

ALTIGEN COMMUNICATIONS INC  
Form 10-Q  
May 15, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009

OR

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

Commission File Number 000-27427

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

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

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

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

94538  
(Zip Code)

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

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

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

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

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

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

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

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

## Item 1. Condensed Consolidated Financial Statements

ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except per share data)

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

30, 2008

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

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

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ALTIGEN COMMUNICATIONS, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

(In thousands, except per share data)

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

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

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

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

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

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

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

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

These financial statements should be read in conjunction with our audited consolidated financial statements for the fiscal year ended September 30, 2008, included in the Company’s 2008 Annual Report on Form 10-K filed with the SEC on December 29, 2008. The Company’s results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

We consider all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents. Cash and cash equivalents are invested in various investment grade institutional money market accounts, U.S. Agency securities and commercial paper. Short-term investments are in highly liquid financial instruments with original maturities greater than three months but less than one year and are classified as “available-for-sale” investments. Investments are reported at their fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders’ equity. The Company’s investment policy requires investments to be rated single-A or better.

INVENTORIES

Inventories (which include costs associated with components assembled by third-party assembly manufacturers, as well as internal labor and allocable overhead) are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market value. Provisions, when required, are made to reduce excess and obsolete inventories to their estimated net realizable values. We regularly monitor inventory quantities on hand and record a provision for excess and obsolete inventories based primarily on our estimated forecast of product demand and production requirements for the next six months. We record a write-down for product and component inventories that



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

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

## REVENUE RECOGNITION

The Company recognizes revenue software in accordance with Statement of Position (“SOP”) 97-2, Software Revenue Recognition (“SOP 97-2”). Revenue consists of sales to end-users, resellers, and distributors. Revenue from sales to end-users and resellers is recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed and determinable. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on the Company's products held by its distributors. Upon termination of such distribution agreements, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled by either party for convenience following a specified notice period. As a result of these provisions, the Company defers recognition of distributor revenue until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as “deferred revenue” in the accompanying consolidated balance sheets. The related cost of revenue is also deferred and reported in the consolidated balance sheets as inventory.

## SOFTWARE ASSURANCE

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

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

## STOCK-BASED COMPENSATION

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

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

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model and is not subject to revaluation as a result of subsequent stock price fluctuations. The Company estimated the fair value of stock option awards in accordance with the provisions of SFAS 123(R) by using the Black-Scholes option valuation model with the following assumptions:

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

The following table shows total stock-based compensation expense included in the consolidated statements of operations for the three and six months ended March 31, 2009 and March 31, 2008 with respect to the plans mentioned above (in thousands):

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

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

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

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

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

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

Under the 1999 Purchase Plan, we had reserved, as of March 10, 2009, 364,882 shares of common stock for issuance to eligible employees at a price equal to 85% of the lower of the fair market value of the common stock on the first day of the offering period or a specified exercise date (last trading day in April or October each year). From October 1, 2008 until the expiration of the 1999 Purchase Plan place on March 10, 2009, 108,177 shares were purchased by and distributed to employees at a price of \$0.59 per share.

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

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

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

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

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

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

## Comprehensive Loss

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

## FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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

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

## SEGMENT REPORTING

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

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

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

## CUSTOMERS

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

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

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

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





## 2. WARRANTY

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

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

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

## 3. COMMITMENTS AND CONTINGENCIES

### Commitments

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

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

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

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

### Contingencies

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

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of U.S. Patents Nos. 6,266,341, 6,289,025, 6,292,482, 6,389,009, and 6,396,849. On October 28, 2002, Vertical Networks amended its complaint to add allegations of infringement of U.S. Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a second amended complaint on November 20, 2002 to identify products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks' Complaint seeks an injunction against future patent infringement, an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. On December 9, 2002, we filed an answer and counterclaims for declaratory relief, and on December 26, 2002, Vertical Networks filed its reply to those counterclaims. On October 4, 2007, the parties entered into a stipulation dismissing the lawsuit in its entirety without prejudice.

#### 4. STOCK REPURCHASE PROGRAM

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

#### 5. SUBSEQUENT EVENTS

##### Lease Agreement

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

##### Stock Repurchase Program

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

##### Salary Reduction

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

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

FORWARD-LOOKING INFORMATION

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

The forward-looking statements contained herein reflect our judgment as of the date of this report with respect to future events, the outcome of which is subject to certain risks that may have a significant impact on our business, operating results or financial condition. You are cautioned that these forward-looking statements are inherently uncertain. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results or outcomes may vary materially from those described herein. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements, or the outcome of present and future litigation, regulatory developments or other contingencies. You should carefully review the cautionary statements contained in our Annual Report on Form 10-K for the year ended September 30, 2008, including those set forth in Item 1A. "Risk Factors" of that report.

OVERVIEW

We are a pioneer and market leader in Internet protocol telephony systems for small- to medium-sized businesses. We design, manufacture and market next generation, Internet protocol phone systems and contact centers that use both the Internet and the public telephone network to take advantage of the convergence of voice and data communications. Unlike traditional proprietary phone systems, our systems are designed with open architecture and are built on an industry standard platform. This adherence to industry standards allows our products to play an important role in the small- to medium-sized business market by delivering phone systems that can interface with other technologies and provide integrated voice and data solutions. We believe this enables our customers to implement communication systems solutions that have an increased return on investment versus past technology investments. We generated net revenue of \$3.6 million and \$8.4 million for the three and six months ended March 31, 2009, respectively, compared to net revenue of \$4.7 million and \$9.0 million for the three and six months ended March 31, 2008, respectively. As of March 31, 2009, we had an accumulated deficit of \$59.3 million. Net cash used in operating activities was \$1.3 million for the six months ended March 31, 2009.

