ALTIGEN COMMUNICATIONS INC
Form 10-Q
May 17, 2004

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 MARCH 31, 2004

| | 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 0-27427

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

DELAWARE	**94-3204299**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
4555 Cushing Parkway **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. YES |___| NO |X|

The number of shares of our common stock outstanding as of May 11, 2004 was: 14,330,299 shares

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PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

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

	March 31, 2004	September 30, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,629	$ 8,548
Short-term investments	2,751	1,598
Accounts receivable, net of allowances of $59 and $60 at March 31, 2004 and September 30, 2003, respectively	1,895	1,521
Inventories	797	910
Prepaid expenses and other current assets	157	193
Total current assets	12,229	12,770
Property and equipment:		
Furniture and equipment	1,822	1,853
Computer software	948	941
	2,770	2,794
Less: Accumulated depreciation and amortization	(2,611)	(2,549)
Net property and equipment	159	245
Other non-current assets:		
Long-term investment	195	195
Long-term deposit	50	
Total other non-current assets	245	195
Total assets	$ 12,633	$ 13,210
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 533	$ 873
Accrued liabilities:		
Payroll and related benefits	304	276
Warranty (Note 3)	659	644
Marketing	204	253
Other	417	462

Deferred revenue	344	412
Total current liabilities	2,461	2,920
Stockholders equity:		
Convertible preferred stock, $0.001 par value; Authorized 5,000,000 shares; None issued and outstanding at March 31, 2004 and September 30, 2003		
Common stock, $0.001 par value; Authorized 50,000,000 shares; Outstanding 15,273,976 shares at March 31, 2004 and 15,054,442 shares at September 30, 2003	15	15
Treasury stock at cost 1,063,895 shares at March 31, 2004 and September 30, 2003	(1,014)	(1,014)
Additional paid-in capital	62,327	62,152
Accumulated deficit	(51,156)	(50,863)
Total stockholders equity	10,172	10,290
Total liabilities and stockholders equity	$ 12,633	$ 13,210

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

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Revenues, net	$ 3,293	$ 2,355	$ 6,923	$ 5,245
Cost of revenues	1,250	1,014	2,688	2,344
Gross profit	2,043	1,341	4,235	2,901
Operating expenses:				
Research and development	819	1,053	1,647	2,000
Sales and marketing	1,033	1,308	2,046	2,572
General and administrative	459	467	881	913
Deferred stock compensation (Note 4)	--	14	--	27
Total operating expenses	2,311	2,842	4,574	5,512
Loss from operations	(268)	(1,501)	(339)	(2,611)
Interest and other income, net	22	48	47	173
Net loss	$ (246)	$ (1,453)	$ (292)	$ (2,438)
Basic and diluted net loss per share	$ (0.02)	$ (0.11)	$ (0.02)	$ (0.18)
Shares used in computing basic and diluted net loss per share	14,160	13,544	14,138	13,532

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

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

	Six Months Ended March 31,	
	2004	**2003**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (292)	$ (2,438)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	62	238
Amortization of deferred stock compensation		27
Changes in operating assets and liabilities		
Accounts receivable	(374)	464
Inventories	112	(98)
Prepaid expenses and other current assets	36	(298)
Accounts payable	(340)	260
Accrued liabilities	(51)	(261)
Deferred revenue	(68)	(47)
Net cash used in operating activities	(915)	(2,153)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(11,752)	(8,002)
Proceeds from sale and maturities of short-term investments	10,599	11,450
Changes in other non-current assets	(50)	53
Purchases of property and equipment	24	(39)
Net cash (used in) provided by investing activities	(1,179)	3,462
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuances of common stock	175	28
Collection of promissory note from officer/stockholder		343
Net cash provided by financing activities	175	371
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,919)	1,680
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	8,548	7,210
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 6,629	$ 8,890
NONCASH INVESTING ACTIVITIES:		
Unrealized gain on short term investments	$	$ 1

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

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ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARYNOTES
TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

AltiGen Communications, Inc. designs, manufactures and markets next generation, time-tested Internet protocol phone systems and contact centers that use both the Internet and the public telephone network to take advantage of the convergence of voice and data communications.

