CALLWAVE INC
Form 10-Q
February 14, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended December 31, 2005

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: 000-50958

CallWave Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0490995**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

136 West Canon Perdido Street, Suite A, Santa Barbara, California 93101

(Address of principal executive offices)

(Zip code)

(805) 690-4100

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ or a Non-accelerated filer x

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

At February 13, 2006, the number of shares outstanding of the registrant s common stock, $0.0001 par value, was 20,674,410.

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CALLWAVE INC.

Form 10-Q

For the Quarter Ended December 31, 2005

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CALLWAVE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except par value)

	As of December 31, 2005	As of June 30, 2005
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 35,375	$ 16,828
Marketable securities	26,563	39,996
Restricted cash	336	335
Accounts receivable; net of allowance for doubtful accounts of $370 and $370	4,583	5,676
Inventory		454
Prepaid income tax	335	113
Other current assets	589	476
Total current assets	67,781	63,878
Property and equipment, net	1,750	2,024
Deferred tax asset		2,929
Other assets	49	414
Total assets	$ 69,580	$ 69,245
Liabilities And Stockholders Equity		
Current liabilities:		
Accounts payable	$ 616	$ 801
Accrued payroll	545	1,014
Deferred revenue	896	1,587
Other current liabilities	1,913	1,447
Total current liabilities	$ 3,970	$ 4,849
Commitments and contingencies		
Stockholders equity:		
Common stock, $0 par value; 100,000 and 50,000 shares authorized at December 31, 2005 and June 30, 2005, respectively; 20,636 and 19,799 shares issued and outstanding at December 31, 2005 and June 30, 2005, respectively	71,494	70,296
Deferred compensation		(545)
Accumulated comprehensive loss	(68)	(24)
Accumulated deficit	(5,816)	(5,331)
Total stockholders equity	65,610	64,396
Total liabilities and stockholders equity	$ 69,580	$ 69,245

See accompanying notes

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CALLWAVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2005	2004	2005	2004
Revenues	$ 9,538	$ 11,669	$ 20,109	$ 22,714
Cost of sales	3,390	2,942	7,151	6,114
Gross profit	6,148	8,727	12,958	16,570
Operating expenses:				
Sales and marketing	2,026	2,857	4,135	4,974
Research and development	1,320	1,608	2,536	3,276
General and administrative	2,501	1,806	4,683	3,081
Impairment of long-lived assets			243	
Total operating expenses	5,847	6,271	11,597	11,331
Operating income	301	2,456	1,361	5,239
Interest income (expense), net	578	266	1,083	317
Income before income taxes	879	2,722	2,444	5,556
Income tax expense (benefit)	2,296	(1,643)	2,929	(1,709)
Net income (loss)	$ (1,417)	$ 4,365	$ (485)	$ 7,265
Net income (loss) per share:				
Basic	$ (0.07)	$ 0.23	$ (0.02)	$ 0.56
Diluted	$ (0.07)	$ 0.20	$ (0.02)	$ 0.38
Weighted average common shares outstanding				
Basic	20,617	19,184	20,487	12,862
Diluted	20,617	21,381	20,487	19,373

See accompanying notes.

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CALLWAVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended December 31, 2005	Six Months Ended December 31, 2004
Cash flows from operating activities:		
Net income (loss)	$ (485)	$ 7,265
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	425	384
Impairment of long-lived assets	243	
Share based compensation	209	122
Deferred tax asset	2,929	(1,149)
Inventory writeoff	314	
Bad debt expense	1,084	576
Changes in operating assets and liabilities:		
Accounts receivable, net of bad debt expense	9	(1,671)
Inventory	140	
Prepaid income tax	(222)	(113)
Other assets	9	114
Accounts payable	(185)	420
Accrued payroll	(469)	(205)
Deferred revenues	(691)	(215)
Income taxes payable		(790)
Accrued other liabilities	466	591
Net cash provided by operating activities	3,776	5,329
Cash flows from investing activities:		
Purchases of marketable securities	(7,326)	(20,223)
Sales of marketable securities	20,713	
Purchases of property and equipment	(151)	(398)
Net cash provided by (used in) investing activities	13,236	(20,621)
Cash flows from financing activities:		
Exercises of stock options and warrants	1,535	1,198
Proceeds from initial public offering		37,200
Costs incurred in initial public offering		(1,975)
Net cash provided by financing activities	1,535	36,423
Net increase in cash and cash equivalents	18,547	21,131
Cash and cash equivalents at beginning of the period	16,828	6,187
Cash and cash equivalents at end of the period	$ 35,375	$ 27,318

