ALTIGEN COMMUNICATIONS INC
Form 10-Q
May 15, 2009

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

FORM 10-Q

xQUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

Commission File Number 000-27427

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

DELAWARE (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

Former name, former address and former fiscal year, if changed since last report: N/A

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company x

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

The number of shares of our common stock outstanding as of May 12, 2009 was: 15,866,680 shares.

ALTIGEN COMMUNICATIONS, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009
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PART I. FINANCIAL INFORMATION

Item 1.Condensed Consolidated Financial Statements

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(In thousands, except per share data)

	March 31, 2009	September 30, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,955	$ 9,467
Short-term investments	2,500	400
Accounts receivable, net of allowances of $38 and $19 at March 31, 2009 and September 30, 2008, respectively.	1,098	2,423
Inventories, net	1,971	1,594
Prepaid expenses and other current assets	282	176
Total current assets	11,806	14,060
Property and equipment:		
Furniture and equipment	2,149	2,009
Computer software	948	948
	3,097	2,957
Less: Accumulated depreciation	(2,645)	(2,534)
Net property and equipment	452	423
Other non-current assets:		
Long-term investments	205	211
Long-term deposit	82	82
Total other non-current assets	287	293
Total assets	$ 12,545	$ 14,776
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,344	$ 1,234
Accrued liabilities:		
Payroll and related benefits	411	550
Warranty	109	137
Marketing	120	136
Accrued expense	404	200
Other current liabilities	474	628
Deferred revenue short-term	2,864	2,489
Total current liabilities	5,726	5,374
Other long-term liabilities………	126	105
Stockholders' equity:		
Convertible preferred stock, $0.001 par value; Authorized—5,000,000 shares; Outstanding—none at March 31, 2009 and September 30, 2008	—	—
Common stock, $0.001 par value; Authorized—50,000,000 shares; Outstanding—15,861,680 shares at March 31, 2009 and 15,777,303 shares at September	17	17

30, 2008		
Treasury stock at cost — 1,318,830 shares at March 31, 2009 and 1,295,030 shares at September 30, 2008	(1,400)	(1,381)
Additional paid-in capital	67,162	66,689
Accumulated other comprehensive income	194	3
Accumulated deficit	(59,280)	(56,031)
Total stockholders' equity	6,693	9,297
Total liabilities and stockholders' equity	$ 12,545	$ 14,776

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

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(In thousands, except per share data)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008	Six Months Ended March 31, 2009	Six Months Ended March 31, 2008
Net revenue:				
Hardware	$ 3,103	$ 4,130	$ 7,298	$ 7,758
Software	474	582	1,139	1,214
Total net revenue	3,577	4,712	8,437	8,972
Cost of revenue:				
Hardware	1,466	2,017	3,360	3,808
Software	4	76	8	139
Total cost of revenue	1,470	2,093	3,368	3,947
Gross profit	2,107	2,619	5,069	5,025
Operating expenses:				
Research and development	1,243	1,035	2,468	1,950
Sales and marketing	1,840	1,841	3,924	3,604
General and administrative	811	946	1,782	1,760
Total operating expenses	3,894	3,822	8,174	7,314
Loss from operations	(1,787)	(1,203)	(3,105)	(2,289)
Equity in net loss of investee	(3)	(6)	(6)	(3)
Interest and other income, net	23	82	59	194
Net loss before income taxes	(1,767)	(1,127)	(3,052)	(2,098)
Income tax provision	—	—	16	—
Net loss	$ (1,767)	$ (1,127)	$ (3,036)	$ (2,098)
Basic and diluted net loss per share	$ (0.11)	$ (0.07)	$ (0.19)	$ (0.13)
Weighted average shares used in computing basic net loss per share	15,862	15,708	15,842	15,753
Weighted average shares used in computing diluted net loss per share	15,862	15,708	15,842	15,753

