ALTIGEN COMMUNICATIONS INC
Form 10-Q
August 08, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003

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

FOR THE TRANSITION PERIOD FROM _______ TO _______

Commission File Number 000-27427

ALTIGEN COMMUNICATIONS, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE	**94-3204299**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**

47427 Fremont Boulevard

Fremont, CA	**94538**
(address of principal executive offices)	**(zip code)**

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

The number of shares of registrant s common stock outstanding as of August 6, 2003 was: 13,803,820 shares.

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PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(in thousands, except share and per share amounts)

	June 30, 2003	September 30, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,709	$ 7,210
Short-term investments	2,163	4,938
Accounts receivable, net of allowances of $194 and $227 at June 30, 2003 and September 30, 2002, respectively	1,622	1,656
Inventories	868	1,263
Prepaid expenses and other current assets	363	213
Promissory note from officer / stockholder (Note 3)		343
Total current assets	12,725	15,623
Property and equipment:		
Furniture and equipment	2,080	2,033
Computer software	922	922
	3,002	2,955
Less: Accumulated depreciation and amortization	(2,660)	(2,320)
Net property and equipment	342	635
Other non-current assets:		
Long-term investment	195	195
Long-term deposit		53
Total other non-current assets	195	248
Total assets	$ 13,262	$ 16,506
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 611	$ 538
Accrued liabilities:		

Payroll and related benefits	316	316
Warranty (Note 4)	633	590
Marketing	338	436
Other	660	850
Deferred revenue	215	405
Total current liabilities	2,773	3,135
Stockholders equity:		
Convertible preferred stock, $0.001 par value; Authorized 5,000,000 shares; None outstanding at June 30, 2003 and September 30, 2002		
Common stock, $0.001 par value; Authorized 50,000,000 shares; Outstanding 14,784,420 shares at June 30, 2003 and 14,543,606 shares at September 30, 2002	15	14
Treasury stock at cost 1,063,895 shares at March 31, 2003 and September 30, 2002	(1,014)	(1,014)
Additional paid-in capital	61,883	61,740
Deferred stock compensation	(14)	(55)
Accumulated other comprehensive gain		
Accumulated deficit	(50,381)	(47,314)
Total stockholders equity	10,489	13,371
Total liabilities and stockholders equity	$ 13,262	$ 16,506

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

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ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(in thousands, except per share amounts)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Revenues, net	$ 3,401	$ 2,765	$ 8,646	$ 6,736
Cost of revenues	1,397	1,206	3,741	3,207
Gross profit	2,004	1,559	4,905	3,529
Operating expenses:				
Research and development	1,003	1,039	3,003	3,090
Sales and marketing	1,154	1,491	3,726	4,491
General and administrative	507	547	1,420	1,622
Deferred stock compensation (Note 5)	14	93	41	278
Total operating expenses	2,678	3,170	8,190	9,481
Loss from operations	(674)	(1,611)	(3,285)	(5,952)
Interest and other income, net	45	61	218	229
Net loss	$ (629)	$ (1,550)	$ (3,067)	$ (5,723)
Basic and diluted net loss per share	$ (0.05)	$ (0.12)	$ (0.23)	$ (0.43)
Shares used in computing basic and diluted net loss per share	13,655	13,390	13,573	13,335

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

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ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(in thousands)

	Nine Months Ended June 30,	
	2003	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (3,067)	$ (5,723)
Adjustments to reconcile net loss to net cash used in operating activities :		
Depreciation and amortization	340	459
Amortization of deferred stock compensation	41	278
Changes in operating assets and liabilities		
Accounts receivable	34	(168)
Inventories	395	954
Prepaid expenses and other current assets	(150)	(76)
Accounts payable	73	229
Accrued liabilities	(245)	123
Deferred revenue	(190)	(184)
Net cash used in operating activities	(2,769)	(4,108)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(10,164)	(26,367)
Proceeds from sale and maturities of short-term investments	12,939	23,198
Purchases of property and equipment	(47)	(86)
Increase in other non-current assets	53	
Net cash provided by (used in) investing activities	2,781	(3,255)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuances of common stock	144	209
Purchase of treasury stock		(910)
Collection of promissory note from officer/stockholder	343	373
Unrealized gain on short term investments		5
Net cash provided by (used in) financing activities	487	(323)
NET DECREASE IN CASH AND CASH EQUIVALENTS	499	(7,686)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,210	11,900
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 7,709	$ 4,214

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

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

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

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2002, included in the Company s 2002 Annual Report on Form 10-K. Our results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

The Company considers all highly liquid investments with an original maturity of three months or less from the date of purchase to be cash equivalents. Short-term investments primarily consist of high-grade debt securities with original maturities greater than three months but less than one year and are classified as available-for-sale investments. As of June 30, 2003, the Company s cash and cash equivalents consisted of commercial paper and cash deposited in checking and money market accounts. For the first nine months of fiscal years 2003 and 2002, the Company did not make any cash payments for interest or income taxes.