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

Our cost of revenue consists of component and material costs, direct labor costs, provisions for excess and obsolete inventory, warranty costs and overhead related to the manufacturing of our products. Several factors that have affected and will continue to affect our revenue growth are the state of the economy, the market acceptance of our products, our ability to add new resellers and our ability to design, develop, and release new products. We engage third-party assemblers, which for the six months ended March 31, 2009 were All Quality Services in Fremont, California and

ISIS Surface Mounting, Inc. in San Jose, California to insert the hardware components into the printed circuit board. We purchase fully-assembled chassis from Advantech Corporation, analog phones from Fanstel Corporation, Internet protocol phones from BCM Communications, Inc., single board computers for our MAX product from AAEON Electronics, Inc. and raw material components from Avnet Electronics. We selected our manufacturing partners with the goals of ensuring a reliable supply of high-quality finished products and lowering per unit product costs as a result of manufacturing economies of scale. We cannot assure you that we will maintain the volumes required to realize these economies of scale or when or if such cost reductions will occur. The failure to obtain such cost reductions could materially adversely affect our gross margins and operating results.

We continue to focus on developing enhancements to our current products to provide greater functionality and increased capabilities, based on our market research, customer feedback and our competitors' product offerings, as well as creating new product offerings to both enhance our position in our target market segment and enter new geographical markets. Additionally, we intend to continue selling our products to small- to medium-sized businesses, enterprise businesses, multisite businesses, corporate and branch offices and call centers. Also, we plan to continue to recruit additional resellers and distributors to focus on selling phone systems to our target customers. We believe that the adoption rate for this Internet telephony is much faster with small- to medium-sized businesses because many of these businesses have not yet made a significant investment for a traditional phone system. Also, we believe that small- to medium-sized businesses are looking for call center-type administration to increase the productivity and efficiency of their contacts with customers.

## CRITICAL ACCOUNTING POLICIES

**Revenue Recognition.** Net sales consist primarily of revenue from direct sales to end-users, resellers and distributors. We recognize revenue pursuant to SEC Staff Accounting Bulletin (“SAB”) No. 104, Revenue Recognition, (“SAB No. 104”). Revenue from sales to end-users is recognized upon shipment, when risk of loss has passed to the customer, collection of the receivable is reasonably assured, persuasive evidence of an arrangement exists, and the sales price is fixed and determinable. We provide for estimated sales returns and allowances and warranty costs related to such sales at the time of shipment in accordance with SFAS No. 48, Revenue Recognition when Right of Return Exists (“SFAS No. 48”). Net revenue consists of product revenue reduced by estimated sales returns and allowances. Sales to distributors are made under terms allowing certain rights of return and protection against subsequent price declines on our products held by the distributors. Upon termination of such distribution agreements, any unsold products may be returned by the distributor for a full refund. These agreements may be canceled without cause for convenience following a specified notice period. As a result of the above provisions, we defer recognition of distributor revenue until such distributors resell our products to their customers. The amounts deferred as a result of this policy are reflected as “deferred revenue” in the accompanying consolidated balance sheets. The related cost of revenue is also deferred and reported in the consolidated balance sheets as inventory. As of March 31, 2009, our total deferred revenue was \$2.9 million compared to \$1.9 million for the same period in fiscal 2008, an increase of \$1.0 million over the same period in the prior year. The increase was primarily the result of continued growth of our new recurring revenue programs. These plans include both the Software Assurance Program, which provides our customers with new software releases and support for an annual fee, and the Premier Service Plan, which includes software assurance and extended hardware warranty.

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

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

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

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

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



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

## Results of Operations

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
<b>Consolidated Statements of Operations Data:</b>				
Net revenue:				
Hardware	86.7%	87.6%	86.5%	86.5%
Software	13.3	12.4	13.5	13.5
Total net revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Hardware	41.0	42.8	39.8	42.4
Software	0.1	1.6	0.1	1.5
Total cost of revenue	41.1	44.4	39.9	43.9
<b>Gross profit</b>	<b>58.9</b>	<b>55.6</b>	<b>60.1</b>	<b>56.1</b>
Operating expenses:				
Research and development	34.7	22.0	29.3	21.7
Sales and marketing	51.4	39.1	46.5	40.2
General and administrative	22.7	20.1	21.1	19.6
Total operating expenses	108.8	81.2	96.9	81.5
Loss from operations	(49.9)	(25.6)	(36.8)	(25.4)
Equity in net loss of investee	(0.1)	(0.1)	( 0.1)	( 0.0)
Interest and other income, net	0.6	1.7	0.7	2.2
Net loss before income taxes	(49.4)	(24.0)	(36.2)	(23.2)
Provision for income taxes	( 0.0)	( 0.0)	0.2	( 0.0)
Net loss	(49.4) %	(24.0) %	(36.0) %	(23.2) %

## Net Revenue

Net sales consist primarily of revenue from direct sales to end-users and resellers and sales to distributors.

We are organized and operate as two operating segments, the Americas and International. The Americas is comprised of the United States, Canada, Mexico, Central America and the Caribbean. The International segment is comprised of China, the United Kingdom and Norway.

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

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

Net revenue by customers that individually accounted for more than 10% of our revenue for the three and six months ended March 31, 2009 and 2008, respectively, were as follows:

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

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

The following table sets forth percentage of net revenue by product type with respect to such revenue for the periods indicated:

	Three Months Ended		Six Months Ended	
	March 31,		March 31,	
	2009	2008	2009	2008
Hardware	69%	88%	72%	86%
Software	13%	12%	14%	14%
Service Support Plans (1)	18%	—	14%	—
Total	100%	100%	100%	100%

(1) In the quarter ended March 31, 2008, revenue generated from these service support plans accounted for less than 10% of our total revenue. For the same period, our hardware revenue includes service support revenue generated primarily from our service support plans starting in September 2007.