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

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

	Six Months Ended March 31, 2009	Six Months Ended March 31, 2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (3,036)	$ (2,098)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	110	124
Stock-based compensation	410	480
Equity in net income (loss) of investee	6	3
Changes in operating assets and liabilities:		
Accounts receivable	1,325	(71)
Inventories, net	(377)	(439)
Prepaid expenses and other current assets	(106)	(130)
Accounts payable	110	490
Accrued liabilities	(133)	132
Deferred revenue short-term	375	1,324
Other long-term liabilities	21	(36)
Net cash used in operating activities	(1,295)	(221)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(5,460)	(22,718)
Proceeds from sale of short-term investments	3,338	26,106
Changes in long-term deposits	—	87
Purchases of property and equipment	(139)	(101)
Net cash provided by (used in) investing activities	(2,261)	3,374
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuances of common stock, net of issuance costs	63	156
Repurchase of treasury stock	(19)	(346)
Net cash provided by (used in) financing activities	44	(190)
NET CHANGE IN CASH AND CASH EQUIVALENTS DURING PERIOD	(3,512)	2,963
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	9,467	6,111
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 5,955	$ 9,074

The accompanying notes are an integral part of these 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 and market leader in Internet protocol telephony systems for small-to 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 interface with other technologies and provide integrated voice and data solutions.

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 (the "SEC"). These unaudited condensed consolidated financial statements reflect the operations of the Company and its wholly-owned subsidiary located in Shanghai, China. 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, 2008, included in the Company's 2008 Annual Report on Form 10-K filed with the SEC on December 29, 2008. The Company'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 purchased with an initial maturity of three months or less to be cash equivalents. Cash and cash equivalents are invested in various investment grade institutional money market accounts, U.S. Agency securities and commercial paper. 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. The Company's investment policy requires investments to be rated single-A or better.

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 standard cost (which approximates actual cost on a first-in, first-out basis) or market value. 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 record a write-down for product and component inventories that have become obsolete or are in excess of anticipated demand or net realizable value. Raw material inventory is considered obsolete and is fully reserved if it has not moved in 365 days. During the six months ended March 31, 2009, we disposed of fully-reserved inventory with a carrying value of zero and an original cost at $176,000. We attribute this overall reduction in obsolete inventory to physically disposing of a portion of the reserved inventory. The disposal of such inventory had no material impact on our revenue, gross margins and net loss. For the six months ended March 31, 2009, we recognized a provision of $67,000 for excess and obsolete inventories. The components of inventories include (in thousands):

	March 31, 2009	September 30, 2008
Raw materials	$ 578	$ 479
Work-in-progress	62	197
Finished goods	1,331	918
Total	$ 1,971	$ 1,594

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REVENUE RECOGNITION

The Company recognizes revenue software in accordance with Statement of Position ("SOP") 97-2, Software Revenue Recognition ("SOP 97-2"). Revenue consists of sales to end-users, resellers, and distributors. Revenue from sales to end-users and resellers is recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exits, 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 of such distribution agreements, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled by either party for convenience following a specified notice period. As a result of these provisions, the Company defers 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 ASSURANCE

Effective September 4, 2007, we introduced our Software Assurance Program which provides our customers with the latest updates, new releases, and technical support for the applications they are licensed to use ("Software Assurance"). The program is an annual subscription and can range from one to three years. Sales from the software assurance program are recorded as deferred revenue and recognized as revenue over the terms of the subscriptions.

Software components are generally not sold separately from our hardware components. Software revenue consists of license revenue that is recognized upon delivery of the application products or features. We provide Software Assurance consisting primarily of the latest software updates, patches, new releases and technical support. In accordance with SOP 97-2, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair value of the elements. The revenue allocated on this element is recognized with the initial licensing fee on delivery of the software. This Software Assurance revenue is in addition to the initial license fee and is recognized over a period of one to three years. The estimated cost of providing Software Assurance during the arrangement is insignificant and the upgrades and enhancements offered at no cost during Software Assurance arrangements have historically been, and are expected to continue to be, minimal and infrequent. All estimated costs of providing the services, including upgrades and enhancements, are spread over the life of the Software Assurance term.