INVENTORIES

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

	June 30, 2003	September 30, 2002
Raw materials	$ 108	$ 455
Work-in-progress	158	80
Finished goods	602	728
	$ 868	$ 1,263

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LONG-TERM INVESTMENT

As of June 30, 2003, the Company has an approximately $195,000 equity investment in a private China based telecommunications company, accounted for using the cost method. AltiGen s interest in the company is approximately 2% and AltiGen does not have the ability to exercise significant influence.

REVENUE RECOGNITION

The Company accounts for the recognition of revenues in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition . Revenues consist of sales to end-users, including dealers, 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 exits, and the price is fixed and determinable. The Company provides for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenues consist of product revenues reduced by estimated sales returns and allowances. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company s products held by its distributors. Upon termination, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled by either party based on a specified notice. As a result of the above provisions, the Company defers recognition of revenues and the proportionate costs of revenues derived from sales to distributors until such distributors resell the Company s products to their customers. The amounts deferred as a result of this policy are reflected as deferred revenue in the accompanying condensed consolidated balance sheets.

Software components are generally not sold separately from the Company s hardware components. Software revenues consist of license revenues that are recognized upon the delivery of application products. The Company provides limited post-contract customer support (PCS), consisting primarily of 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 the Company provides PCS, the revenue allocated to this element is recognized together with the initial licensing fee on delivery of the software because: (1) the PCS fee is included with the initial licensing fee; (2) the PCS included with the initial license fee is for one year or less; (3) the estimated cost of providing PCS during the arrangement is insignificant; and (4) unspecified upgrades/enhancements offered for minimal or no cost during PCS arrangements historically have been and are expected to continue to be minimal and infrequent. All estimated costs of providing the services, including upgrades and enhancements are accrued for at the time of delivery.

STOCK BASED COMPENSATION

The Company accounts for employee stock-based compensation arrangements under the provisions of Accounting Principles Board (APB) Opinion No. 25 and related interpretations. Statement of Financial Accounting Standards (SFAS) No. 123 permits the use of either a fair-value based method or the intrinsic value method under APB Opinion No. 25 to account for employee stock-based compensation arrangements. Companies that elect to use the intrinsic value method provided in APB Opinion No. 25 are required to disclose the pro forma net income (loss) and net income (loss) per share that would have resulted from the use of the fair value method. The Company has provided below the pro forma disclosures of the effect on net loss and net loss per share as if SFAS No. 123, as amended by SFAS No. 148, had been applied in measuring compensation expense for all periods presented (in thousands, except per share data).

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	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	2002	2003	2002
Reported net loss	$ (629)	$ (1,550)	$ (3,067)	$ (5,723)
Add: Total stock-based employee compensation expense included in reported net loss	14	93	41	278
Deduct: Total stock-based employee compensation expense under fair value based method for all Awards	(552)	(665)	(1,735)	(2,110)
Pro forma net loss under SFAS No 123	$ (1,167)	$ (2,122)	$ (4,761)	$ (7,555)
Basic and diluted as reported	$ (0.05)	$ (0.12)	$ (0.23)	$ (0.43)
Basic and diluted pro forma	$ (0.09)	$ (0.16)	$ (0.35)	$ (0.57)
Assumptions:				
Dividend Yield				
Volatility factor	100.40%	109.21%	100.40%	109.21%
Risk free interest rate	2.91%	4.47%	2.91%	4.47%
Expected Life of Option	5 years	5 years	5 years	5 years

COMPUTATION OF BASIC AND DILUTED NET LOSS PER SHARE

Historical net 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 loss per share is calculated by dividing net loss by the weighted average shares of common stock outstanding during the period. For the periods presented, basic and diluted net loss per share numbers are the same, as potential common shares resulting from the exercise of stock options are antidilutive. Options to purchase 4,134,085 shares of common stock were outstanding at June 30, 2003.

COMPREHENSIVE INCOME

SFAS No. 130, Reporting Comprehensive Income establishes standards for reporting and presentation of comprehensive income. Comprehensive loss for the Company consists of net loss plus the effect of foreign currency translation adjustments and other unrealized gains and losses, which are not material for each of the three and nine month periods ended June 30, 2003 and 2002. Total other comprehensive gain for the nine months ended June 30, 2003 and 2002 was $1,000 and $4,000, respectively.