Supplemental disclosures of cash flow information		
Cash paid for:		
Income taxes	$ 223	$ 343
Supplemental schedule of non-cash transactions		
Equity based deferred compensation	$	$ 515

See accompanying notes.

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CallWave Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. The Company and Basis of Presentation

Description of business CallWave, Inc. (CallWave, or the Company), was incorporated in August 1998, first marketed its free services in February 1999 and began marketing paid subscription services in April 2001. CallWave provides software-based communications application services that bridge calls across existing landline, mobile and Internet networks.

Basis of Presentation The accompanying unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company s financial position, results of operations and cash flows for the periods shown. The results of operations for such periods are not necessarily indicative of the results expected for a full year or for any future period.

These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s year end financial statements included in the Form 10-K filed with the Securities and Exchange Commission.

Use of estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The primary accounts that are particularly sensitive to changes in estimates are the allowance for doubtful accounts, inventory allowance, net realizable value of investments and the valuation allowance for the deferred tax asset. Actual results could differ from those estimates.

Revenue recognition The Company earns revenues from paid subscriber services, and to a lesser extent, fees earned from local exchange carrier call termination access charges, advertisements and the offering of third-party products and services to our subscribers. Beginning in fiscal year 2005, the Company entered the prepaid mobile phone market by selling prepaid phones to a distributor and on a subsidized basis directly to its subscriber.

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States and with Securities and Exchange Commission Staff Accounting Bulletin 104 (SAB 104), *Revenue Recognition,* which clarifies certain existing accounting principles for the timing of revenue recognition and classification of revenues in the financial statements. The Company recognizes revenue ratably beginning when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the fees are fixed and determinable and collection is reasonably assured. Install fees are recorded as deferred revenues and amortized to revenue over the expected period of performance, or the estimated average customer subscription life.

In addition to the direct relationship that the Company has with the majority of its paid subscribers, the Company also has channel relationship agreements with Internet service providers (ISPs) and other companies whereby those companies customers are offered a co-branded subscription service. When the agreement provides that the Company is the party responsible for providing the service, has control over the fees charged to customers and bears the credit risk, the Company records the gross amount billed as revenue in accordance with Emerging Issues Task Force 99-19 (EITF 99-19), *Reporting Revenues Gross as a Principal Versus Net as an Agent*. When the agreement provides that CallWave receive a net payment from those companies, based upon the number of their customers registered for CallWave s services, CallWave records the net amount received from those companies as revenue in accordance with EITF 99-19.

In the third quarter of fiscal 2005, the Company purchased prepaid phones and phone cards with the intention of reselling them with a 30-day free trial of CallWave s application-based services and entered into an agreement to sell a portion of these prepaid phones and phone cards to a distributor. Revenue from the sale of prepaid phones and phone cards is recognized when the SAB 104 criteria are met. The Company recognizes sales to this distributor on a sell-through basis and when the cash is collected from the distributor. The Company recognized $92,000 and $225,000 of revenue related to the sale to this distributor in the three and six months ended December 31, 2005, respectively.

Beginning in the fourth quarter of fiscal 2005, the Company began selling prepaid phones into which the CallWave technology is embedded to its subscriber base. These transactions contain multiple elements, including the phone, the minutes, and our CallWave service, to which we have applied EITF 00-21, *Revenue Arrangements with Multiple Deliverables.* The various elements of the arrangement are separable and each element is recognized separately in accordance with SAB 104. In accounting for multiple deliverables, management s judgment is necessary when identifying the nature of deliverables in an arrangement as well as measuring and allocating fair value to the multiple deliverables.