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

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2003, included in the Company s 2003 Annual Report on Form 10-K filed with the SEC on December 29, 2003. AltiGen s results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

We consider all highly liquid investments with an original maturity of three months or less from the date of purchase to be cash equivalents. Short-term investments are in highly liquid financial instruments with original maturities greater than three-months but less than one year and are classified as available-for-sale investments. Investments are reported at their fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders equity. As of March 31, 2004, our cash and cash equivalents consisted of commercial paper and cash deposited in checking and money market accounts. For the six months ended March 31, 2004 and March 31, 2003, we 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 method) or market. Provisions, when required, are made to reduce excess and obsolete inventories to their estimated net realizable values. We regularly monitor inventory quantities on hand and record a provision for excess and obsolete inventories based primarily on our estimated forecast of product demand and production requirements for the next six months. The components of inventories include (in thousands):

	March 31, 2004	September 30, 2003
Raw materials	$ 79	$ 35
Work-in-progress	79	184
Finished goods	639	691
	$ 797	$ 910

LONG-TERM INVESTMENT

As of March 31, 2004, we held an investment of common stock in a private Chinese telecommunication company valued at approximately $195,000 accounted for using the cost method. Our interest in the company is approximately 2%, which interest does not allow us to exercise significant influence.

We perform a periodic review of our investment for impairment. An investment is considered impaired when a review of the investees operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. No write-downs were recorded during the three months and six months ended March 31, 2004 and March 31, 2003.

REVENUE RECOGNITION

We account 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 resellers, and to distributors. Revenues from sales to end-users are recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. We provide for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenues consist of product revenues reduced by estimated sales returns and allowances. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on our products held by its distributors. Upon termination, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled by either party based on specified notice. As a result of the above provisions, we defer recognition of distributor revenues until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as deferred revenue in the accompanying consolidated balance sheets. The related cost of revenue is also deferred and reported in the consolidated balance sheets as inventory.

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

STOCK BASED COMPENSATION

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

We adopted the disclosure-only provisions of SFAS No. 123, and accordingly, no expense has been recognized for options granted to employees under the various equity incentive plans. We amortize deferred stock-based compensation over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS No. 123, the Company s pro forma net loss and net loss per share would be as follows (in thousands, except per share data):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Reported net loss	$ (246)	$ (1,453)	$ (292)	$ (2,438)
Add: Total stockbased employee compensation expense included in reported net loss under APB No. 25		14		27
Deduct: Total stockbased compensation determined under fair value based method for all awards	(494)	(586)	(739)	(1,183)
Pro forma net loss under SFAS No. 123	$ (740)	$ (2,025)	$ (1031)	$ (3,594)
Basic and diluted as reported	$ (0.02)	$ (0.11)	$ (0.02)	$ (0.18)
Basic and diluted pro forma	$ (0.05)	$ (0.15)	$ (0.07)	$ (0.27)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, and is not subject to revaluation as a result of subsequent stock price fluctuations. The following weighted-average assumptions are used:

	Employee Stock Option Plans for Three Months Ended March 31,		Employee Stock Option Plan for Six Months Ended March 31,	
	2004	2003	2004	2003
Expected Life (in years)	5	5	5	5
Risk-free interest rate	3.3%	3.1%	3.3%	3.1%
Volatility	109%	100%	109%	100%
Expected dividend	0.0%	0.0%	0.0%	0.0%

	Employee Stock Purchase Plans for Three Months Ended March 31,		Employee Stock Purchase Plan for Six Months Ended March 31,	
	2004	2003	2004	2003
Expected Life (in years)	0.5	0.5	0.5	0.5
Risk-free interest rate	1.4%	1.5%	1.4%	1.5%
Volatility	108%	100%	108%	100%
Expected dividend	0.0%	0.0%	0.0%	0.0%

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

COMPUTATION OF BASIC AND DILUTED NET LOSS PER SHARE

Historical net 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. Basic and diluted net loss per share numbers were identical as potential common shares resulting from the exercise of stock options are antidilutive.

For the three and six months ended March 31, 2004 and March 31, 2003, 2,629,100 shares and 2,665,173 shares of common stock options with a weighted average exercise price of $4.77 and $4.41, respectively, were excluded from the diluted net income per share computation.

COMPREHENSIVE INCOME

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

SEGMENT REPORTING

We are organized and operate as one operating segment. We operate primarily in one geographic area, the Americas.