STOCK–BASED COMPENSATION

The Company accounts for stock based compensation under the provisions of Statement of Financial Accounting Standard ("SFAS") No. 123(R), Share Based Compensation ("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. The Company adopted SFAS No. 123(R) using the modified prospective method. Under this transition method, stock based compensation cost recognized subsequent to October 1, 2005 included: (i) compensation cost for all share-based awards granted prior to but not yet vested as of September 30, 2005, based on the grant-date fair value estimated in accordance with SFAS No. 123(R) and (ii) compensation cost for all share-based awards granted subsequent to September 30, 2005, based on the grant-date fair value estimated in accordance with SFAS No. 123(R). In accordance with the modified prospective method, the Company has not restated its results of operations and financial position for prior periods.

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 price volatility of our stock. The Company estimates the expected price volatility of our stock based on historical volatility rates since our initial public offering, which rates are trended into future years. Because the Company’s 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. The Company bases the risk-free interest rate for periods within the contractual life of the option upon the U.S. Treasury yield.

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 Company estimated the fair value of stock option awards in accordance with the provisions of SFAS 123(R) by using the Black-Scholes option valuation model with the following assumptions:

	Six Months Ended March 31, 2009	Six Months Ended March 31, 2008
Employee Stock Option Plan:		
Expected Life (in years)	7	7
Risk-free interest rate	1.6%	3.0%
Volatility	141%	88%
Expected dividend	0.0%	0.0%
Employee Stock Purchase Plan:		
Expected Life (in years)	0.5	0.5
Risk-free interest rate	0.4%	1.5%
Volatility	139%	87%
Expected dividend	0.0%	0.0%

The following table shows total stock-based compensation expense included in the consolidated statements of operations for the three and six months ended March 31, 2009 and March 31, 2009 with respect to the plans mentioned above (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
Cost of goods sold	$ 2	$ 6	$ 7	$ 9
Research and development	27	57	92	93
Selling, general and administrative	95	188	311	378
Total	$ 124	$ 251	$ 410	$ 480

The following table summarizes the Company's stock option plan as of October 1, 2008 and changes during the six months ended March 31, 2009:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life (in years)
Outstanding at October 1, 2008	4,551,822	$ 3.14	
Granted	94,500	0.68	
Exercised	—	—	
Forfeitures and cancellations	(277,549)	2.82	
Outstanding at March 31, 2009	4,368,773	$ 3.11	4.89
Vested and expected to vest at March 31, 2009	4,026,071	$ 3.26	4.58
Exercisable at March 31, 2009	3,430,090	$ 3.59	3.87

On March 10, 2009, our 1999 Stock Plan and our 1999 Employee Stock Purchase Plan (the "1999 Purchase Plan") expired. These plans will, however, continue to govern the securities previously granted under them. We intend to adopt a new stock plan and employee stock purchase plan in the third quarter of fiscal 2009.

At March 31, 2009, the aggregate intrinsic value of outstanding stock options was $56,000. The total vested and expected to vest stock options represented 4.0 million shares, the weighted average exercise price was $3.26, the aggregate intrinsic value was $54,000, and the weighted average remaining contractual term was 4.5 years. The total exercisable stock options represented approximately 3.4 million shares, the aggregate intrinsic value was $50,000, the weighted average exercise price was $3.59, and the weighted average remaining contractual term was 3.87 years.

At March 31, 2009, expected future compensation expense relating to options outstanding at that date is $272,000, which will be amortized over a weighted-average period of 4 years.

Under the 1999 Purchase Plan, we had reserved, as of March 10, 2009, 364,882 shares of common stock for issuance to eligible employees at a price equal to 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 each year). From October 1, 2008 until the expiration of the 1999 Purchase Plan place on March 10, 2009, 108,177 shares were purchased by and distributed to employees at a price of $0.59 per share.

COMPUTATION OF BASIC AND DILUTED NET LOSS PER SHARE

The Company bases its basic earnings per share upon the weighted average number of common shares outstanding during the period in accordance with SFAS No. 128, Earnings per Share ("SFAS No. 128"). Basic earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

Basic and diluted loss per share for each of the three and six month periods ended March 31, 2009 and 2008 were as follows (in thousands, except per share data):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008

Net loss	$ (1,767)	$ (1,127)	$ (3,036)	$ (2,098)
Weighted average shares outstanding – basic loss per share	15,862	15,708	15,842	15,753
Weighted average shares outstanding – diluted loss per share	15,862	15,708	15,842	15,753
Basic loss per share	$ (0.11)	$ (0.07)	$ (0.19)	$ (0.13)
Diluted loss per share	$ (0.11)	$ (0.07)	$ (0.19)	$ (0.13)

Options to purchase 4.5 million shares of common stock were outstanding as of March 31, 2009 and 2008 and were excluded from the computation of diluted net earnings per share for these periods because their effect would have been antidilutive.

