lease our facilities under various operating lease agreements expiring on various dates through February 2009. The lease for our headquarters expires on February 21, 2009. Rent expense for this operating lease totaled approximately \$126,000 and \$162,000 for the three months ended December 31, 2004 and 2003, respectively. Minimum future lease payments under a noncancellable operating lease as of December 31, 2004 are as follows (in thousands):

Fiscal Year Ending September 30,	Capital Leases	Operating Leases
2005	4	314
2006	2	403
2007	2	361
2008	--	271
Thereafter	--	92
Total minimum lease payment	8	\$ 1,441
Amount representing interest	1	
Present value of minimum lease payment	7	
Current portion	4	
Long-term portion	\$ 3	

##### *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 litigate our position. Management's view is that any loss from this litigation is not probable or estimable.

#### 5. SUBSEQUENT EVENT

In January 2005, we sent 90 days written notice to Ingram Micro to terminate our distribution agreement. As of December 31, 2004, the balances outstanding with Ingram Micro were \$45,000 in inventory and \$136,000 in accounts receivable.



## **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 judgment as of the date of this report with respect to future events, the outcome of which is subject to certain risks, that may have a significant impact on our business, operating results or financial condition. You are cautioned that these forward-looking statements are inherently uncertain. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results or outcomes may vary materially from those described herein. 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 provide converged Internet protocol phone systems to small-to-medium sized businesses. We first recognized revenues from product sales of our Quantum board and AltiWare software in July 1996. We generated net revenues of \$4.3 million and \$3.6 million for the three months ended December 31, 2004 and 2003, respectively. As of December 31, 2004, we had an accumulated deficit of \$50.5 million.

We derive our revenues from sales of our AltiServ system, which includes hardware and software bundled into a suite of telephone systems. Product revenues consist of sales to end-users (including dealers) and to distributors. Revenues 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 on the inventories they carry on hand.

Our cost of revenues consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to the manufacturing of our products. Several factors that have affected, and will continue to affect, our revenue growth include 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, which, for the three months ended December 31, 2004, were All Quality Services and Bestronics in San Jose, 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. We cannot assure you that we will achieve or 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, or maintain such reductions if they occur, could materially adversely affect our gross margins and operating results.

We continue to focus on developing enhancements to our current products to provide greater functionality and increased capabilities, based on our market research, customer feedback and our competitors' product offerings. We also continue to focus on creating new product offerings. In particular, we are focusing on developing products that allow us to enhance our position in our target market segment and 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, which are offices with less than 500 employees, with particular emphasis in the Internet protocol phone systems segment of the telecommunications market. Also, we plan to continue to recruit additional resellers and distributors that focus on selling phone systems to our target customers. There can be no assurance, however, that we will be successful in developing any new products or enhancements to existing products, entering new geographical or product markets or expanding our network of resellers and distributors. We believe that the adoption rate for this new technology is much faster with small-to-medium sized businesses because they do not have significant investment on their books for traditional phone systems. We believe that these businesses are looking for call center-type administration to increase the productivity and efficiency of their contacts with customers. Assuming continuing market trends, successful product enhancements, continuing acceptance of the call center products, continuing growth in the marketplaces of China, the United Kingdom and Norway, and the status quo of the North American economy, we expect to see continued revenue growth year over year.

## CRITICAL ACCOUNTING POLICIES

*Revenue recognition.* Revenues consist of sales to end-users, including resellers, and to distributors. Revenues from sales to end-users are recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. We provide for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenues consist of product revenues reduced by estimated sales returns and allowances. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on our 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 without cause by either party following a specified notice period. As a result of the above provisions, we defer recognition of distributor revenues 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 revenues is also deferred and reported in the consolidated balance sheets as inventory. Our total deferred revenue was \$295,000 as of December 31, 2004.

Software components are generally not sold separately from our hardware components. Software revenues consist of license revenues 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 \$30,000 as of December 31, 2004.

*Inventory.* Inventory is stated at the lower of cost (first-in, first-out method) or market. Our inventory balance was \$0.9 million as of December 31, 2004. 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. Our inventory allowance was \$2.6 million as of December 31, 2004.

*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 \$407,000 as of December 31, 2004.