Net revenue by geographic region based on customer location for the three and six months ended March 31, 2004 and March 31, 2003, respectively, were as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Americas	90%	96%	91%	95%
International	10%	4%	9%	5%
	100%	100%	100%	100%

International is comprised of revenues from China, Taiwan, the United Kingdom and Norway. The Taiwan revenue included sales to affiliate, which comprised 3% and 1% for the three and six months ended March 31, 2004, respectively.

Net revenue by customers that individually accounted for more than 10% of our revenue for the three and six months ended March 31, 2004 and March 31, 2003, respectively, were as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
AltiSys	15%	14%	16%	18%
Ingram Micro	14%	28%	16%	25%
Synnex	47%	49%	48%	45%
Other	24%	9%	20%	12%
	100%	100%	100%	100%

On June 2003, we signed a new distributor agreement with Graybar Electric Company. Net revenues from Graybar were 7% and 4% for the three and six months ended March 31, 2004, respectively.

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

2. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2002, the Emerging Issues Task Force (EITF) reached a consensus on EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. This pronouncement addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue- generating activities. The guidance in this pronouncement was effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF 00-21 did not have an effect on our consolidated financial statements.

The Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, in January 2003, and a revised interpretation of FIN 46 (FIN 46-R) in December 2003. FIN 46 requires certain variable interest entities (VIEs) to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The adoption of FIN 46 did not have an impact on the Company s financial position. For all arrangements entered into after January 31, 2003, the Company is required to continue to apply FIN 46 through April 30, 2004, after that date the Company is required to adopt the provisions of FIN 46-R for those arrangements on May 1, 2004. For arrangements entered into prior to February 1, 2003, the Company is required to adopt the provisions of FIN 46-R on May 1, 2004. The Company does not expect the adoption of FIN 46-R to have an impact on the financial position, results of operations or cash flows of the Company.

In April 2003, the FASB issued SFAS No. 149, Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 was effective for contracts entered into or modified after June 30, 2003 and did not have an impact on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which requires that certain financial instruments be presented as liabilities that were previously presented as equity or as temporary equity. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and was effective at the beginning of the first interim period beginning after June 15, 2003. In November 2003, the FASB issued FASB Staff Position (FSP) No. 150-3, Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under SFAS No. 150, which defers the effective date for various provisions of SFAS No. 150. As of March 31, 2004, we had no financial instruments within the scope of this pronouncement.

3. WARRANTY

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

Changes in our warranty liability for the three and six months ended March 31, 2004 and March 31, 2003, respectively, are as follows (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Beginning balance	$ 670	$ 625	$ 644	$ 590
Provisions for warranty liability	24	79	84	196
Warranty cost including labor, components and scrap	(35)	(74)	(69)	(156)
Ending balance	$ 659	$ 630	$ 659	$ 630

4. DEFERRED STOCK COMPENSATION

In connection with the issuance of certain stock options to employees in fiscal years 1999 and 1998, we recorded deferred stock compensation in the aggregate amount of approximately $3,892,000, which represents the difference between the deemed fair value of our common stock and the exercise price of stock options at the date of grant. We have fully amortized the deferred stock compensation in fiscal year 2003.

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 March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Research and development	$ —	$ 5	$ —	$ 10
Sales and marketing	—	2	—	4
General and admistrative	—	7	—	13
Ending balance	$ —	$ 14	$ —	$ 27

5. COMMITMENTS AND CONTINGENCIES

Commitments

We lease our facility under an operating lease agreement expiring on February 2009. Rent expense for this operating lease totaled approximately $112,000 and $274,000 for the three and six months ended March 31, 2004, respectively as compared to $206,000 and $408,000 for the three and six months ended March 31, 2003. Minimum future lease payments under a noncancellable operating lease as of March 31, 2004 are as follows (in thousands):

Fiscal Year	
2004	148
2005	248
2006	256
2007	264
2008	271
Thereafter	92
	$ 1,279

Contingencies

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

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks 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 our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys fees and costs. We filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to our Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on us on April 9, 2003 and we served 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. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the United States Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously litigate our position. Management s view is that any loss from this litigation is not probable or estimable.

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, may, plan and similar expressions, as they relate to us or our management.

The forward-looking statements contained in this report 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. Investors 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. Our stockholders should carefully review the cautionary statements contained in this Form 10-Q, including the Certain Factors Affecting Business, Operating Results and Financial Condition below.