Comprehensive Loss

Comprehensive income consists of two components—net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains, and losses that under U.S. generally accepted accounting principles are recorded as an element of stockholders' equity but are excluded from net income. The Company's other comprehensive income consists of unrealized gains and losses on marketable securities categorized as available-for-sale and foreign exchange gains and losses.

FAIR VALUE MEASUREMENTS

Effective October 1, 2008, we adopted SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). The Company did not record an adjustment to retained earnings as a result of the adoption of SFAS 157, and the adoption did not have a material effect on the Company's results of operations. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS No. 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS No. 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 - Financial instruments for which quoted market prices for identical instruments are available in active markets.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The adoption of this statement with respect to our financial assets and liabilities, did not impact our consolidated results of operations and financial condition, but requires additional disclosure for assets and liabilities measured at fair value. In accordance with SFAS No. 157, the following table represents our fair value hierarchy for our financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of March 31, 2009. Level 1 available-for-sale investments are primarily comprised of investments in U.S. Agency securities. These securities are valued using market prices on active markets. The Company had no material Level 2 or Level 3 measurements for the quarter ended March 31, 2009.

Assets measured at fair value as of March 31, 2009 are summarized as follows:

(In thousands)		Quoted Prices in Active Markets for Identical Instruments (Level 1)
Cash equivalents (1)		
Money market funds	$	3,021
		3,021

Investments (2)		
Agency discount notes		2,500
Cash equivalents and investments	$	5,521

(1) Included in cash and cash equivalents on our condensed consolidated balance sheet.
(2) Included in short-term investments in marketable securities on our condensed consolidated balance sheet.

SEGMENT REPORTING

The Company manages its business primarily on a geographic basis. Accordingly, the Company determined its operating segments, which are generally based on the nature and location of its customers, to be the Americas and International. The Company's two geographical segments, sell the same products to the same types of customers. The Company's reportable operating segments are comprised of the Americas and International operations. The Americas segment includes the United States, Canada, Mexico, Central America and the Caribbean. The International segment is comprised of China, the United Kingdom and Norway.

The following table sets forth percentages of net revenue by geographic region with respect to such revenue for the periods indicated:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
Americas	86%	88%	86%	87%
International	14%	12%	14%	13%
Total	100%	100%	100%	100%

CUSTOMERS

Our customers are primarily end-users, resellers and distributors. We have distribution agreements with AltiSys, Synnex and Jenne in the Americas. Our agreements with AltiSys and Synnex have initial terms of one year and our agreement with Jenne has an initial term of two years. Each of these agreements are renewed automatically for additional one year terms, provided that each party shall have the right to terminate the agreement for convenience upon ninety (90) days' written notice prior to the end of the initial term or any subsequent term of the agreement. In addition, our agreements with AltiSys, Synnex and Jenne also provide for termination, with or without cause and without penalty, by either party upon 30 days' written notice to the other party or upon insolvency or bankruptcy. For a period of 60 days' following termination of the agreement, AltiSys, Synnex and Jenne may distribute any products in their possession at the time of termination or, at their option, return any products to us that are in their inventories. Upon termination of the distribution agreement, all outstanding invoices for the products will become due and payable within 30 days' of the termination.

The following table sets forth our net revenue by customers that individually accounted for more than 10% of our revenue for the periods indicated:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
Synnex	28%	34%	30%	35%
Jenne	14%	11%	18%	7%
AltiSys	9%	15%	6%	16%
Graybar(*)	—	15%	—	14%
Total	51%	75%	54%	72%

(*) In April 2008, we terminated our distribution agreement with Graybar. The termination of our relationship with Graybar did not have a material impact on our business.