**Results of Operations**

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

	<b>Three Months Ended December 31</b>	
	<b>2004</b>	<b>2003</b>
<b>Consolidated Statements of Operations Data:</b>		
Net revenue:		
Hardware	83.4%	88.7%
Software	16.6	11.3
Total net revenue	100.0	100.0
Cost of revenues:		
Hardware	37.8	38.7
Software	1.2	0.9
Total cost of revenues	39.0	39.6
Gross profit	61.0	60.4
Operating expenses:		
Research and development	19.2	22.8
Sales and marketing	23.4	27.9
General and administrative	11.1	11.6
Total operating expenses	53.7	62.3
Income (loss) from operations	7.3	(1.9)
Interest and other income, net	0.9	0.7
Net income (loss) before tax	8.2	(1.2)
Provision for income taxes	0.2	--
Net income (loss)	8.0%	(1.2)%

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

Net Revenue by Geographic Area:

	<b>Three Months Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
Americas	85%	92%
International	15%	8%
	100%	100%

## Net Revenue by Customers:

	Three Months Ended December 31,	
	2004	2003
AltiSys	10%	17%
Ingram Micro (see Note 5)	7%	18%
Synnex	49%	48%
Graybar	10%	--

Revenues generated in the Americas accounted for \$3.6 million or 85% of revenues for the three months ended December 31, 2004 and \$3.3 million or 92% of revenues for the three months ended December 31, 2003. Net revenues increased 18% to \$4.3 million for the three months ended December 31, 2004 from \$3.6 million for the three months ended December 31, 2003 due to the increased sales in telephone systems as a result of increasing our market presence through better performing resellers, selling more products into the call center market space, the sales of larger systems and the doubling of our international revenues, primarily through sales in China. Effective February 7, 2005, we lowered the price on our AltiServ1-IP Internet Protocol business system in response to increased price competition in the 8 to 50 users target market. The potential negative impact to our gross profit in the second quarter of fiscal year 2005 could be approximately \$90,000.

**Cost of revenues.** Cost of revenues for the three months ended December 31, 2004 increased \$0.3 million or 16% to \$1.7 million from approximately \$1.4 million for the three months ended December 31, 2003 primarily due to an increase in overall sales of products and the requisite increase in product costs. Cost of revenues as a percentage of net revenues remained unchanged at approximately 39% for the three months ended December 31, 2004 and 2003, respectively. No additional provision for excess or obsolete inventory was necessary in the three months ended December 31, 2004.

**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 remained unchanged at \$0.8 million for the three months ended December 31, 2004 and 2003, respectively. We expect research and development expenses to remain relatively flat due to the uncertainty about customers' spending patterns in the current economic environment. Management continues to monitor research and development 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 remained unchanged at \$1.0 million for the three months ended December 31, 2004 and 2003, respectively. We expect sales and marketing expenses to remain relatively flat due to the uncertainty about customers' spending patterns in the current economic environment; however, some expenses vary with revenues, such as commissions, which move with sales of our products.

**General and administrative expenses.** General and administrative expenses consist of salaries and related expenses for executive, finance and administrative personnel, facilities, allowance for doubtful accounts, legal, and other general corporate expenses. General and administrative expenses remained unchanged at \$0.4 million for the three months ended December 31, 2004 and 2003, respectively. We expect to maintain general and administrative expenses at the same level, except for the impact complying with Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") during fiscal year 2005. We have not completed our estimates of the cost of this compliance.



**Interest and other income, net.** Net interest and other income increased slightly to \$42,000 for the three months ended December 31, 2004 from \$25,000 for the three months ended December 31, 2003. The increase in net interest and other income for the three months ended December 31, 2004 was primarily a result of higher interest rates. We expect net interest and other income to remain relatively flat with little change in cash available to invest.

## **Liquidity and Capital Resources**

Since inception, we primarily have financed our operations through the sale of equity securities. As of December 31, 2004, we had cash, cash equivalents, and short-term investments totaling \$10.0 million, which consisted of cash and cash equivalents of \$6.8 million and \$3.2 million of short-term investments.

### *Changes in Cash Flows*

During the three months ended December 31, 2004, net cash used in operating activities was \$191,000, which was approximately \$520,000 lower than the cash used in operating activities during the same period of fiscal 2004 due to a net profit being generated in the first quarter of fiscal 2005. For the three months ended December 31, 2004, net cash provided by non-operating activities was \$1.4 million, which was primarily attributable to proceeds from maturities of short-term investments.

Net accounts receivable slightly increased to \$2.0 million at December 31, 2004 from \$ 1.9 million at September 30, 2004. The increase in net accounts receivable was primarily due to increases in revenue.