Net revenue for the three months ended March 31, 2009 was \$3.6 million as compared to \$4.7 million for the three months ended March 31, 2008. Revenue generated in the Americas segment accounted for \$3.1 million, or 86% of our total net revenue, as compared to \$4.1 million, or 88% of our total net revenue, for the three months ended March 31, 2009 and March 31, 2008, respectively. Revenue generated in the International segment accounted for \$489,000, or 14% of our total net revenue, as compared to \$576,000, or 12% of our total net revenue, for the three months ended March 31, 2009 and March 31, 2008, respectively. In the Americas segment, during the three months ended March 31, 2009 and 2008, we generated \$664,000 and \$183,000, respectively, in non-system related revenue. Non-system related revenue is primarily comprised of revenue generated from our service support plans. In the Americas segment, the decrease in net revenue excluding non-system related revenue was approximately 39%. This decrease was primarily attributable to a lower number of systems shipped during the three months ended March 31, 2009 as compared to the corresponding period in the previous year.

Net revenue for the six months ended March 31, 2009 was \$8.4 million as compared to \$9.0 million for the six months ended March 31, 2008. Revenue generated in the Americas segment accounted for \$7.2 million, or 86% of our total net revenue, as compared to \$7.8 million, or 87% of our total net revenue, for the six months ended March 31, 2009 and March 31, 2008, respectively. Revenue generated in the International segment accounted for \$1.2 million, or 14% of our total net revenue, as compared to \$1.2 million, or 13% of our total net revenue, for the six months ended March 31, 2009 and March 31, 2008, respectively. In the Americas segment, during the six months ended March 31, 2009 and 2008, we generated approximately \$1.3 million and \$241,000, respectively, in non-system related revenue. Non-system related revenue is primarily comprised of revenue generated from our service support plans. In the Americas segment, the decrease in net revenue excluding non-system related revenue was approximately 21%. This decrease in this segment was primarily attributable to change in our product mix. During the six months ended March 31, 2009, the number of systems shipped was approximately 23% lower than the corresponding period in the previous year but the average revenue per system was higher by approximately 1.7%. The average revenue per system was higher as result of a decrease in our smaller systems of approximately 33% and an increase in our larger systems of approximately 11%, reflecting a higher number of extensions per system shipped.

#### Cost of Revenue

Our cost of product revenue consists primarily 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. The majority of these costs vary with the unit volumes of product sold.

Cost of revenue as a percentage of net revenue decreased to 41% for the three months ended March 31, 2009 as compared to 44% for the same period of the previous fiscal year. This decrease was primarily caused by a shift in our product mix in the period and the impact of lower sales volume over the prior year quarter. For the six months ended March 31, 2009 and 2008, cost of revenue as a percentage of net revenue decreased from 44% to 40%, respectively. This change was primarily attributable to an increase of our non-system related revenue.

#### Research and Development

Research and development expenses consist primarily of costs related to personnel and overhead expenses, consultant expenses and other costs associated with the design, development, prototyping and testing of our products and enhancements of our converged telephone system software. For the second quarter of fiscal 2009, research and development expenses were \$1.2 million, or 35% of net revenue, compared to \$1.0 million, or 22% of net revenue, for the second quarter of fiscal 2008. The increase in absolute dollars was primarily attributable to an increase of \$52,000 in personnel-related expenses, an increase of \$56,000 in project related expenses and an increase of \$53,000 in consulting related services. Research and development expenses increased to \$2.4 million, or 29% of net revenue, for the six months ended March 31, 2009 from \$1.9 million, or 22% of net revenue, for the same period in fiscal 2008.

This increase in absolute dollars reflects increased personnel-related and overhead expenses of approximately \$134,000, an increase of \$144,000 in project related expenses and an increase of \$121,000 in consulting related services. Additionally, research and development activities increased in Shanghai, which resulted in an increase of \$68,000 in overall expenses.

We intend to continue to make investments in our research and development and we believe that focused investments in research and development are critical to the future growth and our ability to enhance our competitive position in the marketplace. We believe that our ability to develop and meet enterprise customer requirements is essential to our success. Accordingly, we have assembled a team of engineers with expertise in various fields, including voice and IP communications, unified communications network design, data networking and software engineering. Our principal research and development activities are conducted in Fremont, California and our subsidiary in Shanghai, China. Management continues to focus on cost control until business conditions improve. If business conditions deteriorate or the rate of improvement does not meet our expectations, we may implement additional cost-cutting actions.

## Sales and Marketing

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. For the second quarter of fiscal 2009 and 2008, sales and marketing expenses were \$1.8 million. Sales and marketing as a percentage of net revenue increased to 51% for the three months ended March 31, 2009 from 39% for the same period in the previous fiscal year. Sales and marketing expenses increased to \$3.9 million, or 46% of net revenue, for the six months ended March 31, 2009 from \$3.6 million, or 40% of net revenue, for the same period in fiscal 2008. This increase in absolute dollars was driven by an increase in personnel-related and overhead expenses of \$287,000, primarily as a result of increased headcount of approximately 12%.

We anticipate that sales and marketing expenses will decrease but will remain the largest category of our operating expenses in future periods over the short term. We plan to continue investing in our domestic and international marketing activities to help build brand awareness and create sales leads for our channel partners. Management continues to focus on cost control until business conditions improve. If business conditions deteriorate or the rate of improvement does not meet our expectations, we may implement additional cost-cutting actions.

## General and Administrative

General and administrative expenses consist of salaries and related expenses for executive, finance and administrative personnel, facilities, allowance for doubtful accounts, legal and other general corporate expenses. For the second quarter of fiscal 2009, general and administrative expenses were \$811,000 or 23% of revenue, compared to \$946,000 or 20% of revenue for the second quarter of fiscal 2008. The decrease in absolute dollars in general and administrative was attributable to decreased non-cash stock-based compensation expenses of \$62,000 and decreased consulting related services of \$54,000. For the six months ended March 31, 2009 and 2008, general and administrative expenses were \$1.8 million. As a percentage of net revenue, general and administrative increased to 21% for the six months ended March 31, 2009 from 20% for the same period in the previous fiscal year.