SEGMENT REPORTING

The Company is organized and operates as one operating segment. The Company operates primarily in one geographic area, North America, and mainly in one country, the United States.

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Net revenue by geographic region based on customer location for the three and nine month periods ended June 30, 2003 and 2002 were as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	2002	2003	2002
Net Revenue				
North America	91%	94%	94%	95%
International	9%	6%	6%	5%
	100%	100%	100%	100%

Net revenue by certain customers individually that account for more than 10% of revenue for the three and nine month periods ended June 30, 2003 and 2002 were as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	2002	2003	2002
Altisys	22%	20%	20%	27%
Ingram Micro	18%	28%	22%	26%
Synnex	48%	28%	46%	30%
Others	12%	24%	12%	17%
	100%	100%	100%	100%

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

Note 2. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the Financial Accounting Standards Board (FASB) issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities . The Company adopted the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

In November 2002, the FASB issued FASB interpretation number (FIN) 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others , which elaborates on the disclosures to be made by guarantor in its interim and annual financial statements about its obligations under certain guarantees that it is issued. The Company has adopted the disclosure requirement of this standard in connection with product warranties.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables . The provisions of EITF Issue No. 00-21 are applicable to agreements entered into in fiscal periods beginning after June 15, 2003. The management is in the process of determining the impact of the provisions of the EITF No. 00-21 on operating results and financial condition of the Company.

Note 3. PROMISSORY NOTE TO OFFICER AND STOCKHOLDER:

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

On September 17, 2001, the Company entered into a new note (Promissory Note) with Mr. Hu, replacing the Prior Note, for the then unpaid principal amount of $800,000. The Promissory Note was full recourse and was secured by a security interest in Mr. Hu s personal assets. During fiscal 2002, approximately $380,000 was collected against the Promissory Note. On December 27, 2002, the

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remaining balance on the Promissory Note was fully repaid by Mr. Hu.

Note 4. WARRANTIES

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

Changes in our warranty liability for the three and nine months ended June 30, 2003, are as follows (in thousands):

	Three months	Nine months
Beginning balance	$ 630	$ 590
Provisions for warranty liability	55	251
Warranty cost including labor, components and scrap	(52)	(208)
Ending balance	$ 633	$ 633

Note 5. DEFERRED STOCK COMPENSATION

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

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	2002	2003	2002
Research and development	$ 5	$ 36	$ 15	$ 108
Sales and marketing	2	29	6	87
General and administrative	7	28	20	83
	$ 14	$ 93	$ 41	$ 278

Note 6. CONTINGENCIES

On September 6, 2002, Vertical Networks, Inc. filed suit against AltiGen Communications, Inc. in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks United States 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 Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a Second Amended Complaint on November 20, 2002 to identify the AltiGen products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement, damages, including treble damages for alleged willful infringement, and attorneys fees and costs. AltiGen filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to AltiGen s Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on AltiGen on April 9, 2003 and AltiGen served its 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. AltiGen believes it has strong defenses and arguments in this dispute and intends to vigorously litigate its position. Thus, management s view is that any loss from this litigation is not probable or estimable.

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

FORWARD-LOOKING INFORMATION

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

OVERVIEW

We are a leading provider of converged Internet Protocol phone systems for small and medium sized business. We began operations in July 1994 and we first recognized revenues from product sales of our Quantum board and AltiWare software in July 1996. We generated net revenues of $3.4 million and $8.6 million for the third quarter and the first nine months of fiscal 2003, respectively, compared to net revenues of $2.8 million and $6.7 million for the third quarter and the first nine months of fiscal 2002. As of June 30, 2003, we had an accumulated deficit of $50.4 million.

We derive our revenues from sales of our AltiServ system, which includes Quantum boards, Triton boards and AltiWare software. Product revenues consist of sales to end users (including dealers) and to distributors. Revenues from product sales to end users are recognized upon shipment. We defer recognition of sales to distributors until they resell our products to their customers. Under our distribution contracts, a distributor has the right in certain circumstances to return products the distributor determines are overstocked, so long as 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 gross margins have been affected by our product mix, the average selling prices of our products and our cost of revenues.

Our cost of revenues consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to manufacturing our products. We outsource our manufacturing to contract manufacturers. In the third quarter of fiscal 2003, we principally contracted with All Quality Services in San Jose. We select our manufacturing partners with the goals of ensuring a reliable supply of high-quality finished products and lowering per unit product costs as a result of manufacturing economies of scale.