We ended the first quarter of fiscal 2005 with a cash conversion cycle of 51 days as compared to 64 days for the first quarter of fiscal 2004. 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 days of sales outstanding added to days of supply in inventories , reduced by days of payable outstanding .

Inventories decreased to \$0.9 million at December 31, 2004 from \$1.1 million at September 30, 2004 and our inventory turn rate increased to 7.4 times at December 31, 2004 from 5.7 times at September 30, 2004. Our inventory turn rate represents the number of times inventory is replenished during the quarter. 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 decreased to \$724,000 at December 31, 2004 from \$798,000 at September 30, 2004. This decrease primarily was due to inventory purchased in the last month of the prior quarter for which payment was made in the quarter ended December 31, 2004. Our accrued payroll-related liabilities decreased to \$273,000 at December 31, 2004 from \$330,000 at September 30, 2004, primarily as a result of a decrease in employee stock purchase plan contribution due to a common stock purchase made under our ESPP in November 2004.

In the first quarter of fiscal 2005, our net cash provided by financing activities was primarily attributable to the \$174,000 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 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 December 31, 2004. We have commitments under our noncancellable operating lease in the amount of \$1.4 million as of December 31, 2004. The following table represents our future commitments as of December 31, 2004 (in thousands):

	Payment Due by Period				
	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Operating leases obligation	\$ 1,441	\$ 314	\$ 764	\$ 363	\$ --
Capital leases obligation	8	4	4	--	--
Total	\$ 1,449	\$ 318	\$ 768	\$ 363	\$ --

We believe we have sufficient cash reserves to allow us to continue operations for more than a year.

### Recent Accounting Pronouncements

In July 2004, the EITF reached a consensus on Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock" ("EITF No. 02-14"). The consensus was that an investor should only apply the equity method of accounting when it has investments in either common stock (as already required by APB Opinion No. 18) or in-substance common stock of a corporation, provided that the investor has the ability to exercise significant influence over the operating and financial policies of the investee. EITF No. 02-14 defines in-substance common stock and provides guidance on determining whether an investment is substantially similar to the common stock of the investee. EITF No. 02-14 should be applied in the first reporting period beginning after September 15, 2004. The adoption of this standard did not have a material impact on our consolidated financial statements.

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, "Inventory Costs." The statement requires that abnormal amounts of idle facility expense, freight handling costs and wasted material be recognized as current-period expenses. In addition, the statement requires that the allocation of production overhead be based on normal capacity. The adoption of this standard in October 2004 did not have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have material impact on our consolidated financial statements.

Also in December 2004, the FASB issued SFAS No. 123, "Share-Based Payments (revised 2004)," (SFAS No. 123R). This statement eliminates the option to apply the intrinsic value measurement provisions of APB Opinion No. 25,

"Accounting for Stock Issued to Employees", to stock compensation awards issued to employees. Rather the statement requires companies 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. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award - the requisite service period (usually the vesting period). SFAS No. 123R will also require enterprises to measure the cost of employee services received in exchange for employee stock purchase plan ("ESPP") awards and we will be required to expense the grant-date fair value of our ESPP awards. SFAS No. 123R will be effective for our fiscal quarter beginning July 1, 2005. We have not yet quantified the effect of the future adoption of SFAS No. 123R on a going forward basis.

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

### *Risks Related to AltiGen*

*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 December 31, 2004, we had an accumulated deficit of \$50.5 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 revenues or revenue growth, we will not maintain 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.

*We have a limited operating history, which makes it difficult to evaluate our business and our future prospects.*

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

§ Establish and increase market acceptance of our technology, products and systems;

§ Expand our network of distributors, dealers and companies that buy our products in bulk, customize them for particular applications or customers, and resell them under their own names;

§ Introduce products and systems incorporating our technology and enhancements to our product applications on a timely basis;

§ Respond effectively to competitive pressures; and

§ Successfully market and support our products and systems.

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

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

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

§ Our sales cycle, which may vary substantially from customer to customer;

§ Unfavorable changes in the prices and delivery of the components we purchase;

§ The size and timing of orders for our products, which may vary depending on the season, and the contractual terms of 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 multifunction 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 decrease or make our products could become obsolete. To be 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.

*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 69% of our net revenues for the three months ended December 31, 2004. Graybar became our distributor starting in June 2003. Our business and operating results will suffer if any one of these distributors (or any additional 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. In January 2005, we sent 90 days written notice to Ingram Micro to terminate our distribution agreement.