OVERVIEW

We provide converged Internet protocol phone systems for small-to-medium sized businesses. We were incorporated in California in May 1994 and began operations in July 1994. We first recognized revenues from product sales of our Quantum board and AltiWare software in July 1996. We generated net revenues of $3.3 million and $6.9 million for the second quarter and the first six months of fiscal 2004. respectively, compared to net revenues of $2.4 million and $5.2 million for the second quarter and the first six months of fiscal 2003. As of March 31, 2004, we had an accumulated deficit of $51.2 million.

We derive our revenues from sales of our AltiServ system. Product revenues consist of sales to end-users (including dealers) and to distributors. Revenues from product sales to end-users and resellers are recognized upon shipment. We defer recognition of revenue for sales to distributors until they resell our products to their customers. Upon shipment, we also provide a reserve for the estimated cost that may be incurred for product warranty. Under our distribution contracts, a distributor has the right, in certain circumstances, to return products it determines are overstocked, so long as it provides an offsetting purchase order for products in an amount equal to or greater than the dollar value of the returned products. In addition, we provide distributors protection from subsequent price reductions.

Our cost of revenues consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to the manufacturing of our products. We have experienced operating losses and negative cash flows from operations in each period since our inception. Several factors that have affected, and will continue to affect, our revenue growth include the state of the economy, the market acceptance of our products, our ability to add new resellers and our ability to design, develop, and release new products. We engage a third-party assembler, which, in the three months ended March 31, 2004, was principally All Quality Services in San Jose, to insert the hardware components into the printed circuit board. We selected our manufacturing partner 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 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, or maintain such inductions if they occur, could materially adversely affect our gross margins and operating results.

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

CRITICAL ACCOUNTING POLICIES

Revenue recognition. Revenues consist of sales to end-users, including to resellers, and to distributors. Revenues from sales to end-users are recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. We provide for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment. Net revenues consist of product revenues reduced by estimated sales returns and allowances. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on our products held by its distributors. Upon termination, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled without cause by either party following a specified notice period. As a result of the above provisions, we defer recognition of distributor revenues until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as deferred revenue in the accompanying consolidated balance sheets. The related cost of revenues is also deferred and reported in the consolidated balance sheets as inventory. Our total deferred revenue was $344,000 as of March 31, 2004.

Allowance for Doubtful Accounts. The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there were a deterioration of a major customer s creditworthiness, or actual defaults were higher than our historical experience, we could be required to increase our allowance and our earnings could be adversely affected. Our allowance for doubtful accounts was $59,000 of March 31, 2004.

Inventory. Inventory is stated at the lower of cost (first-in, first-out method) or market. Our inventory balance was $0.8 million as of March 31, 2004. We regularly review value of inventory in detail, with consideration given to future customer demand for our products, obsolescence from rapidly changing technology, and other factors. If actual market conditions are less favorable than those projected by management, and our estimates prove to be inaccurate, we could be required to increase our inventory provision and our gross margins could be adversely affected. Our inventory allowance was $2.7 million as of March 31, 2004.

Warranty. We accrue for warranty costs based on estimated product return rates and the expected material and labor costs to provide warranty services. If actual return rates and repair and replacement costs differ significantly from our estimates, our gross margin could be adversely affected. The liability for product warranties was $659,000 as of March 31, 2004.

Results of Operations

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Consolidated Statements of Operations Data:				
Revenues, net	100.0%	100.0%	100.0%	100.0%
Cost of revenues	38.0	43.1	38.8	44.7
Gross profit	62.0	56.9	61.2	55.3
Operating expenses:				
Research and development	24.9	44.7	23.8	38.1
Sales and marketing	31.4	55.5	29.6	49.0
General and administrative	13.9	19.8	12.7	17.4
Deferred stock compensation	0.0	0.6	0.0	0.5
Total operating expenses	70.2	120.6	66.1	105.0
Loss from operations	(8.2)	(63.7)	(4.9)	(49.7)
Interest and other income, net	0.7	2.0	0.7	3.3
Net loss	(7.5)%	(61.7)%	(4.2)%	(46.4)%

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

Net Revenue by Products:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Telephone systems	84%	92%	88%	92%
Phones	15%	7%	12%	7%
Product support	1%	1%	—	1%

Net Revenue by Geographic Area:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
Americas	90%	96%	91%	95%
International	10%	4%	9%	5%
	100%	100%	100%	100%