We have experienced operating losses and negative cash flows from operations in each quarterly and annual period since our inception and we currently expect to continue to incur losses and negative cash flows for the foreseeable future. Several factors that have affected and will continue to affect our operating results are the state of economy, the market acceptance of our products, our timely release of new products and our ability to locate and engage new dealers with expertise in selling to our target customers. We have not recognized any future tax benefits of our cumulative net operating losses due to uncertainty as to future realizability.

As a result of the slowing economy, the geopolitical environment and the downturn in the

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telecommunications industry, our ability to maintain or increase our sales in the telecommunications market is uncertain. We currently are developing enhancements to our current products to provide greater functionality and increased capabilities, based on market research, customer feedback and our competitors product offerings. In particular, we are developing products that could allow us to enhance our position in our target market segment, enter new geographical markets, such as Europe, and enter the call center market for the small to medium-sized businesses. Additionally, we will continue to focus on selling our products to small to medium-sized businesses, which are business with less than 500 employees, with particular emphasis in the Internet Protocol phone systems segment of the telecommunications market. Also, we will continue to recruit new resellers that excel in selling phone systems to our target customers. However, there can be no assurances that we will be successful in developing any new products, entering new geographical or product markets or in expanding our network of resellers.

CRITICAL ACCOUNTING POLICIES

Revenue recognition: Revenues consist of sales to end-users, including dealers, 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 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 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 by either party based on a specified notice. As a result of the above provisions, we defer recognition of revenues and the proportionate costs of revenues derived from sales to distributors 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.

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.

Inventory: Inventory is stated at the lower of cost (first-in, first-out method) or market. 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.

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/or repair and replacement costs differ significantly from our estimates, our gross margin could be adversely affected.

Results of Operations

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

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	Three Months Ended June 30,		Nine Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
	(unaudited)		(unaudited)	
Revenues, net	100.0%	100.0%	100.0%	100.0%
Cost of revenues	41.1	43.6	43.3	47.6
Gross profit	58.9	56.4	56.7	52.4
Operating expenses:				
Research and development	29.5	37.5	34.7	45.9
Sales and marketing	33.9	53.9	43.1	66.7
General and administrative	14.9	19.9	16.4	24.1
Deferred stock compensation	0.4	3.4	0.5	4.1
Total operating expenses	78.7	114.7	94.7	140.8
Loss from operations	(19.8)	(58.3)	(38.0)	(88.4)
Interest and other income, net	1.3	2.2	2.5	3.4
Net loss	(18.5)%	(56.1)%	(35.5)%	(85.0)%

Revenues, net. Revenues consist of sales to end users (including dealers) and to distributors. Our revenue generated from sales in North America accounted for approximately 91% and 94% for the third quarter and the first nine months of fiscal 2003, respectively, compared to 94% and 95% for the third quarter and the first nine months of fiscal 2002. Net revenues were $3.4 million and $8.6 million for the same periods of fiscal 2003, an increase of 23% and 28% from net revenues of $2.8 million and $6.7 million for the same periods of fiscal 2002, respectively. Sales through our main distributors, AltiSys, Ingram Micro and Synnex, accounted for approximately 21.7%, 17.8%, and 48.4%, respectively, of our revenues for the third quarter of fiscal 2003 as compared to 19.6%, 28.4%, and 27.8%, respectively, of our revenues for the same periods of fiscal 2002. The increase in revenues for the third quarter and the first nine months of fiscal 2003 compared to the same periods of fiscal 2002 was due to increased demand for our AltiServ Office product and our recently introduced Internet Protocol Phone. AltiServ Office product contributed 34% and 36% of our revenues for the third quarter and the first nine months of fiscal 2003, compared to approximately 27% and 29% of our revenues for the third quarter and the first nine months of fiscal 2002, respectively.

Cost of revenues. Cost of revenues was $1.4 million and $3.7 million for the third quarter and the first nine months of fiscal 2003, respectively, compared to $1.2 million and $3.2 million for the same periods of fiscal 2002. Cost of revenues consists primarily of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to manufacturing our products. Cost of revenues as a percentage of net revenues decreased from 43.6% and 47.6% for the third quarter and the first nine months of fiscal 2002, respectively, to 41.1% and 43.3% for the same periods of fiscal 2003, respectively. The decrease was primarily due to lower component, overhead and warranty costs of approximately $139,000 for the third quarter of fiscal 2003 as compared to the same period of fiscal 2002, resulting from an increase in the Company s manufacturing volume due to increased demand for our AltiServ Office product and operating efficiencies. For the first nine months of fiscal 2003, the decrease was primarily due to lower component and overhead cost of approximately $61,000 as compared to the same period of fiscal 2002.