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In the second quarter of fiscal 2006, the Company changed its marketing strategy for the CallWave for Mobile services to give prepaid cell phones to customers at no cost if they signed up for a one month trial subscription to CallWave services and reimbursed the Company s shipping and handling costs. The phones are recorded as cost of sales to generate subscription services revenue in accordance with EITF 01-9, *Accounting for Consideration Given by a Vendor to a Customer*. The reimbursement of shipping and handling costs is recorded as an offset to cost of sales.

Deferred revenue Deferred revenue consists of customer prepayments of subscription fees, which will be earned in the future under agreements existing at the balance sheet date. Deferred revenue is amortized ratably over the period in which services are provided.

Marketable securities Marketable securities consist of investment grade government agency and corporate debt securities due within one year. Investments with maturities beyond one year are classified as short-term based on their highly liquid nature and because such investments represent the investment of cash that is available for current operations. All investments are classified as available-for-sale and are recorded at market value. Unrealized gains and losses are reflected in other comprehensive income.

Comprehensive income (loss): Comprehensive net income (loss) was ($529,000) and $7,265,000 for the six months ended December 31, 2005 and 2004, respectively. The comprehensive net income differs from the net income by the net unrealized gain or loss on short-term investments.

Inventories: Inventories consist of finished goods and are stated at the lower of cost or market, cost being determined under the first-in, first-out method. Inventory at December 31, 2005 and June 30, 2005 consisted of the following:

	December 31, 2005	June 30, 2005
CallWave inventory	$	$ 243,000
Inventory at distributors	60,000	286,000
Valuation Allowance	(60,000)	(75,000)
Total inventory	$	$ 454,000

At June 30, 2005, CallWave inventory consisted of prepaid cell phones and phone cards that the Company held for sale. The value of the phone cards was determined to be impaired in the quarter ended September 30, 2005, and reduced to net realizable value, or zero. Due to a change in marketing strategy, the phones are now given to customers at no cost if they register for a one month trial subscription to CallWave services and reimburse the Company s shipping and handling costs. As the phones are no longer held for sale, they are not recorded as inventory, but are expensed as purchased.

Inventory at distributors represents phone cards sold to distributors accounted for on the sell-through basis which are fully reserved since the distributor has not sold them through to its customers. Management s judgment is required in determining net realizable value and the extent of any impairment to our inventory. Judgment is also required in determining the collectibility of amounts that are due from our distributors as a result of selling our inventory through to end customers.

Concentrations of credit risk The Company has a concentration of credit risk from an agreement with a vendor for billing and collection services provided for a portion of the Company s paid users. The Company would be subject to sustaining a loss relative to its current receivable balance if the vendor failed to perform under the terms of the agreement. The receivable from the vendor at December 31, 2005 and June 30, 2005 was $4,375,000 and $5,152,000, respectively.

The Company s cash balances at financial institutions exceed the maximum amounts insured by the Federal Deposit Insurance Corporation.

I*nvestments in minority owned companies* The Company accounts for investments in minority interests of other companies over which it does not exercise significant influence on the cost method in accordance with SFAS 115*, Accounting for Certain Investments in Debt and Equity Securities*. Under the cost method, an investment is carried at cost until it is sold or there is evidence that changes in the business environment or other facts and circumstances suggest it may be other than temporarily impaired based on criteria outlined in FAS Staff Position Nos. FAS 115-1 and FAS 124-1 and on EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.*

Share-Based Compensation The Company adopted FAS 123(R), *Share-Based Payment,* using the modified-prospective-transition-method as of July 1, 2005. Historically, the Company elected to account for employee stock compensation under the fair value method in accordance with SFAS 123, *Accounting for Stock-Based Compensation,* and had reflected compensation expense related to the fair value of options issued to employees in the statement of operations. See further discussion in Note 4.