Net Revenue by Customers:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2004	2003	2004	2003
AltiSys	15%	14%	16%	18%
Ingram Micro	14%	28%	16%	25%
Synnex	47%	49%	48%	45%
Other	24%	9%	20%	12%
	100%	100%	100%	100%

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Total revenues were $3.3 million and $6.9 million for the second quarter and the first six months of fiscal 2004, an increase of 40% and 32% from total revenues of $2.4 million and $5.2 million for the same periods in fiscal 2003, respectively. Revenue generated in the Americas accounted for $3.0 million, or 90%, and $6.3 million, or 91%, for the second quarter and the first six months of fiscal 2004, respectively, compared to $2.3 million, or 96%, and $5.0 million, or 95%, for the second quarter and the first six months of fiscal 2003. Net product sales related to our telephone systems for the second quarter of fiscal 2004 increased by $621,000, or 29%, to $2.8 million from $2.2 million for the second quarter of fiscal 2003. Net product sales related to our telephone systems for the first six months of fiscal 2004 increased by $1.3 million, or 26%, to $6.1 million from $4.8 million for the first six months of fiscal 2003. This increase was due to strong customer acceptance of our AltiServ Office line, AltiServ 1IP and AltiServ 2IP, which has contributed to increased sales in each quarter since the products were introduced in the second quarter of last fiscal year. Net product sales related to phones for the second quarter of fiscal 2004 increased by $317,000, or 183%, to $490,000 from $173,000 for the second quarter of fiscal 2003. Net product sales related to phones for the first six months of fiscal 2004 increased by $419,000, or 110%, to $800,000 from $381,000 for the first six months of fiscal 2003. This increase was due to the introduction of the new analog phone and increased in sales of our internet protocol phones.

Cost of revenues. Cost of revenues were $1.3 million and $2.7 million for the second quarter and the first six months of fiscal 2004, respectively, compared to $1.0 million and $2.3 million for the same periods in fiscal 2003. This increase was due to an increase in overall sales of products and the requisite increase in product costs. Cost of revenues as a percentage of net revenues decreased from 43% and 45% for the second quarter and the first six months of fiscal 2003, to 38% and 39% for the same periods in fiscal 2004, respectively, which resulted in an increase in product gross margin. For the three months ended March 31, 2004, the decrease primarily was caused by lower warranty reserve due to the decline in the product return rate and reversal of inventory allowance in the amount of $64,000 related to the sale of products which were fully reserved against obsolesces. Production overhead decreased by $77,000 from $328,000 for the first six months of fiscal 2003 to $251,000 for the first six months of fiscal 2004. This decrease primarily was caused by lower actual component costs and overhead expenses. In addition, manufacturing and other related costs decreased by $101,000 from $369,000 for the first six months of fiscal 2003 to $268,000 for the first six months of fiscal 2004, resulting from lower warranty reserve due to the decline in the product return rate, lower depreciation on equipment and facilities charges associated with manufacturing activities. No additional provision for excess or obsolete inventory was necessary in the three months ended March 31, 2004.

Research and development expenses. Research and development expenses consist principally of salaries and related personnel expenses, consultant fees and prototype expenses related to the design, development and testing of our products and enhancement of our converged telephone system software. Research and development expenses decreased to $819,000 for the second quarter of fiscal 2004 from $1.1 million for the same period in fiscal 2003. This decrease was the result of a decrease in headcount-related costs of $147,000 resulting from a reduction in our research and development workforce, a decrease in office rent expense of $46,000 and a decrease in service fees of $35,000. Research and development expenses as a percentage of revenue decreased to 25% for the second quarter of fiscal 2004 from 45% for the same period in fiscal 2003. Research and development expenses decreased to $1.7 million for the first six months of fiscal 2004 from $2.0 million for the same period in fiscal 2003. This decrease was the result of a decrease in headcount-related costs of $295,000 resulting from a reduction in our research and development workforce and a decrease in office rent expense of $75,000. Research and development expenses as a percentage of revenue decreased to 24% for the first six months of fiscal 2004 from 38% for the same period in fiscal 2003. We expect research and development expenses to remain relatively flat due to the uncertainty about customers spending patterns in the current economic environment. Management continues to monitor research and development expenses in line with revenue growth.