2. WARRANTY

The Company provides a warranty for hardware products for a period of one year following shipment to end users. We have historically experienced minimal warranty costs. Factors that affect our reserves for 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 reserves for warranty liability every quarter and make adjustments to those reserves if necessary.

Changes in the reserves for our warranty liability for the three and six months ended March 31, 2009 and 2008, respectively, are as follows (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
Beginning balance	$ 128	$ 145	$ 137	$ 148
Provision for warranty liability	25	40	58	80
Warranty cost including labor, components and scrap	(44)	(40)	(86)	(83)
Ending balance	$ 109	$ 145	$ 109	$ 145

3. COMMITMENTS AND CONTINGENCIES

Commitments

We lease our facilities under various operating lease agreements expiring on various dates through December 2011. The Company leases approximately 32,000 square feet to serve as our headquarters for corporate administration, research and development, manufacturing, and sales and marketing facility in Fremont, California. Generally, these leases have multiple options to extend for a period of years upon termination of the original lease term. The lease for our headquarters expired on February 21, 2009, although we continue to occupy the premises on a month-to-month basis in accordance with the terms of that lease. In April 2009, the Company entered into a lease for a new corporate headquarters in San Jose, California for a period of five years. In the third quarter of fiscal 2009, we expect to vacate our Fremont office and transition into our new facility.

Rent expense for all operating leases totaled approximately $185,000 and $360,000 for the three and six months ended March 31, 2009, respectively as compared to $170,000 and $338,000 for the three and six months ended March 31, 2008, respectively. We also lease certain equipment under capital lease arrangements. The minimum future lease payments under all noncancellable capital and operating leases as of March 31, 2009 are shown in the following table (in thousands):

Fiscal Years Ending September 30,	Capital Leases	Operating Leases
Remainder of 2009	$ 22	$ 179
2010	33	357
2011	—	16
Total contractual lease obligation	$ 55	$ 552
Amount representing interest	$ 3	
Present value of minimum lease payment	$ 52	

Current portion	$	41
Long-term portion		11
Total capital lease commitments	$	52

Contingencies

From time to time, 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 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 products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks' Complaint seeks an injunction against future patent infringement, an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. On December 9, 2002, we filed an answer and counterclaims for declaratory relief, and on December 26, 2002, Vertical Networks filed its reply to those counterclaims. On October 4, 2007, the parties entered into a stipulation dismissing the lawsuit in its entirety without prejudice.

4. STOCK REPURCHASE PROGRAM

On October 23, 2007, our Board of Directors approved the repurchase of up to $2.0 million of our common stock in the open market through November 12, 2008. On November 11, 2008, our Board of Directors extended the repurchase program by another year to November 14, 2009. Stock repurchases under this program may be made from time to time at our management’s discretion through November 14, 2009. When exercising such discretion, management will consider a variety of factors such as our stock price, general business and market conditions and other investment opportunities. The repurchase will be made in the open market and will be funded from available working capital. Pursuant to the 2007 authority, we repurchased 231,135 shares in fiscal 2008 at an aggregate cost of $367,000. Pursuant to the 2008 authority, we repurchased 23,800 shares in the six months ended March 31, 2009 at an aggregate cost of $19,000. In April 2009, we suspended further purchases of stock under this program. For additional information, refer to note 5 to the accompanying unaudited consolidated financial statements.

5. SUBSEQUENT EVENTS

Lease Agreement

In April 2009, the Company entered into a lease for a new corporate headquarters for a period of five years with one consecutive option to extend for an additional five years. This facility is leased through June 2014 and will serve as our headquarters for corporate administration, research and development, manufacturing, and sales and marketing facility in San Jose, California. Under the terms of the lease agreement, we will pay rent of approximately $1.5 million for a period of five years. Concurrently with the execution of the lease, the Company reserved $100,000 as collateral for an irrevocable and negotiable standby letter of credit (the "Letter of Credit") as security for a facility lease. Under the terms of the agreement, the Letter of Credit will expire in July 2014. We believe that the new facility will be suitable, adequate and sufficient to meet the needs of the Company through July 2014.