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Gross profit. Gross profit increased to $2.0 million and $4.9 million for the third quarter and the first nine months of fiscal 2003, respectively, from $1.6 million and $3.5 million for the same periods of fiscal 2002. As a percentage of net revenues, gross profit increased to 58.9% and 56.7% for the third quarter and the first nine months of fiscal 2003, respectively, from 56.4% and 52.4% for the same periods of fiscal 2002. The increase in gross profit as a percentage of net revenues was primarily due to lower component, overhead and warranty costs resulting from an increase in the Company s manufacturing volume and operating efficiencies.

Research and development expenses. Research and development expenses remained relatively unchanged at $1.0 million and $3.0 million for the third quarter and the first nine months of fiscal 2003, respectively, as compared to $1.0 million and $3.1 million for the same periods of fiscal 2002. 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. Management continues to monitor research and development expenses in line with the revenue growth.

Sales and marketing expenses. Sales and marketing expenses decreased to $1.2 million and $3.7 million for the third quarter and the first nine months of fiscal 2003, respectively, from $1.5 million and $4.5 million for the same periods of fiscal 2002. Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in sales and marketing functions, trade show expenses, and promotional and marketing programs and related expenses.

The decrease was primarily due to cutbacks in professional service fee, trade show and advertising activities of approximately $128,000 and $411,000 for the third quarter and the first nine months of fiscal 2003, respectively, as compared to the same periods of fiscal 2002.

General and administrative expenses. General and administrative expenses remained relatively unchanged at $507,000 for the third quarter of fiscal 2003 as compared to $547,000 for the same period of fiscal 2002. General and administrative expenses decreased to $1.4 million for the first nine months of fiscal 2003 from $1.6 million for the same periods of fiscal 2002. The decrease was primarily due to a reduction in professional services fees of approximately $201,000.

Deferred stock compensation expense. Deferred stock compensation expense was $14,000 and $41,000 for the third quarter and the first nine months of fiscal 2003, respectively, as compared to $93,000 and $278,000 for the same periods of fiscal 2002. Deferred stock compensation expense reflects the amortization of stock compensation charges resulting from granting stock options at exercise prices below the deemed fair value of our common stock on the dates the options were granted. The Company expects to amortize approximately $14,000 in the remaining quarter of fiscal 2003, which represents the remaining balance of this deferred stock compensation.

Interest and other income, net. Net interest and other income decreased to $45,000 and $218,000 for the third quarter and the first nine months of fiscal 2003, respectively, from $61,000 and $229,000 for the same period of fiscal 2002 due to reductions in invested principal and interest rates. The Company invests primarily in highly liquid, short-term investments.

Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the sale of equity securities. As of June 30, 2003, we had cash and short-term investments totaling $9.9 million, consisting of cash and cash equivalents of $7.7 million and $2.2 million of highly liquid short-term investments.

Net cash used in our operating activities was $2.8 million and $4.1 million for the nine months ended June 30, 2003 and 2002, respectively. The decrease in net cash used by operating activities for the first nine months of fiscal 2003 compared to the same period of fiscal 2002 was primarily the result of decreases in (i) research and development expenses of approximately $87,000, (ii) selling and marketing expenses of approximately $765,000, (iii) general and administrative expenses of approximately $202,000, and (iv) the inventory balance as of June 30, 2003 of approximately $395,000 as a result of inventory management.

Net cash provided by (used in) investing activities was $2.8 million and ($3.3) million for the nine months ended June 30, 2003 and 2002, respectively was primarily a result of proceeds net of purchases from the sale of short-term investments net of purchases of $2.8 million and ($3.2) million.

Net cash provided by financing activities was $487,000 for the nine months ended June 30, 2003, which consisted primarily of proceeds from issuances of common stock under our employee stock options and stock purchase plans of approximately $144,000 and collection of outstanding promissory notes of approximately $343,000. Net cash used in financing activities was $323,000 for the nine months ended June 30, 2002, which was primarily a result of repurchases of our common stock of approximately $910,000, proceeds from issuances of common stock under our employee stock option and stock purchase plan of approximately $209,000 and collection of outstanding promissory notes of approximately $373,000.

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

We do not have any material commitments for capital expenditures as of June 30, 2003. We estimate that we have sufficient cash reserves to allow us to continue operations for more than a year. Our cash and short term investments totaled $9.9 million as of June 30, 2003, and our recent quarterly net cash used in operating activities was $616,000.