Sales and marketing expenses. Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales and customer support functions, as well as trade shows, advertising, and promotional expenses. Sales and marketing expenses decreased to $1.0 million for the second quarter of fiscal 2004 from $1.3 million for the same period in fiscal 2003. This decrease was the result of a decrease in headcount-related costs of $149,000 resulting from a reduction in our marketing workforce and a decrease in advertising expense of $92,000. Sales and marketing expenses as a percentage of revenue decreased to 31% for the second quarter of fiscal 2004 from 56% for the same period in fiscal 2003. Sales and marketing expenses decreased to $2.1 million for the first six months of fiscal 2004 from $2.6 million for the same period in fiscal 2003. This decrease was the result of a decrease in headcount-related costs of $263,000 resulting from a reduction in our marketing workforce and a decrease in advertising expense of $89,000 and a significant cost reduction measures in the areas of service fees of approximately $102,000. Sales and marketing expenses as a percentage of revenue decreased to 30% for the first six months of fiscal 2004 from 49% for the same period in fiscal 2003. We expect sales and marketing expenses to remain relatively flat due to the uncertainty about customers spending patterns in the current economic environment.

General and administrative expenses. General and administrative expenses consist of salaries and related expenses for executive, finance and administrative personnel, facilities, bad debt, legal, and other general corporate expenses. General and administrative expenses remained relatively unchanged at $459,000 and $881,000 for the second quarter and the first six months of fiscal 2004, compared to $467,000 and $913,000 for the same periods in fiscal 2003, respectively. General and administrative expenses as a percentage of revenue decreased to 14% and 13% for the second quarter and the first six months of fiscal 2004, compared to 20% and 17% for the same periods in fiscal 2003, respectively, due to primarily to increased revenues. We expect to maintain general and administrative expenses at the current level.

Amortization of deferred stock compensation. We had no amortization of deferred stock compensation in the second quarter and the first six months of fiscal 2004. Amortization of deferred stock compensation was $14,000 and $27,000 for the second quarter and the first six months of fiscal 2003, respectively. Deferred stock compensation expense reflects the amortization of stock compensation charges resulting from granting stock options at exercise prices below the deemed fair value of our common stock on the dates the options were granted. We amortized these deferred amounts using the straight-line method over the vesting period of the related stock options. All outstanding deferred stock compensation was amortized in fiscal year 2003.

Interest and other income, net. Net interest and other income decreased to $22,000 and $47,000 for the second quarter and the first sixmonths of fiscal 2004, respectively, from $48,000 and $173,000 for the same periods in fiscal 2003. The decrease primarily was due to the recognition of interest received from full repayment of an outstanding promissory note held by our Chief Executive Officer, Gilbert Hu in fiscal 2003. We expect net interest and other income to continue to decrease as a result of further decreases in cash available to invest and relatively flat or lower interest rates.

Liquidity and Capital Resources

Since inception, we primarily have financed our operations through the sale of equity securities. As of March 31, 2004, we had cash, cash equivalents, and short-term investments totaling $9.4 million, which consisted of cash and cash equivalents of $6.6 million and $2.8 million of short-term investments.

Changes in Cash Flows

During the first six months of fiscal 2004, net cash used in operating activities was $0.9 million, which is $1.2 million lower than the cash used in operating activities during the same period in fiscal 2003.

Net accounts receivable increased to $1.9 million at March 31, 2004 from $1.5 million at September 30, 2003. The increase in net accounts receivable primarily was due to higher sales of $1.7 million generated in the last month of the quarter.

Inventories decreased to $0.8 million at March 31, 2004 from $0.9 million at September 30, 2003 and our inventory turn rate increased to 6.9 times at March 31, 2004 from 5.4 times at September 30, 2003. Inventory turn rate is annualized and represents the number of times inventory is replenished during the year. The increase in the inventory turn rate is the result of lower inventory levels and our ability to efficiently manage our inventory to meet customer demands. Inventory management will continue to be an area of focus as we balance the need to maintain strategic inventory levels to help ensure competitive lead times with the risk of inventory obsolescence due to rapidly changing technology and customer requirements.

Accounts payable decreased to $0.5 million at March 31, 2004 from $0.9 million at September 30, 2003. This decrease primarily was due to less inventory purchases in the recent quarter.

Accrued payroll-related liabilities increased to $304,000 at March 31, 2004 from $276,000 at September 30, 2003. This increase primarily was due to an increase in sales commission related to an increase in revenues.