*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 revenues.*

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

*We rely on 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 revenues.*

Users expect telephone systems to provide a high level of reliability. Our products are inherently complex and may have undetected software or hardware errors. We have detected and may continue to detect errors and product defects in our installed base of products, new product releases and product upgrades. End-users may install, maintain and use our products improperly or for purposes for which they were not designed. These problems may degrade or terminate the operation of our products, which could cause end-users to lose telephone service, cause us to incur significant warranty and repair costs, damage our reputation and cause significant customer relations problems. Any significant delay in the commercial introduction of our products due to errors or defects, any design modifications required to correct these errors or defects or any negative effect on customer satisfaction as a result of errors or defects could seriously harm our business, financial condition and results of operations.

Any claims brought because of problems with our products or services could seriously harm our business, financial condition and results of operations. We currently offer a one-year hardware guarantee to end-users. If our products fail within the first year, we face replacement costs. Our insurance policies may not provide sufficient or any coverage should a claim be asserted. In addition, our introduction of products and systems with reliability, quality or compatibility problems could result in reduced revenues, uncollectible accounts receivable, delays in collecting

accounts receivable, warranties and additional costs. Our customers, end-users or employees could find errors in our products and systems after we have begun to sell them, resulting in product redevelopment costs and loss of, or delay in, their acceptance by the markets in which we compete. Further, we may experience significant product returns in the future. Any of these events could have a material adverse effect on our business, financial condition and results of operations.

*We may face infringement issues that could harm our business by requiring us to license technology on unfavorable terms or temporarily or permanently cease sales of key products.*

We may become parties to litigation in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex litigation are difficult to predict.

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 litigate our position. Management's view is that any loss from this litigation is not probable or estimable.

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 revenues 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.

*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.

*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.

*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.

*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.

*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.

*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 months ended December 31, 2004, approximately 15% of our net revenues 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.

*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 revenues. 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.

*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.

*Our strategy to outsource assembly and test functions in the future could delay delivery of products, decrease quality or increase costs.*

Based on volume or customer requirements, we may begin outsourcing some assembly and test functions. In addition, we may determine that we need to establish assembly and test operations overseas to better serve our international customers. Establishing overseas assembly and test operations may be more difficult or take longer than we anticipate. This outsourcing strategy involves certain risks, including the potential lack of adequate capacity and reduced control over delivery schedules, manufacturing yield, quality and costs. In the event that any significant subcontractor 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.

*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.

*If, as of the end of our 2005 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, 2005, the end of our 2005 fiscal year, the Sarbanes-Oxley Act requires 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 2005 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.

*FASB's adoption of Statement 123R 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 FASB adopted Statement 123R, "Share-Based Payment," which will require us, starting in the fourth quarter of fiscal year 2005, to measure compensation costs for all stock based compensation (including stock options and our employee stock purchase plan, as currently constructed) at fair value and take a compensation charge equal to that value. This statement will have a future effect on our net income.

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

*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.

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

In April 1998, the Federal Communications Commission submitted a report to Congress stating that it may regulate certain Internet services if it determines that such Internet services are functionally equivalent to conventional telecommunications services. The increasing growth of the voice over data network market and the popularity of supporting products and services, 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. Future laws, legal decisions or regulations, as well as changes in interpretations of existing laws and regulations, could require us to expend significant resources to comply with them. In addition, these future events or changes may create uncertainty in our market that could reduce demand for our products.

*Evolving standards may delay our product introductions, increase our product development costs or cause end users to defer or cancel plans to purchase our products, any of which could adversely affect our business.*

The standards in our market are still evolving. These standards are designed to ensure that integrated, multifunction telecommunications products from different manufacturers can operate together. Some of these standards are proposed by other participants in our market, including some of our competitors, and include proprietary technology. In recent years, these standards have changed, and new standards have been proposed, in response to developments in our market. Our failure to conform our products to existing or future standards may limit their acceptance by market participants. We may not anticipate which standards will achieve the broadest acceptance in our market in the future, and we may take a significant amount of time and expense to adapt our products to these standards. We 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.



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

*Market Risk.* Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in cash equivalents and short-term instruments. Due to the short-term nature of our cash equivalents and investments; however, we have concluded that a change in interest rates does not 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 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.**

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.

See Note 4 in the Notes to Unaudited Condensed Consolidated Financial Statements of this Form 10-Q titled "Commitments and Contingencies."

### **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.**

None

### **Item 5. Other Information.**

None

### **Item 6. Exhibits.**

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

**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: February 11, 2005

By: /s/ Philip M. McDermott

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

**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, file 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, file 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.