Our cash needs depend on numerous factors, including market acceptance of and demand for our products, our ability to develop and introduce new products and product enhancements, prices at which we can sell our products, the resources we devote to developing, marketing, selling and supporting our products, the timing and expense associated with expanding our distribution channels, increases in manufacturing costs and the prices of the components we purchase as well as other factors. If we are unable to raise additional capital or if sales from our new products are lower than expected, we will be required to make additional reductions in operating expenses and capital expenditures to ensure that we will have adequate cash reserves to fund operations.

Additional financing, if required, may not be available on acceptable terms, or at all. We may also require additional capital to acquire or invest in complementary businesses or products, or obtain the right to use complementary technologies. If we can not raise funds, if needed, on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities, or to respond to competitive pressures or unanticipated requirements, which could seriously harm our business. Even if additional financing is available, we may be required to obtain the consent of our stockholders, which 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 the risk or perceived risk of AltiGen.

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CERTAIN FACTORS AFFECTING BUSINESS, OPERATING RESULTS, AND FINANCIAL CONDITION

Risks Related to AltiGen

We have a history of losses and expect to incur future losses, which may prevent us from becoming profitable.

We have experienced operating losses since our inception. As of June 30, 2003 we had an accumulated deficit of $50.4 million. We expect to incur operating losses for the foreseeable future, and these losses may be substantial. Further, we expect our operating cash flows to be negative for the foreseeable future. Because we expect continued expenditures for product development, and sales and marketing activities, we will need to increase revenues significantly to achieve profitability and positive operating cash flows. Even if we do achieve profitability and positive operating cash flows, we may not be able to sustain or increase profitability or positive operating cash flows on a quarterly or annual basis.

If we are unable to comply with Nasdaq s continued listing requirements, our common stock could be delisted from the Nasdaq SmallCap Market.

On February 27, 2002, Nasdaq staff notified us that our common stock had failed to maintain a minimum bid price of $1.00 over the previous 30 consecutive trading days as required by The Nasdaq National Market set forth in Marketplace Rule 4450(a)5 (the Rule). In accordance with Marketplace Rule 4450(e)2, we were provided 90 calendar days, or until May 28, 2002 to regain compliance with the Rule. On June 12, 2002, we transferred to The Nasdaq SmallCap Market and we were afforded the remainder of this market s 180 calendar day grace period, or until August 26, 2002, to regain compliance with the minimum $1.00 bid price per share requirement, set forth on Marketplace Rule 4310(c)8(D) and on August 27, 2002, we were provided an additional 180 calendar days, or until February 24, 2003, to regain compliance with the Rule. Further, on March 18, 2003, we were provided an additional 90 calendar days, or until May 27, 2003, to regain compliance with the Rule. Since April 7, 2003, the closing bid price of our common stock has been at $1.00 per share or greater for at least 10 consecutive trading days. Accordingly, we have regained compliance with the Rule. However, there can be no assurances that we will continue to be in compliance with the Rule.

If we are delisted from The Nasdaq SmallCap Market, there would be a reduction in the liquidity of any investment in our common stock and a material adverse effect on the price of our common stock. Delisting would reduce the ability of holders of our common stock to purchase or sell shares as quickly and as inexpensively as they could have done in the past. This lack of liquidity would make it more difficult for us to raise capital in the future.

The current economic downturn may continue to adversely affect our revenues, gross margins and expenses.

Our annual revenue and operating results have and may continue to fluctuate due to the effects of general economic conditions in the United States and globally, and, in particular, market conditions in the telecommunications industry. In recent quarters, our operating results have been adversely affected as a result of the economic slowdown and reduced capital spending, particularly in the United States. We experienced a lower gross margin due to inventory write-downs needed to reflect the slowdown in telecommunications capital spending and general downturn in the U.S. economy. We are uncertain about the extent, severity, and length of the economic downturn. If the economic conditions in the United States and globally do not improve, or if we experience a worsening in the global economic slowdown, we may continue to experience material negative effects on our business,

operating results, and financial condition.

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

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

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

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

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

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

- our sales cycle, which may vary substantially from customer to customer;
- unfavorable changes in the prices and delivery of the components we purchase;
- the size and timing of orders for our products, which may vary depending on the season, and the contractual terms of those orders;

the size and timing of our expenses, including operating expenses and expenses of developing new products and product enhancements;

deferrals of customer orders in anticipation of new products, services or product enhancements introduced by us or by our competitors; and

our ability to attain and maintain production volumes and quality levels for our products.