Management continues to focus on cost control until business conditions improve. If business conditions deteriorate or the rate of improvement does not meet our expectations, we may implement additional cost-cutting actions.

## Equity Investment in Common Stock of Private Company

In July 2004, we purchased common stock of a private Korean telecommunications company for approximately \$79,000. As a result of this investment, we acquired approximately 23% of the voting power of the company. This gives us the right to nominate and elect one of the three members of the company's current board of directors. We are accounting for this investment using the equity method. For the three months ended March 31, 2009, the total equity loss with respect to this company was approximately \$3,000 compared to net loss of \$6,000 for the same period in fiscal 2008. For the six months ended March 31, 2009 and 2008, the total equity loss with respect to this company was approximately \$6,000 and \$3,000, respectively.

## Interest Expense and Other Income, Net

Interest expense primarily consists of interest incurred on our capital lease commitments and other income primarily consists of interest earned on cash, cash equivalents and short-term investments. Net interest and other income decreased to \$23,000 and \$59,000 for the three and six months ended March 31, 2009, respectively, from \$82,000 and \$194,000 for the same periods in fiscal 2008. The decrease in interest and other income, net for the three and six month periods ended March 31, 2009 as compared with the same periods of the prior year was a combination of lower invested balances, reduced cash balances and reduced rates of interest available for cash and investments in financial

assets in fiscal 2009. In the longer term, we may generate less interest income if our total invested balance decreases and these decreases are not offset by rising interest rates or increased cash generated from operations or other sources.

#### Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the sale of equity securities. As of March 31, 2009, we held cash, cash equivalents and short-term investments totaling \$8.5 million. Total cash, cash equivalents and short-term investments represents approximately 72% of total current assets for the quarter ended March 31, 2009. As of March 31, 2009, \$6.0 million of our total assets are classified as cash and cash equivalents compared with \$9.4 million at September 30, 2008. Short-term investments were approximately \$2.5 million and \$400,000 at March 31, 2009 and September 30, 2008, respectively.

For the six months ended March 31, 2009, net cash used in investing activities was \$2.3 million as compared net cash provided by investing activities of \$3.4 million during the same period in fiscal 2008. This was directly related to proceeds from maturities of short-term investments of approximately \$3.3 million and purchases of short-term investments of approximately \$5.4 million during the first six months of fiscal 2009 as compared to proceed from maturities of short-term investments of approximately \$26.1million and purchases of short-term investments of approximately \$22.7 million during fiscal 2008. The maturities of the Company's short term investments are staggered throughout the year so that cash requirements are met. For the six month period ended March 31, 2009, the Company spent approximately \$139,000 on purchases of property and equipment compared to \$101,000 million for the six month period ended March 31, 2008.

Net cash provided by financing activities for the six months ended March 31, 2009 was approximately \$44,000, as compared to net cash used in financing activities of \$190,000 during the same period in fiscal 2008. This change was primarily attributable to the repurchase of our treasury stock of approximately \$19,000 for the six months ended March 31, 2009 as compared to \$346,000 during the same period in fiscal 2008. During the six months of fiscal 2009, proceeds from exercise of employee stock options represented approximately \$63,000 as compared to \$156,000 during the same period in the prior year.

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

We believe our existing balances of cash, cash equivalents and short-term investments, as well as cash expected to be generated from operating activities, will be sufficient to satisfy our working capital needs, capital expenditures and other liquidity requirements associated with our existing operations over the next 12 months.

The following table presents selected financial information for each of the fiscal periods indicated below (in thousands):

	March 31, 2008	September 30, 2008
Cash and cash equivalents	\$ 5,955	\$ 9,467
Short-term investments	2,500	400
Total cash, cash equivalents and short-term investments	\$ 8,455	\$ 9,867

  

	Six Months Ended March 31,	
	2009	2008
Net cash used in operating activities	\$ (1,295)	\$ (221)
Net cash provided by (used in) investing activities	\$ (2,261)	\$ 3,374
Net cash provided by (used in) financing activities	\$ 44	\$ (190)
Net decrease in cash, cash equivalents, end of period	\$ (3,512)	\$ 2,963



## Changes in Cash Flows

During the six months ended March 31, 2009, our net cash used in operating activities was \$1.3 million compared to \$221,000 during the same period in fiscal 2008. This was primarily attributable to our net loss of \$3.0 million, a decrease of \$1.3 million in accounts receivable, an increase of \$377,000 in net inventories, an increase of \$110,000 in accounts payable, an increase of \$375,000 in deferred revenue short-term and an increase of \$106,000 in prepaid expenses. The cash impact of the loss for the six months ended March 31, 2009 was partially offset by a non-cash expense of \$410,000 in stock-based compensation expense and \$110,000 in depreciation and amortization costs. The decrease in accounts receivable was primarily due to lower shipments and good collections during the second quarter of fiscal 2009. Accounts payable increased due to timing of payments to vendors. Inventories increased mostly due to inventory that was not consumed during the period due to decreased sales in second quarter. The increase in deferred revenue for the six months ended March 31, 2009 was primarily due to an increase of \$264,000 from our service support plans and an increase of \$111,000 in deferred channel revenue; due to the volume of products shipped to distribution as apposed to what was sold. We work closely with our distributors to monitor channel inventory levels and attempt to ensure that appropriate levels of products are available to resellers and end users.

Net accounts receivable decreased 54% from \$2.4 million at September 30, 2008 to \$1.1 million at March 31, 2009. Quarterly accounts receivable days sales outstanding (DSO) decreased from 43 days as of September 30, 2008 to 28 days as of March 31, 2009. Net accounts receivable and DSO decrease was primarily due to lower shipments and good collections during the second quarter of fiscal 2009.