Income taxes Income taxes are recorded in accordance with SFAS 109, *Accounting for Income Taxes*. SFAS 109 requires the recognition of deferred tax assets and liabilities to reflect the future tax consequences of events that have been recognized in the

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Company s financial statements or tax returns. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of the Company s assets and liabilities result in a deferred tax asset, SFAS 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such assets. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized.

Net income (loss) per share The Company computes net income (loss) per share in accordance with SFAS 128, *Earnings per Share*. Under the provisions of SFAS 128, basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of shares issuable upon exercise of stock options and warrants and conversion of convertible preferred stock. The dilutive effect of outstanding stock options and warrants is reflected in diluted income per share by application of the treasury stock method. As of July 1, 2005, the date the Company adopted FAS 123(R), deferred compensation related to unvested outstanding options is included as a component of proceeds upon exercise in calculation of the diluted shares under the treasury stock method. Convertible preferred stock is reflected on an if-converted basis.

For the three and six month periods ended December 31, 2005, potential common shares resulting from outstanding options and warrants were not included in the diluted earnings per share calculation as their inclusion would be anti-dilutive.

The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
	(unaudited, in thousands except per share data)			
Basic and diluted net income (loss) per share:				
Net income (loss) attributable to common stockholders	$ (1,417)	$ 4,365	$ (485)	$ 7,265
Weighted-average common shares outstanding	20,617	19,184	20,487	12,862
Effect of dilutive securities:				
Stock options and warrants		2,197		2,288
Convertible preferred shares				4,223
Weighted-average common shares outstanding for diluted calculation	20,617	21,381	20,487	19,373
Net income (loss) per share:				
Basic	$ (0.07)	$ 0.23	$ (0.02)	$ 0.56
Diluted	$ (0.07)	$ 0.20	$ (0.02)	$ 0.38

Options to purchase 967,000 and 59,000 shares with exercise prices equal to or greater than the average fair value of common stock were outstanding during the six months ended December 31, 2005 and 2004, respectively. These options were also excluded from the respective computations of diluted earnings per share because their effect would be anti-dilutive.

2. Related Party Transactions

In February 2004, the Company entered into an agreement with Insight Venture Management, LLC, an affiliate of Insight Venture Associates IV, LLC, a shareholder of the Company, to make available to it certain of Insight s business development personnel to assist the Company with market assessment, research and analysis. Under the terms of this agreement, the Company paid Insight $75,000 per year, payable in four quarterly installments at the end of each calendar quarter. The price paid in this transaction was determined by considering the market rate for business development personnel possessing similar skills and experience. The Company terminated this agreement in February 2005.

3. Stockholders Equity

Common Stock

As of December 31, 2005, the Company is authorized to issue 100,000,000 shares of common stock. As of December 31, 2005, 2,399,000 shares of common stock are reserved for the 120,000 warrants and 2,279,000 stock options issued and outstanding.

The Company s board of directors has the authority without further action by the stockholders, to issue up to 10,000,000 shares of preferred stock in one or more series, to establish from time to time the number of shares to be included in each such series, to fix the rights, preferences and privileges of the shares of each wholly unissued series and any qualifications, limitations or restrictions thereon, and to increase or decrease the number of shares of any such series (but below the number of shares of such series then outstanding).

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Warrants

As of December 31, 2005, the Company has issued and outstanding warrants to purchase up to 120,000 shares of common stock at exercise prices of between $0.55 - $4.00. The Company had 293,000 warrants issued and outstanding at June 30, 2005, and 173,000 warrants were exercised during the six months ended December 31, 2005.

4. Share-Based Payments

FAS 123(R) Adoption

At December 31, 2005, the Company has three stock-based employee compensation plans which are described more fully below. Prior to July 1, 2005, the Company accounted for those plans under the recognition and measurement provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation.* Effective July 1, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment*, using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the three months ended September 30, 2005 includes the compensation expense that had been recognized under FAS 123 reduced by the amount of (a) estimated forfeitures related to the share-based payments granted prior to, but not yet vested as of July 1, 2005, and (b) estimated forfeitures for all share based payments granted subsequent to July 1, 2005. Results for prior periods have not been restated.