Stock Repurchase Program

In April 2009, we suspended further purchases of stock under the repurchase program. For additional information regarding stock repurchase program, refer to the Stock Repurchase Program discussion section of this Quarterly Report on Form 10-Q.

Salary Reduction

In April 2009, we implemented a mandatory salary reduction for all of our employees, including our executive officers. These salary reductions ranged between 5% and 15%, depending on several factors, including, but not limited to, participation in commission plans and the original base salary. The salaries of all of our executive officers were reduced by 15%.

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, or the outcome of present and future litigation, regulatory developments or other contingencies. You should carefully review the cautionary statements contained in our Annual Report on Form 10-K for the year ended September 30, 2008, including those set forth in Item 1A. “Risk Factors” of that report.

OVERVIEW

We are a pioneer and market leader in Internet protocol telephony systems for small- to 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 interface with other technologies and provide integrated voice and data solutions. We believe this enables our customers to implement communication systems solutions that have an increased return on investment versus past technology investments. We generated net revenue of $3.6 million and $8.4 million for the three and six months ended March 31, 2009, respectively, compared to net revenue of $4.7 million and $9.0 million for the three and six months ended March 31, 2008, respectively. As of March 31, 2009, we had an accumulated deficit of $59.3 million. Net cash used in operating activities was $1.3 million for the six months ended March 31, 2009.

We derive our revenue from sales of our telephone systems. Product revenue is comprised of direct sales to end-users and resellers and sales 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, which for the six months ended March 31, 2009 were All Quality Services in Fremont, California and

ISIS Surface Mounting, Inc. in San Jose, California to insert the hardware components into the printed circuit board. We purchase fully-assembled chassis from Advantech Corporation, analog phones from Fanstel Corporation, Internet protocol phones from BCM Communications, Inc., single board computers for our MAX product from AAEON Electronics, Inc. and raw material components from Avnet Electronics. 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 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 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, as well as creating new product offerings to both enhance our position in our target market segment and enter new geographical markets. Additionally, we intend to continue selling our products to small- to medium-sized businesses, enterprise businesses, multisite businesses, corporate and branch offices and call centers. Also, we plan to continue to recruit additional resellers and distributors to focus on selling phone systems to our target customers. We believe that the adoption rate for this Internet telephony is much faster with small- to medium-sized businesses because many of these businesses have not yet made a significant investment for a traditional phone system. 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.

CRITICAL ACCOUNTING POLICIES

Revenue Recognition. Net sales consist primarily of revenue from direct sales to end-users, resellers and distributors. We recognize revenue pursuant to SEC Staff Accounting Bulletin (“SAB”) No. 104, Revenue Recognition, (“SAB No. 104”). Revenue from sales to end-users is 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 sales 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 in accordance with SFAS No. 48, Revenue Recognition when Right of Return Exists (“SFAS No. 48”). 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 the distributors. Upon termination of such distribution agreements, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled without cause for convenience 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. As of March 31, 2009, our total deferred revenue was $2.9 million compared to $1.9 million for the same period in fiscal 2008, an increase of $1.0 million over the same period in the prior year. The increase was primarily the result of continued growth of our new recurring revenue programs. These plans include both the Software Assurance Program, which provides our customers with new software releases and support for an annual fee, and the Premier Service Plan, which includes software assurance and extended hardware warranty.

Service Support Plans. In September 2007, we introduced our Software Assurance Program which provides our customers with the latest updates, new releases, and technical support for the applications they are licensed to use. In fiscal 2008, we initiated our Premier Service Plan, which includes software assurance and extended hardware warranty. These programs have an annual subscription and can range from one to three years. Sales from our service support programs are recorded as deferred revenue and recognized as revenue over the terms of their subscriptions. As of March 31, 2009, our deferred revenue was approximately $2.1 million compared to $722,000 for the same period in fiscal 2008. Our new service plan offering remains a significant growth opportunity as we continue to add new service customers.