Net inventories increased 24% from \$1.6 million at September 30, 2008 to \$1.9 million at March 31, 2009. The increase in net inventories was mostly due to inventory that was not consumed during the period due to decreased sales in the second quarter. Our annualized inventory turn rate, which represents the number of times inventory is replenished during the year decreased from 5.3 turns as of September 30, 2008 to 3.0 turns as of March 31, 2009. 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.

We ended second quarter of fiscal 2009 with a cash conversion cycle of 66 days, as compared to 82 days for second quarter of fiscal 2008. The cash conversion cycle is the duration between purchase of inventories and services and the collection of the cash from the sale of our products and services and is a metric on which we have focused as we continue to try to efficiently manage our assets. The cash conversion cycle results from the calculation of (a) the days of sales outstanding added to (b) the days of supply in inventories and reduced by (c) the days of payable outstanding.

#### Liquidity and Capital Resources

As of March 31, 2009, our principal sources of liquidity included cash, cash equivalents and short-term investments of approximately \$8.5 million. The maturities of our short-term investments are staggered throughout the year to ensure we meet our cash requirements.

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 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 to obtain the right to use complementary technologies. If we cannot raise additional funds in the future if needed, on acceptable terms, we may not be able to further develop or enhance our products, take advantage of 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 the risk or perceived risk of investing in our securities.

We did not have any material commitments for capital expenditures as of March 31, 2009. We had total outstanding commitments on noncancelable capital and operating leases of \$607,000 as of March 31, 2009. Lease terms on our existing facility operating leases generally range from three to nine years. The lease for our headquarters expired on February 21, 2009. In April 2009, the Company entered into a lease for a new corporate headquarters in San Jose, California for a period of five years. In the third quarter of fiscal 2009, we expect to vacate our Fremont office and transition into our new facility.

#### Contractual Obligations

The following table presents certain payments due by us under contractual obligations with minimum firm commitments as of March 31, 2009 (in thousands):

Contractual Obligations	Total	Payment Due by Period		
		Payments Due in Less Than 1 Year	Payments Due in 1 – 3 Years	Payments Due in More Than 5 Years
Operating leases obligation	\$ 552	\$ 179	\$ 373	\$ —
Capital leases obligation	55	22	33	—
Total contractual lease obligation	\$ 607	\$ 201	\$ 406	\$ —

## Effects of Recently Issued Accounting Pronouncements

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

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

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

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

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

(In thousands)	Quoted Prices in Active Markets for Identical Instruments (Level 1)
Cash equivalents (1)	
Money market funds	\$ 3,021
	3,021
Investments (2)	
Agency discount notes	2,500
Cash equivalents and investments	\$ 5,521

(1) Included in cash and cash equivalents on our condensed consolidated balance sheet.

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

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

#### Market Interest Rate Risk

At March 31, 2009, our investment portfolio consisted primarily of fixed income securities, excluding those classified as cash and cash equivalents of \$3.0 million. These securities are subject to interest rate risk and will decline in value if market interest rates increase. Our interest income and expense is most sensitive to fluctuations in the general level of U.S. interest rates. As such, changes in U.S. interest rates affect the interest earned on our cash, cash equivalents and short-term investments, and the fair value of those investments. Due to the short duration and conservative nature of these instruments, we do not believe that we have a material exposure to interest rate risk. For example, if market interest rates were to increase immediately and uniformly by 10% from levels as of March 31, 2009, the decline in the fair value of the portfolio would not have a material effect on our results of operations over the next fiscal year.

#### Foreign Currency Exchange Risk

We transact a portion of our business in non-U.S. currencies, primarily the Chinese Yuan (Renminbi). In the short term, we do not foresee foreign exchange currency fluctuations to pose a material market risk to us. In future periods over the long term, we anticipate we will be exposed to fluctuations in foreign currency exchange rates on accounts receivable from sales in these foreign currencies and the net monetary assets and liabilities of the related foreign subsidiary located in Shanghai, China. A hypothetical 10% favorable or unfavorable change in foreign currency exchange rates would not have a material impact on our results of operations.

### Item 4T. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

Our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of our quarter ended March 31, 2009 pursuant to Exchange Act Rule 13a-15(e) and 15d-15(e). The term “disclosure controls and procedures” is defined under the Exchange Act and means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of our quarter ended March 31, 2009, our disclosure controls and procedures were effective.

#### Changes in Internal Control Over Financial Reporting

There have been no changes in our internal controls over financial reporting during the Company’s fiscal quarter ended March 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

On September 6, 2002, Vertical Networks, Inc. filed suit against us in the United States District Court for the Northern District of California, alleging infringement of U.S. Patents Nos. 6,266,341, 6,289,025, 6,292,482, 6,389,009, and 6,396,849. On October 28, 2002, Vertical Networks amended its complaint to add allegations of infringement of U.S. Patents Nos. 5,617,418 and 5,687,174. Vertical Networks filed a second amended complaint on November 20, 2002 to identify products and/or activities that allegedly infringe the seven patents-in-suit. Vertical Networks' complaint seeks an injunction against future patent infringement, an award of damages, including treble damages for alleged willful infringement, and attorneys' fees and costs. On December 9, 2002, we filed an answer and counterclaims for declaratory relief, and on December 26, 2002, Vertical Networks filed its reply to those counterclaims. On October 4, 2007, the parties entered into a stipulation dismissing the lawsuit in its entirety without prejudice.