As a result of adopting FAS 123(R) on July 1, 2005, the Company s income (loss) before income taxes and net income (loss) for the three and six months ended December 31, 2005, are $57,000 and $100,000, respectively, higher than if it had continued to account for forfeitures as they occurred which was permissible under FAS 123 but not under FAS 123(R).

FAS 123(R) requires companies to record as paid-in-capital, any tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) unless the company has net operating losses. In accordance with FAS 123(R) guidance regarding companies with net operating losses, the Company will not record any excess tax benefits until the deduction actually reduce taxes payable.

Stock Option Plans

At December 31, 2005, the Company has three share-based compensation plans, which are described below. Compensation cost that has been charged to expense for those plans was $209,000 and $515,000 for the three months ended December 31, 2005 and 2004, respectively.

The Company s stock option plans consist of the 2004 Option Plan, the 2000 Option Plan and the 1999 Option Plan. Shares reserved under these plans at December 31, 2005, consist of 1,700,000 shares, 2,250,000 shares and 1,350,000 shares authorized of which 855,538, 1,089,965 and 333,370 options are outstanding under the 2004, 2000 and 1999 Option Plans, respectively.

The Company s board of directors grants options at an exercise price equal to the fair market value of the Company s common stock at the date on which the grant is approved by the board. Stock options granted prior to the Company s initial public offering had a term of ten years from the date on which the grant is approved by the board. Options granted subsequent to the Company s initial public offering have a term of five years. Generally, stock options vest 1/8th after six months, and 1/48th per month thereafter, becoming fully vested in four years. The weighted-average fair value of stock options granted is estimated at the date of grant using the Black-Scholes option pricing model and the following assumptions:

	Three Months Ended December 31,		Six-Months Ended December 31,	
	2005	2004	2005	2004
Weighted average fair value of stock options granted	$ 1.83	$ 4.41	$ 1.94	$ 1.74
Risk free interest rate	4.36%	4.12%	4.19%	4.27%
Expected life (in years)	4.0	4.0	4.0	4.0
Expected volatility	50.0%	50.00%	50.0%	2.94%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%

Expected volatilities are based on the historical volatility of the Company s stock and other factors. The Company uses historical data to estimate option exercise and employee termination within the model. Separate groups of options with similar pricing are considered separately for valuation purposes. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury rate in effect at the time of the grant.

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A summary of option activity under the plans as of December 31, 2005, and changes during the quarter and six months then ended is presented below:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Contractual Term	Aggregate Intrinsic Value
Balance June 30, 2005	**2,502,189**	**$ 3.48**		
Options granted	471,826	4.56		
Options exercised	(627,923)	1.63		
Options forfeited or expired	(17,403)	3.49		
Balance September 30, 2005	**2,328,689**	**$ 4.20**		
Options granted	201,000	4.20		
Options exercised	(41,759)	2.09		
Options forfeited or expired	(209,057)	8.13		
Balance December 31, 2005	**2,278,873**	**$ 3.88**	**5.42**	**$ 2,538,000**
Exercisable at December 31, 2005	**1,199,369**	**$ 3.33**	**5.33**	**$ 1,992,000**

The total intrinsic value of options exercised during the six months ended December 31, 2005 and 2004, was $102,000 and $61,000, respectively.

A summary of the status of the Company s nonvested shares as of December 31, 2005 and changes during the six month period ended December 31, 2005, is presented below:

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested Shares		
Nonvested at July 1, 2005	**828,737**	**$ 1.36**
Granted	471,826	1.98
Vested	(88,054)	1.13
Forfeited	(16,233)	0.58
Nonvested at September 30, 2005	**1,196,276**	**$ 1.63**
Granted	201,000	1.83
Vested	(109,766)	1.38
Forfeited	(208,006)	1.72
Nonvested at December 31, 2005	**1,079,504**	**$ 1.17**

As of December 31, 2005, there was $1.7 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over a weighted-average period of 2.1 years. The total fair value of shares vested during the six months ended December 31, 2005 and 2004 was $245,000 and $125,000, respectively.