Software components are generally not sold separately from our hardware components. Software revenue consists of license revenue that is recognized upon delivery of the application products or features. We provide Software Assurance consisting primarily of the latest software updates, patches, new releases and technical support. In accordance with SOP 97-2, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair value of the elements. The revenue allocated on this element is recognized with the initial licensing fee on delivery of the software. This Software Assurance revenue is in addition to the initial license fee and is recognized over a period of one to three years. The estimated cost of providing Software Assurance during the arrangement is insignificant, and unspecified upgrades and enhancements offered at no cost during Software Assurance arrangements have historically been, and are expected to continue to be, minimal and infrequent. All estimated costs of providing the services, including upgrades and enhancements, are spread over the life of the Software Assurance term.

Cash and Cash Equivalent. We consider all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents. Cash and cash equivalents are invested in various investment grade institutional money market accounts, U.S. Agency securities and commercial paper. The Company's investment policy requires investments to be rated single-A or better.

Short-Term Investment. The Company's policy is to invest in highly-rated securities with strong liquidity and requires investments to be rated single-A or better. Short-term investments are comprised of U.S. Agency securities and commercial paper. Short-term investments are highly liquid financial instruments with original maturities greater than three months but less than one year and are classified as "available-for-sale" investments. We classify our available-for-sale securities as current assets and report them at their fair value. Further, we recognize unrealized gains and losses related to these securities as an increase or reduction in stockholders' equity.

Inventory. Inventory is stated at the lower of cost (first-in, first-out method) or market. Our inventory balance for both the six months ended March 31, 2009 and March 30, 2008 was $2.0 million. We perform a detailed review of inventory each fiscal quarter, with consideration given to future customer demand for our products, obsolescence from rapidly changing technology, product development plans, and other factors. If future demand or market conditions for our products are less favorable than those projected by management, or if our estimates prove to be inaccurate due to unforeseen technological changes, we may be required to record additional inventory provision which would negatively affect gross margins in the period when the write-downs were recorded. In prior periods, we had established a reserve to write off excess inventory that management believed would not be sold. For the six months ended March 31, 2009, we disposed of fully-reserved inventory with a carrying value of zero and an original cost at $176,000. We attribute this overall reduction in obsolete inventory to physically disposing of a portion of the reserved inventory. The disposal of such inventory had no material impact on our revenue, gross margins and net loss. For the six months ended March 31, 2009, we recognized a provision of $67,000 for excess and obsolete inventories as compared to a reduction of $1,000 during the same period in the prior year. Inventory allowance was $722,000 as of March 31, 2009 compared to $850,000 as of September 30, 2008. The change in inventory allowance was primarily attributable to the disposal of fully-reserved inventory with a carrying value of zero and an original cost of $176,000.

Warranty Cost. We accrue for warranty costs based on estimated product return rates and the expected material and labor costs to provide warranty services. If actual products return rates, repair cost or replacement costs differ significantly from our estimates, then our gross margin could be adversely affected. The reserve for product warranties was $109,000 as of March 31, 2009 compared to $137,000 as of September 30, 2008. This change was the result of a significant decline in the product return rate caused by changes in our management of the return programs. As a consequence of the Company's standardized manufacturing processes and product testing procedures, returns of defective product are infrequent and the quantities have not been significant. Accordingly, historical warranty costs have not been material.

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,	
	2009	2008	2009	2008
Consolidated Statements of Operations Data:				
Net revenue:				
Hardware	86.7%	87.6%	86.5%	86.5%
Software	13.3	12.4	13.5	13.5
Total net revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Hardware	41.0	42.8	39.8	42.4
Software	0.1	1.6	0.1	1.5
Total cost of revenue	41.1	44.4	39.9	43.9
Gross profit	58.9	55.6	60.1	56.1
Operating expenses:				
Research and development	34.7	22.0	29.3	21.7
Sales and marketing	51.4	39.1	46.5	40.2
General and administrative	22.7	20.1	21.1	19.6
Total operating expenses	108.8	81.2	96.9	81.5
Loss from operations	(49.9)	(25.6)	(36.8)	(25.4)
Equity in net loss of investee	(0.1)	(0.1)	(0.1)	(0.0)
Interest and other income, net	0.6	1.7	0.7	2.2
Net loss before income taxes	(49.4)	(24.0)	(36.2)	(23.2)
Provision for income taxes	(0.0)	(0.0)	0.2	(0.0)
Net loss	(49.4) %			