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

### Item 1A. Risk Factors

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

In addition to other information contained in this Form 10-Q, investors should carefully consider the following factors that could adversely affect our business, financial condition and operating results as well as adversely affect the value of an investment in our common stock. This Quarterly Report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. All statements other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any statements regarding: projections of revenues, future research and development expenses, future selling, general and administrative expenses, other expenses, gross profit, gross margin, or other financial items; the plans and objectives of management for future operations; our exposure to interest rate risk; future economic conditions or performance; plans to focus on cost control; In some cases, forward-looking statements can be identified by the use of terminology such as "may," "will," "expects," "plans," "anticipates," "estimates," "potential," or "continue," or the negative thereof or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements contained herein are reasonable, there can be no assurance that such expectations or any of the forward-looking statements will prove to be correct, and actual results could differ materially from those projected or assumed in the forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to risks and uncertainties, including but not limited to the factors set forth below and elsewhere in this report. All forward-looking statements and reasons why results may differ included in this Quarterly Report are made as of the date hereof, and we assume no obligation to update any such forward-looking statement or reason why actual results may differ.

#### Business-Related Risks

Our business could be harmed by adverse global economic conditions in our target markets or reduced spending on information technology and telecommunication products.

Current uncertainty in global economic conditions pose a risk to the overall economy as consumers and businesses may defer purchases in response to tighter credit and negative financial news, which could negatively affect product demand and other related matters. Our business depends on the overall demand for information technology, and in particular for telecommunications systems. The market we serve is emerging and the purchase of our products involves significant upfront expenditures. In addition, the purchase of our products can be discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions in our target markets, or a reduction in information technology or telecommunications spending even if economic conditions improve, would likely adversely impact our business, operating results and financial condition in a number of ways, including longer sales cycles, lower prices for our products and reduced unit sales.

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

We have had a history of operating losses since our inception and, as of March 31, 2009, we had an accumulated deficit of \$59.3 million. We may incur operating losses in the future, and these losses could be substantial and impact our ability to attain profitability. We do not expect to significantly increase expenditures for product development, general and administrative expenses, and sales and marketing expenses; however, if we cannot maintain current revenue or revenue growth, we will not achieve or sustain profitability or positive operating cash flows. Even if we achieve profitability and positive operating cash flows, we may not be able to sustain or increase profitability or positive operating cash flows on a quarterly or annual basis.

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

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

- our ability to respond effectively to competitive pricing pressures;
- our ability to establish or increase market acceptance of our technology, products and systems;
- our success in expanding our network of distributors, dealers and companies that buy our products in bulk, customize them for particular applications or customers, and resell them under their own names;
- market acceptance of products and systems incorporating our technology and enhancements to our product applications on a timely basis;
- our success in supporting our products and systems;
- our sales cycle, which may vary substantially from customer to customer;
- unfavorable changes in the prices and delivery of the components we purchase;
- the size and timing of orders for our products, which may vary depending on the season, and the contractual terms of the orders;
- the size and timing of our expenses, including operating expenses and expenses of developing new products and product enhancements;
- deferrals of customer orders in anticipation of new products, services or product enhancements introduced by us or by our competitors; and
- our ability to attain and maintain production volumes and quality levels for our products.

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

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

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

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

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

We face competition from companies providing traditional private telephone systems. Our principal competitors that produce these telephone systems are Avaya Communications, NEC and Nortel Networks. We also compete against providers of multi-function telecommunications systems, including 3Com Corporation, ShoreTel and Cisco Systems, Inc., as well as any number of future competitors. Many of our competitors are substantially larger than we are and have significantly greater name recognition, financial resources, sales and marketing teams, technical and customer support, manufacturing capabilities and other resources. These competitors also may have more established



distribution channels and stronger relationships with service providers. These competitors may be able to respond more rapidly to new or emerging technologies and changes in customer requirements or to devote greater resources to the development, promotion and sale of their products. These competitors may enter our existing or future markets with products that may be less expensive, provide higher performance or additional features or be introduced earlier than our phone systems. We also expect that other companies may enter our market with better products and technologies. If any technology that is competing with ours is more reliable, faster, less expensive or has other advantages over our technology, then the demand for our products and services could decrease and harm our business.

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

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

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

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

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

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

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

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

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

Our customers and end users expect frequent product introductions and have changing requirements for new products and features. In order to be competitive, we need to develop and market new products and product enhancements that

respond to these changing requirements on a timely and cost-effective basis. Our failure to do so promptly and cost effectively would seriously harm our business, financial condition and results of operations. Also, introducing new products could require us to write-off existing inventory as obsolete, which could harm our results of operations.

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

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

If we fail to establish and maintain proper and effective internal control over financial reporting, our operating results and our ability to operate our business could be harmed.

The Sarbanes-Oxley Act of 2002 requires, among other things, that we establish and maintain internal control over financial reporting and disclosure controls and procedures. In particular, under the current rules of the SEC, beginning with the year ended September 30, 2010, we must perform system and process evaluation and testing of our internal control over financial reporting to allow management to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. Our independent registered public accounting firm is also required to report on our internal control over financing reporting. We have incurred and we expect to continue to incur substantial accounting and auditing expense and expend significant management time in complying with the requirements of Section 404. If we are not able to comply with the requirements of Section 404 in a timely manner, or if we or our independent registered public accounting firm identify deficiencies in our internal control over financial reporting that are deemed to be material weaknesses, the market price of our stock could decline and we could be subject to investigations or sanctions by the SEC, The NASDAQ Capital Market, or NASDAQ, or other regulatory authorities or subject to litigation. To the extent any material weaknesses in our internal control over financial reporting are identified in the future, we could be required to expend significant management time and financial resources to correct such material weaknesses or to respond to any resulting regulatory investigations or proceedings.

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

We have experienced a period of rapid growth in our headcount and operation over the last two years; we have substantially increased our workforce and expanded our channel partner network and the number and size of enterprise customers implementing our systems. In the event our products obtain greater market acceptance, we may be required to expand our operations. This growth has placed, and anticipated future growth will place, a significant strain on our management, administrative, operational and financial infrastructure. Our success will depend in part upon our ability to manage this growth effectively. To manage the expected growth of our operations and personnel, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. Failure to effectively manage growth could result in difficulty in filling enterprise customer orders, declines in product quality or customer satisfaction, increases in costs or other production and distribution difficulties, and any of these difficulties could adversely impact our business performance and results of operations.