5. Investment in Minority Owned Company

On January 6, 2005, the Company acquired a minority interest in a UK company (the investee) for $125,000 which was recorded on the cost method of accounting for investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Additionally, the investee issued to the Company a $125,000 promissory note due January 6, 2011. The promissory note is convertible into common stock in certain circumstances and bears interest at 4% per year, compounded monthly. The Company also purchased a license to the investee s technology for five years for $125,000, which was amortized to expense over the life of the license. A total of $375,000 was recorded as Other Assets. At September 30, 2005, the Company determined that the investment in and receivable from the investee was other than temporarily impaired and recorded an impairment loss in the amount of $253,000. This impairment loss was partially offset by a gain of $10,000 on the sale of an asset that had been previously written off. At December 31, 2005, the Company wrote off the remaining unamortized cost of the license in the amount of $106,000 to research and development expense as it decided not to pursue use of the license.

6. Commitments and Contingencies

Leases

The Company leases office space under non-cancelable operating leases. Rental expense under operating lease agreements was $95,000 and $118,000 for the three months ended December 31, 2005 and 2004, respectively, and $222,000 and $237,000 for the six months ended December 31, 2005 and 2004, respectively.

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Future minimum commitments remaining under these agreements as of December 31, 2005, are as follows:

	Minimum Commitment
	(in thousands)
Fiscal Year Ending September 30:	
2005	$ 333
2006	707
2007	694
2008	481
2009	493
2010	41

Other Commitments and Contingencies

The Company has long-distance service agreements with four carriers. As of December 31, 2005, minimum obligations under these agreements due within one year total $2.0 million. However, the Company expects to maintain some form of long-distance service agreements indefinitely, and will likely assume similar obligations following the expiration of these agreements. As of September 30, 2005, minimum obligations due within one year under agreements with providers of billing and collection services total $98,000.

The Company and its subsidiaries are subject to certain claims and may encounter future legal claims in the normal course of business. In the opinion of the Company s management, the resolution of existing legal claims are not expected to have a material adverse impact on the Company s financial position, results of operations or cash flows. See Note 8 for additional discussion of litigation.

7. Income Taxes

The provision for income taxes consists of the following for each of the periods ended:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	2004	2005	2004
Current federal provision	$	$ 334	$	$ 542
Current state	1	17	1	168
Deferred (benefit)	1,295	(1,994)	2,928	(2,419)
	$ 1,296	$ $(1,643)	$ 2,929	$ (1,709)

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which temporary differences and net operating losses become deductible and tax credits become usable. Use of net operating loss and other carryforwards are limited by the change of ownership rules described below. Due to the uncertainty surrounding the timing of realizing the benefits of its NOLs and other favorable tax attributes in future tax returns, the Company has placed a valuation allowance against its otherwise recognizable deferred tax assets. The valuation allowance increased by approximately $2.4 million during the quarter ended December 31, 2005.

As of December 31, 2005, the Company has cumulative net operating loss carryforwards for federal and California income tax purposes of approximately $4.3 million and $14.6 million, respectively. The losses begin to expire in fiscal year 2009 if unused. In addition, the Company has available tax credit carryforwards of approximately $2.0 million and $.5 million for federal and California tax purposes, respectively. The federal tax credits begin to expire in 2028. California tax credits can be carried over indefinitely.

Due to the change of ownership provision of the Tax Reform Act of 1986, utilization of the Company s net operating loss and tax credit carryforwards are subject to an annual limitation against taxable income in future periods. As a result of the annual limitation, a portion of these carryforwards may expire before ultimately becoming available to reduce future income tax liabilities. In addition, the Company is preparing an analysis of the change of ownership provision on its California state operating loss carryforwards. Management believes that such analysis may result in the recording of an additional deferred tax asset with a corresponding valuation allowance subject to the realization analysis discussed above.