Other liabilities decreased to $417,000 at March 31, 2004 from $462,000 at September 30, 2003. This decrease primarily was due to a decrease in accounting service fees and other related operational costs.

During the first six months of fiscal 2004, net cash used in investing activities was a $50,000 long-term deposit for our new office lease and purchases of short-term investments of $11.8 million. On October 1, 2003, we entered into a lease for approximately 32,000 square feet to serve as our new headquarters for corporate administration, research and development, manufacturing, and sales and marketing facility in Fremont, California. The lease commenced on December 22, 2003 and expires on February 21, 2009. During the first six months of fiscal 2004, we received proceeds from the sale and maturities of short-term investments of $10.6 million.

During the first six-months of fiscal 2004, net cash provided by financing activities was $175,000 of proceeds from the exercise of employee stock options and employee stock purchase plan rights.

Liquidity and Capital Resources

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

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

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

We do not have any material commitments for capital expenditures as of March 31, 2004. We have commitments under our noncancellable operating lease in the amount of $1.3 million as of March 31, 2004. The following table represents our future commitments as of March 31, 2004:

	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
Office lease obligation	$ 1,279	$ 148	$ 504	$ 535	$ 92
Operating lease obligation	7	4	3	—	—
Total	$ 1,286	$ 152	$ 507	$ 535	$ 92

We believe we have sufficient cash reserves to allow us to continue operations for more than a year assuming our quarterly cash burn rate does not increase over that period, which we currently do not expect to occur.

Recent Accounting Pronouncements

In December 2002, the Emerging Issues Task Force (EITF) reached a consensus on EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. This pronouncement addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue- generating activities. The guidance in this pronouncement was effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF 00-21 did not have an effect on our consolidated financial statements.

The Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, in January 2003, and a revised interpretation of FIN 46 (FIN 46-R) in December 2003. FIN 46 requires certain variable interest entities (VIEs) to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The adoption of FIN 46 did not have an impact on the Company s financial position. For all arrangements entered into after January 31, 2003, the Company is required to continue to apply FIN 46 through April 30, 2004, after that date the Company is required to adopt the provisions of FIN 46-R for those arrangements on May 1, 2004. For arrangements entered into prior to February 1, 2003, the Company is required to adopt the provisions of FIN 46-R on May 1, 2004. The Company does not expect the adoption of FIN 46-R to have an impact on the financial position, results of operations or cash flows of the Company.

In April 2003, the FASB issued SFAS No. 149, Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 was effective for contracts entered into or modified after June 30, 2003 and did not have an impact on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which requires that certain financial instruments be presented as liabilities that were previously presented as equity or as temporary equity. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and was effective at the beginning of the first interim period beginning after June 15, 2003. In November 2003, the FASB issued FASB Staff Position (FSP) No. 150-3, Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under SFAS No. 150, which defers the effective date for various provisions of SFAS No. 150. As of March 31, 2004, we had no financial instruments within the scope of this pronouncement.

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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 March 31, 2004, we had an accumulated deficit of $51.2 million. We expect to incur operating losses for the foreseeable future, and these losses may be substantial. We do not expect to increase expenditures for product development, general and administrative expenses, and sales and marketing expenses; however, if we cannot increase revenues significantly, we will not achieve either profitability or 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.

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 specific market conditions in the telecommunications industry. 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 the global economic slowdown worsens, 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 likely will vary significantly in the future. A number of factors, many of which are beyond our control, may cause our operating results to vary, including:

- Our sales cycle, which may vary substantially from customer to customer;
- Unfavorable changes in the prices and delivery of the components we purchase;
- The size and timing of orders for our products, which may vary depending on the season, and the contractual terms of the orders;
- The size and timing of our expenses, including operating expenses and expenses of developing new products and product enhancements;

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

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

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

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

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

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

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

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

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

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

Sales through our four key distributors, Altisys, Ingram Micro Inc., Graybar and Synnex, accounted for 83% and 84% of our net revenues in the second quarter and the first six months of fiscal year 2004, respectively. Our business and operating results will suffer if any one of these distributors does not continue distributing our products, fails to distribute the volume of our products that it currently distributes or fails to expand our customer base. We also need to establish and maintain relationships with additional distributors and original equipment manufacturers. We may not be able to establish, or successfully manage, relationships with additional distribution partners. In addition, our agreements with distributors typically provide for termination by either party upon written notice to the other party. For example, our agreement with Ingram Micro provides for termination, with or without cause, by either party upon 30 days written notice to the other party, or upon insolvency or bankruptcy. Generally, these agreements are non-exclusive and distributors sell products that compete with ours. If we fail to establish or maintain relationships with distributors and original equipment manufacturers, our ability to increase or maintain our sales and our customer base will be substantially harmed.