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

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

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

Our market is highly competitive, and we may not have the resources to compete adequately.

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

We face competition from companies providing traditional private telephone systems. Our principal competitors that produce traditional private telephone systems are Avaya Communications, NEC and Nortel Networks. We also compete against providers of multifunction telecommunications systems, including 3Com Corporation, Artisoft, Inc., Cisco System, Inc. and Shoreline Communications, Inc., as well as any number of future competitors. Many of our competitors are substantially larger than we are and have significantly greater name recognition, financial, sales and marketing, technical, customer support, manufacturing and other resources. These competitors may also have more established distribution channels and stronger relationships with service providers. These competitors may be able to respond more rapidly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sale of their products. These competitors may enter our existing or future markets with solutions that may be less expensive, provide higher performance or additional features or be introduced earlier than our solutions. If any technology that is competing with ours is more reliable, faster, less expensive or has other advantages over our technology, then the demand for our products and services could decrease and harm our business.

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

Losing any of our key distributors would harm our business. We also need to establish and maintain relationships with additional distributors and original equipment manufacturers.

Sales through our three key distributors, Altisys, Synnex, and Ingram Micro accounted for 87.9% of our net revenues in the third quarter of fiscal 2003. Our business and operating results will suffer if any of these distributors does not continue distributing our products, fails to distribute the volume of our products that it currently distributes or fails to expand our customer base. We also need to establish and maintain relationships with additional distributors and original equipment manufacturers. We may not be able to establish, or successfully manage, relationships with additional distribution partners. In addition, our agreements with distributors typically provide for termination by either party upon written notice to the other party. For example, our agreement with Synnex provides for termination, with or without cause, by either party upon 30 days written notice to the other party, or

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upon insolvency or bankruptcy. Generally, these agreements are non-exclusive and distributors sell products that compete with ours. If we fail to establish or maintain relationships with distributors and original equipment manufacturers, our ability to increase or maintain our sales and our customer base will be substantially harmed.

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

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

We rely on sole-sourced components and third-party technology and products; if these components are not available, our business may suffer.

We purchase technology from third parties that are incorporated into our products, including virtually all of our hardware products. We order sole-sourced components using purchase orders and do not have supply contracts for them. One sole-sourced component, a Texas Instruments digital signal processing integrated circuit chip, is particularly important to our business because it is included in virtually all of our Triton family products. If we were unable to purchase an adequate supply of these sole-sourced components on a timely basis, we would be required to develop alternative solutions. This could entail qualifying an alternative source or redesigning our products based on different components. Our inability to obtain these sole-sourced components, especially the Texas Instruments digital integrated circuit chip, could significantly delay shipment of our products, which could have a negative effect on our business, financial condition and results of operations.

We rely on dealers to promote, sell, install and support our products, and their failure to do so may substantially reduce our sales and thus seriously harm our business.

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

Software or hardware errors may seriously harm our business and damage our reputation, causing loss of customers and revenues.

Users expect telephone systems to provide a high level of reliability. Our products are inherently complex and may have undetected software or hardware errors. We have detected and may continue to detect errors and product defects in our installed base of products, new product releases and product upgrades. For example, a small number of our boards failed and were returned. We have replaced these boards and made certain design changes. We cannot be sure that the problem has been fully addressed or that similar or different problems will not occur in existing or new boards in the future. In addition, end users may install, maintain and use our products improperly or for purposes for which they were not designed. These problems may degrade or terminate the operation of our products, which could cause end users to lose telephone service, cause us to incur significant

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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.

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. Claims could also be brought because of problems with our products or services. 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.

More generally, litigation related to these types of claims may require us to acquire licenses under third-party patents which may not be available on acceptable terms, if at all. We believe that an increasing portion of our revenues in the future will come from sales of software applications for our hardware products. The software market has traditionally experienced widespread unauthorized reproduction of products in violation of developers intellectual property rights. This activity is difficult to detect, and legal proceedings to enforce developers intellectual property rights are often burdensome and involve a high degree of uncertainty and substantial costs.

On September 6, 2002, Vertical Networks, Inc. filed suit against AltiGen Communications, Inc. in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks United States 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 Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a Second Amended Complaint on November 20, 2002 to identify the AltiGen products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement, damages, including treble damages for alleged willful infringement, and attorneys fees and costs. AltiGen filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to AltiGen s Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on AltiGen on April 9, 2003 and AltiGen served its 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. AltiGen believes it has strong defenses and arguments in this dispute and intends to vigorously litigate its position.