On September 11, 2002, the Governor of California signed into law new tax legislation that suspended the use of California net operating loss carryforwards in the Company s tax years ending June 30, 2003 and 2004. As a result, the Company cannot use its California net operating loss carryforwards to offset its taxable income for the years ended June 30, 2003 and 2004. The Company eliminated its California tax using tax credit carryforwards for both periods. This suspension will not apply to the Company s tax years ending June 30, 2005, and beyond.

8. Litigation

On August 24, 2004, j2 Global Communications, Inc., or j2, filed a complaint against the Company in the United States District Court for the Central District of California alleging that the Company s operations infringe U. S. Patent No. 6,350,066, or the `066 patent. j2 s complaint seeks unspecified damages and permanent injunctive relief, among other relief. On December 30, 2004, j2 filed a first amended complaint, alleging that in addition to infringing the 066 patent, the Company infringes U. S. Patent Nos. 6,564,321, or the `321 patent, and 6,208,638, or the `638 patent. On January 31, 2005, the Company filed its response to the first amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On April 21, 2005, j2 filed a second amended complaint, alleging that the Company infringes the claims of U.S. Patent No. 6,857,074, or the `074 patent. On May 10, 2005, the Company filed its response to the second amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On December 15, 2005, a Markman hearing was held in the case. Before any order issued from that hearing, however, on January 11, 2006, the Court stayed the action pending reexamination of some of the patents in the United States Patent and Trademark Office, or USTPO. It is unclear what the duration of that stay will be. Although the Company is confident that it does not infringe the asserted patents, if the USPTO affirms the validity of the patents and trial resumes, then the Company s efforts to defend against j2 s assertions will be expensive and time-consuming.

The Company in October 2004 received a letter from counsel to Web Telephony, LLC, or Web Telephony, implying that our operations infringe certain claims in U.S. Patent No. 6,445,694, Internet Controlled Telephone System, or the `694 patent, and U.S. Patent No. 6,785,266, Internet Controlled Telephone System, or the `266 patent. On January 19, 2005, the Company filed in the United States District Court for the Central District of California an action for declaratory relief, in which the Company is seeking to have the court declare that the Company does not infringe the `694 patent or the `266 patent. The Company has received an opinion of counsel that the Company s operations do not infringe `694 patent or `266 patent, although the Company can offer no assurance that a court would agree with that opinion. Web Telephony has filed a motion to dismiss the complaint, alleging that the court lacks personal jurisdiction over Web Telephony. The Company filed a First Amended Complaint on May 2, 2005, adding a cause of action for interference with prospective economic advantage. Web Telephony filed an Answer to the First Amended Complaint on September 6, 2005, and counterclaimed, alleging infringement of the `694 and `266 patents. A trial date of June 6, 2006, has been set in this case, and the parties are proceeding with discovery. Given the proximity of that trial date, the Company expects that its efforts to defend against Web Telephony s assertions will be expensive and time-consuming in the current fiscal year.

On July 1, 2005, Catch Curve, Inc., a Delaware corporation, or Catch Curve, filed a complaint against the Company in the United States District Court for the Central District of California (Action No. CV05-4819) alleging that the Company s operations infringe U.S. Patents No 6,785,021, or the `021 Patent, U.S. Patent No. 6,643,034, or the `034 Patent, U.S. Patent No. 5,291,302, or the `302 Patent, and U.S. Patent No. 4,994,926, or the `926 Patent. The Company in thereafter filed its answer, denying the allegations and asserting certain counterclaims and affirmative defenses. Catch Curve thereafter filed its answer to those counterclaims, denying the Company s allegations. A trial date of October 2, 2007, has been set in this case. The Company has received from intellectual property counsel opinions that the Company s present operations do not infringe the claims of the `021 patent, the `034 patent, the `302 patent, or the `926 patent. By reason thereof, the Company believes that it does not infringe the asserted patents of Catch Curve.