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

Sales through our three key distributors, Altisys, Synnex and Jenne, accounted for 51% of our net revenue in the quarter ended March 31, 2009. Our business and operating results will suffer if any one of these distributors does not continue distributing our products, fails to distribute the volume of our products that it currently distributes or fails to expand our customer base. We also need to establish and maintain relationships with additional distributors and original equipment manufacturers.

We may not be able to establish, or successfully manage, relationships with additional distribution partners. In addition, our agreements with distributors typically provide for termination by either party upon written notice to the other party. For example, our agreement with Synnex provides for termination, with or without cause, by either party upon 30 days' written notice to the other party, or upon insolvency or bankruptcy. Generally, these agreements are non-exclusive and distributors sell products that compete with ours. If we fail to establish or maintain relationships with distributors and original equipment manufacturers, our ability to increase or maintain our sales and our customer base will be substantially harmed.

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

We purchase technology that is incorporated into many of our products, including virtually all of our hardware products, from a single third-party supplier. 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.

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

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ National Market rules, are creating uncertainty for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. As a result, our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding our required assessment of our internal controls over financial reporting and beginning with the year ended September 30, 2010, our external auditor's audit of the effectiveness of our internal controls over financial reporting has required the commitment of significant financial and managerial resources. We expect these efforts to require the continued commitment of significant resources. Further, our board members, chief executive officer, and chief financial officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which could harm our business. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed.

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

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

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

We may begin to outsource a substantial amount of our product assembly and test functions. This outsourcing strategy involves certain risks, including the potential lack of adequate capacity and reduced control over delivery schedules, manufacturing yield, quality and costs. In the event that any significant subcontractors were to become unable or unwilling to continue to manufacture or test our products in the required volumes, we would have to identify and qualify acceptable replacements. Finding replacements could take time and we cannot be sure that additional sources would be available to us on a timely basis. Any delay or increase in costs in the assembly and testing of products by third-party subcontractors could seriously harm our business, financial condition and results of operations.

Our expansion in international markets has been slow and steady. However, our plan is to accelerate this growth rate and 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.

In the quarter ended March 31, 2009, approximately 14% of our net revenue came from customers outside of the Americas. We intend to expand our international sales and marketing efforts. Our efforts are subject to a variety of risks associated with conducting business internationally, any of which could seriously harm our business, financial condition and results of operations. These risks include:

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

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

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

Although we have been issued sixteen patents and expect to continue to file 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 the patents to which we own rights, may obtain access to our know-how or may claim to have issued patents that prevent the sale of one or more of our products. Also, it may be possible for third parties to obtain and use our proprietary information without our authorization. Further, the laws of some countries, such as those in Japan, one of our target markets, may not adequately protect our intellectual property or such protection may be uncertain. Our success also depends on trade secrets that cannot be patented and are difficult to protect. If we fail to protect our proprietary information effectively, or if third parties use our proprietary technology without authorization, our competitive position and business will suffer.

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

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

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

We may become parties to litigation in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex litigation are difficult to predict. We were previously a defendant in a patent infringement suit brought by Vertical Networks. On October 4, 2007, the parties entered into a stipulation dismissing the lawsuit in its entirety without prejudice. Consequently, Vertical Networks may reassert these or related claims in one or more separate proceedings.

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

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

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

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

Integrated, multifunction telecommunications systems may not achieve widespread acceptance.

The market for integrated, multifunction telecommunications systems is relatively new and rapidly evolving. Businesses have invested substantial resources in the existing telecommunications infrastructure, including



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

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

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

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

The Federal Communications Commission (FCC) has submitted a report to Congress stating that it may regulate certain Internet services if it determines that such Internet services are functionally equivalent to conventional telecommunications services. The increasing growth of the voice over data network market and the popularity of supporting products and services, heighten the risk that national governments will seek to regulate the transmission of voice communications over networks such as the Internet. In addition, large telecommunications companies may devote substantial lobbying efforts to influence the regulation of this market so as to benefit their interests, which may be contrary to our interests. These regulations may include, for example, assessing access or settlement charges, imposing tariffs or imposing regulations based on encryption concerns or the characteristics and quality of products and services. In February 2004, the FCC found that an entirely Internet based voice over Internet protocol service was an unregulated information service. At the same time, the FCC began a broader proceeding to examine what its role should be in this new environment of increased consumer choice and what can be done to meet its role of safeguarding the public interest. Future laws, legal decisions or regulations, as well as changes in interpretations of existing laws and regulations, could require us to expend significant resources to comply with them. In addition, these future events or changes may create uncertainty in our market that could reduce demand for our products.

#### Risks Related to Ownership of our Common Stock

Our stock price may be volatile.

The trading price of our common stock has been and may continue to be volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control. Factors that could affect the trading price of our common stock could include:

- variations in our operating results;
- announcements of technological innovations, new products or product enhancements, strategic alliances or significant agreements by us or by our competitors;
- the gain or loss of significant customers;
- recruitment or departure of key personnel;
- the impact of unfavorable worldwide economic and market conditions, including the restricted credit environment impacting credit of our customers;
- changes in estimates of our operating results or changes in recommendations by any securities analysts who follow our common stock;
  - significant sales, or announcement of significant sales, of our common stock by us or our stockholders; and
  - adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, the stock market in general, and the market for technology companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of our common stock, regardless of our actual operating performance. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

If securities or industry analysts do not publish research or reports about our business, or if they issue an adverse or misleading opinion regarding our stock, our stock price and trading volume could decline.

The trading market for our common stock will be influenced by the research and reports that industry or securities analysts publish about us or our business. If any of the analysts who cover us issue an adverse or misleading opinion regarding our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company or fail to publish reports on us regularly, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

We may choose to raise additional capital. Such capital may not be available, or may be available on unfavorable terms, which would adversely affect our ability to operate our business.