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

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used in our products.

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

Our products may not meet the legal standards required for their sale in some countries; if we cannot sell our products in these countries, our results of operations may be seriously harmed.

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

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

Our market is subject to changing preferences; failure to keep up with these changes would result in our losing market share, thus seriously harming our business, financial condition and results of operations.

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

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

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

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

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

Our planned expansion in international markets will involve new risks that our previous domestic operations have not prepared us to address; our failure to address these risks could harm our business, financial condition and results of operations.

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

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

We need additional qualified personnel to maintain and expand our business; our failure to promptly attract and retain qualified personnel may seriously harm our business, financial condition and results of operations.

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

Our facility is vulnerable to damage from earthquakes and other natural disasters; any such damage could seriously or completely impair our business.

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

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

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

Risks Related to the Industry

Integrated, multifunction telecommunications systems may not achieve widespread acceptance.

The market for integrated, multifunction telecommunications systems is relatively new and rapidly evolving. Businesses have invested substantial resources in the existing telecommunications infrastructure, including traditional private telephone systems, and may be unwilling to replace these systems in the near term or at all. Businesses may also be reluctant to adopt integrated, multifunction telecommunications systems because of their concern about the current limitations of data networks, including the Internet. For example, end users sometimes experience delays in receiving calls and reduced voice quality during calls when routing calls over data networks. Moreover, businesses that begin to route calls over the same networks that currently carry only their data may also experience these problems if the networks do not have sufficient capacity to carry all of these communications at the same time.

Legislative actions and potential new accounting pronouncements are likely to cause our general and administrative expenses to increase and impact our future financial position and results of operations.

In order to comply with the newly adopted Sarbanes-Oxley Act of 2002, proposed changes to listing standards by Nasdaq and proposed accounting changes by the Securities and Exchange Commission, we may be required to increase our internal controls, hire additional personnel and

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additional outside legal, accounting and advisory services, all of which could cause our general and administrative costs to increase. Proposed changes in the accounting rules, including legislative and other proposals to account for employee stock options as compensation expense among others, could increase expenses and adversely affect our operating results.

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

In April 1998, the Federal Communications Commission submitted a report to Congress stating that it may regulate certain Internet services if it determines that such Internet services are functionally equivalent to conventional telecommunications services. The increasing growth of the voice over data network market and the popularity of supporting products and services, however, heighten the risk that national governments will seek to regulate the transmission of voice communications over networks such as the Internet. In addition, large telecommunications companies may devote substantial lobbying efforts to influence the regulation of this market so as to benefit their interests, which may be contrary to our interests. These regulations may include, for example, assessing access or settlement charges, imposing tariffs or imposing regulations based on encryption concerns or the characteristics and quality of products and services. Future laws, legal decisions or regulations, as well as changes in interpretations of existing laws and regulations, could require us to expend significant resources to comply with them. In addition, these future events or changes may create uncertainty in our market that could reduce demand for our products.

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

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

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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.

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.

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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.

On September 6, 2002, Vertical Networks, Inc. filed suit against AltiGen Communications, Inc. in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks United States 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 Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a Second Amended Complaint on November 20, 2002 to identify the AltiGen products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement, damages, including treble damages for alleged willful infringement, and attorneys fees and costs. AltiGen filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to AltiGen s Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on AltiGen on April 9, 2003 and AltiGen served its 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. AltiGen believes it has strong defenses and arguments in this dispute and intends to vigorously litigate its position.

Item 2. Changes in Securities and Use of Proceeds

During the three months ended June 30, 2003, we issued 95,409 shares of common stock pursuant to the exercise of stock options at an exercise price ranging from $0.23 to $1.06 per share. All of these stock options were granted under our 1994 and 1999 Stock Option Plans. For the same period, 81,536 shares of the Company s common stock were purchased by and distributed to employees at a price ranging from $0.44 to $0.50 per share, pursuant to the Company s 1999 Employee Stock Purchase Plan. The issuance of these shares was exempt from registration requirements pursuant to rule 701 promulgated under the Securities Act of 1933, as amended.

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5 Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Number	Exhibit Description
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
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
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

(b) Reports on Form 8-K:

Report on Form 8-K dated and filed as of July 23, 2003 under Item 7 containing the Company s press release dated July 23, 2003 with respect to announcing its financial results for the fiscal quarter ended June 30, 2003.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, in the city of Fremont, State of California, on the 8th day of August, 2003.

ALTIGEN COMMUNICATIONS, INC.

By: /s/ Philip M. McDermott

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