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

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

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

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

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

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

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

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

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

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

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

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks' 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 our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. We filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to our Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on us on April 9, 2003 and we served 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. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the United States Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously litigate our position. Thus, management's view is that any loss from this litigation is not probable or estimable.

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

Any failure by us to protect our intellectual property could harm our business and competitive position.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

For the second quarter and the first six months of fiscal year 2004, approximately 10% and 9% of our net revenues, respectively, came from customers outside of the United States. We intend to expand our international sales and marketing efforts. Our efforts are subject to a variety of risks associated with conducting business internationally, any of which could seriously harm our business, financial condition and results of operations. These risks include:

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

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

We depend, in large part, on our ability to attract and retain highly skilled personnel, particularly engineers and sales and marketing personnel. We need highly trained technical personnel to design and support our server-based telecommunications systems. In addition, we need highly trained sales and marketing personnel to expand our marketing and sales operations in order to increase market awareness of our products and generate increased revenues. Competition for highly trained personnel is intense, especially in the San Francisco Bay Area where most of our operations are located. We cannot be certain that we will be successful in our recruitment and retention efforts. If we fail to attract or retain qualified personnel or suffer from delays in hiring required personnel, our business, financial condition and results of operations may be seriously harmed.

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

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

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

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

Risks Related to the Industry

Integrated, multifunction telecommunications systems may not achieve widespread acceptance.

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

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

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

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are adequate and effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commiss ion rules and forms.

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of Vertical Networks 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 our products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks seeks a judgment of patent infringement and an award of damages, including treble damages for alleged willful infringement, and attorneys fees and costs. We filed an Answer and Counterclaims for Declaratory Relief on December 9, 2002. On December 26, 2002, Vertical Networks filed its Answer to our Counterclaims. Vertical Networks served its Preliminary Infringement Contentions on us on April 9, 2003 and we served 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. On October 7, 2003, the parties filed a stipulation to stay this action, pending the outcome of the reissue of some of the subject patents before the United States Patent and Trademark Office. We believe we have strong defenses and arguments in this dispute and intend to vigorously litigate our position. Thus, management s view is that any loss from this litigation is not probable or estimable.

Item 2. Changes in Securities and Use of Proceeds

During the three months ended March 31, 2004, we issued 85,262 shares of common stock pursuant to the exercise of stock options at an exercise price ranging from $0.58 to $2.13 per share. All of these stock options were granted under our 1994 and 1999 Stock Option Plans. 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

On February 12, 2004, we held our annual meeting of stockholders to seek their approval as to the following matters:

The reelection of Richard Black and Wen-Huang (Simon) Chang as Class II Directors.

As to the reelection:

Mr. Black received 11,738,866 votes for reelection and 48,640 shares withheld.

Mr. Chang received 11,720,621 votes for reelection and 66,885 shares withheld.

The ratification of the appointment of Deloitte & Touche, LLP as our independent auditors.

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

11,722,016 shares voted for the appointment, 46,140 shares voted against the appointment and 19,350 shares abstained from voting.

In addition, the terms of the following directors continued after the date of the meeting: Kenneth Tai, Tacheng Chester Wang, and Gilbert Hu.

There were 14,124,819 shares issued, outstanding and eligible to vote at the meeting.

Effective as of March 1, 2004, Mr. Chang resigned from the Board of Directors in order to pursue other opportunities.

Item 5 Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

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

(b) Reports on Form 8-K

We filed a current report on Form 8-K with the Securities and Exchange Commission reporting under Items 7 and 12, on January 29, 2004 furnishing our press release, dated January 29, 2004, announcing financial results for the first quarter of fiscal year 2004.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALTIGEN COMMUNICATIONS, INC.

Date: May 14, 2004

By: /s/ Philip M. McDermott

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

EXHIBIT INDEX

Exhibit Number	Description
3.2	Second Amended and Restated Bylaws of Registrant
31.1	Certification of Principal Executive Officer.
31.2	Certification of Principal Financial Officer.
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.