We expect that our existing cash balances will be sufficient to meet our working capital and capital expenditure needs for the foreseeable future. If we choose to raise additional funds, due to unforeseen circumstances or material expenditures, we cannot be certain that we will be able to obtain additional financing on favorable terms, if at all, and any additional financings could result in additional dilution to our existing stockholders.

Provisions in our charter documents, Delaware law, employment arrangements with certain of our executive officers and Preferred Stock Rights Agreement could discourage a takeover that stockholders may consider favorable.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. These provisions include but are not limited to the following:

- our board of directors has the right to increase the size of the board of directors and to elect directors to fill a vacancy created by the expansion of the board of directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors;
- our board of directors is staggered into three (3) classes and each member is elected for a term of 3 years, which prevents stockholders from being able to assume control of the board of directors;
- our stockholders may not act by written consent and are limited in their ability to call special stockholders' meetings; as a result, a holder, or holders, controlling a majority of our capital stock would be limited in their ability to take certain actions other than at annual stockholders' meetings or special stockholders' meetings called by the board of directors, the chairman of the board or the president;
- our certificate of incorporation prohibits cumulative voting in the election of directors, which limits the ability of minority stockholders to elect director candidates;
- stockholders must provide advance notice to nominate individuals for election to the board of directors or to propose matters that can be acted upon at a stockholders' meeting, which may discourage or deter a potential acquiror from conducting a solicitation of proxies to elect the acquiror's own slate of directors or otherwise attempting to obtain control of our company; and
- our board of directors may issue, without stockholder approval, shares of undesignated preferred stock; the ability to issue undesignated preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.

As a Delaware corporation, we are also subject to certain Delaware anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us.

Certain of our executive officers may be entitled to accelerated vesting of their options pursuant to the terms of their employment arrangements upon a change of control of AltiGen. In addition to the arrangements currently in place with some of our executive officers, we may enter into similar arrangements in the future with other officers. Such arrangements could delay or discourage a potential acquisition of AltiGen.

Our board of directors declared a dividend of one (1) right for each share of Common Stock under the terms and conditions of a Preferred Stock Rights Agreement by and between AltiGen and Computershare Trust Company, N.A. dated April 21, 2009, which right is exercisable for shares of AltiGen's Preferred Stock after the date on which a hostile acquiror obtains, or announces a tender offer for, 15% or more of the Company's Common Stock. If an acquiror obtains 15% or more of the Company's Common Stock, each stockholder (except the acquiror) may purchase either our Common Stock or in certain circumstances, the acquiror's Common Stock, at a discount, resulting in substantial dilution to the acquiror's interest. Such rights could delay or discourage a potential acquisition of AltiGen.

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

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

Repurchases of our common stock under the latest Board of Directors' authorization is represented in the following table:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Approximate Dollar Value of	
			Shares Purchased as Part of Publicly Announced Program	Shares that May Yet be Purchased as Part of the Program
November 1, 2007 through November 30, 2007	16,413	\$ 1.59	16,413	\$ 1,973,965
December 1, 2007 through December 31, 2007	92,965	1.60	92,965	1,825,685
February 1, 2008 through February 29, 2008	80,218	1.66	80,218	1,692,660
March 1, 2008 through March 31, 2008	23,919	1.61	23,919	1,654,084
August 1, 2008 through August 31, 2008	7,211	1.21	7,211	1,645,374
September 1, 2008 through September 30, 2008	10,409	1.16	10,409	1,633,338
December 1, 2008 through December 31, 2008	10,400	0.77	10,400	1,625,311
January 1, 2009 through January 31, 2009	4,275	0.79	4,275	1,621,953
February 1, 2009 through February 28, 2009	3,325	0.87	3,325	1,619,045
March 1, 2009 through March 31, 2009	5,800	0.79	5,800	1,614,461
<b>Total</b>	<b>254,935</b>	<b>\$ 1.51</b>	<b>254,935</b>	<b>\$ 1,614,461</b>

Item 6. Exhibits.

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

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SIGNATURE

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

ALTIGEN COMMUNICATIONS, INC.

Date: May 14, 2009

By: /s/ Philip M. McDermott  
Philip M. McDermott  
Chief Financial Officer

EXHIBIT INDEX

Exhibit Number	Description
3.1 (1)	Amended and Restated Certificate of Incorporation.
3.2 (2)	Second Amended and Restated Bylaws.
3.3(3)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of AltiGen Communications, Inc.
4.1(4)	Preferred Stock Rights Agreement, dated as of April 21, 2009, between AltiGen Communications, Inc. and Computershare Trust Company, N.A., including the Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B and C, respectively.
10.19(5)	Amended and Restated Executive Employment Agreement by and between Philip McDermott and the Company, dated March 6, 2009.
10.20	Executive Employment Agreement by and between Jeremiah J. Fleming and the Company, dated December 18, 2007.
10.21(6)	Executive Employment Agreement by and between Gilbert Hu and the Company, dated March 6, 2009.
31.1	Certification of Principal Executive Officer, filed herewith.
31.2	Certification of Principal Financial Officer, filed herewith.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

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- (1) Incorporated by reference to exhibit filed with the Registrant's Registration Statement on Form S-1 (No. 333-80037) declared effective on October 4, 1999.
  - (2) Incorporated by reference to exhibit filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.
  - (3) Incorporated by reference to exhibit filed with the Registrant's Registration Statement on Form 8-A on April 23, 2009.
  - (4) Incorporated by reference to exhibit filed with the Registrant's Current Report on Form 8-K on April 23, 2009.
  - (5) Incorporated by reference to exhibit filed with the Registrant's Current Report on Form 8-K on March 10, 2009.
  - (6)



Incorporated by reference to exhibit filed with the Registrant's Current Report on Form 8-K on March 10, 2009.