In the event of an adverse result in the j2 litigation, the Web Telephony litigation, the Catch Curve litigation, or in any other litigation between the Company and third parties that may arise in the future with respect to intellectual property rights relevant to the Company s services, the Company could be required to pay substantial damages, including treble damages if a court determines that the Company has willfully infringed a third party s patent rights, to cease the use and sale of infringing services, to expend significant resources to develop non-infringing technology, or to obtain licenses to the infringing technology. The Company cannot be certain that licenses will be available on commercially reasonable terms, or at all, from j2 or Web Telephony or Catch Curve, or any third party that has such intellectual property claims against us. In addition, litigation frequently involves substantial expenditures and can require significant management attention even if the Company ultimately prevails. Accordingly, the Company cannot predict whether the j2 litigation, the Web Telephony litigation or the Catch Curve litigation will have a material adverse effect on the Company s business, operating results, financial condition or cash flows. Due to the early stage of these three actions, and because neither j2, nor Web Telephony, nor Catch Curve has sought specified damages, the Company cannot determine with precision the outcome of the litigation or any costs or payments resulting from the litigation or the settlement of any of those actions. Accordingly, no provision for any loss which may result from the j2 litigation or the Web Telephony litigation or the Catch Curve litigation has been recorded in the accompanying financial statements. In addition, the Company and its subsidiary in the future may encounter legal claims in the normal course of business. In the opinion of the Company, the costs associated with the resolution of existing legal claims cannot be precisely estimated at this time, but the Company has determined such costs have had and likely will have an adverse impact on the Company s financial position, results of operations and cash flows.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as anticipates, expects, believes, plans, predicts, and similar terms. Forward-looking statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled Risk Factors below. The following discussion should be read in conjunction with our Annual Report on Form 10-K filed September 15, 2005, and the consolidated financial statements and notes thereto included elsewhere in this Form 10-Q. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Overview

Historically, we have provided application services on a subscription basis that add features and enhanced functionality to the telecommunications services used by mainstream consumers and small and home offices. Our software-based services are delivered on our proprietary Enhanced Services Platform, which allows subscribers to manage calls across existing landline, mobile and Internet networks. As of December 31, 2005, we had approximately 787,000 total subscribers for these application services. Because our services improve the utilization of existing telecommunications services by our subscribers, we believe that our application services complement the efforts of landline, mobile and Internet service providers to reduce their subscriber churn. This has allowed us to establish cooperative relationships with network service providers.

In the fourth quarter of fiscal 2005, we began test marketing a new mobile product that was officially launched in the first quarter of fiscal 2006. We provide mobile subscribers with subsidized cell phones in the first month of service. As of December 31, 2005, we had approximately 13,000 paying subscribers for the mobile service. We account for the cell phones and fulfillment expenses as cost of sales which affects our gross margin.

In fiscal 2006, we are shifting our marketing strategy from directly marketing our services to consumers and small businesses to marketing our services to users through indirect distribution arrangements in which we enter into agreements with telecommunications services providers, which agree to distribute our services to their subscribers. There typically is a long lead time prior to concluding agreements, including negotiations, implementation and the time to market and persuade the customer to subscribe for our services. As we are reducing the amount of resources spent to market and distribute our services directly to users and will be making an investment in developing our indirect distribution arrangements, we are forecasting six quarters of losses prior to returning to profitability.

Critical Accounting Policies and the Use of Estimates

Revenue recognition. We earn revenues primarily from paid subscriber services and to a lesser extent, fees earned from local exchange carrier call termination access charges and the offering of third-party products and services to our subscribers. Beginning in 2005, we entered the prepaid mobile phone market by selling prepaid phones directly to our subscriber base and to a distributor. As of October 1, 2005, we stopped selling the phones and started to give the phones free of charge to customers who sign up for the CallWave for Mobile service and reimburse us for shipping and handling costs.

We recognize revenue in accordance with accounting principles generally accepted in the United States and with Securities and Exchange Commission Staff Accounting Bulletin 104 (SAB 104), *Revenue Recognition*, which clarifies certain existing accounting principles for the timing of revenue recognition and classification of revenues in the financial statements, we recognize revenue beginning when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the fees are fixed and determinable and collection is reasonably assured. Our subscriber revenues consist of monthly recurring subscription fees. We recognize revenue ratably over the subscription period when the SAB 104 criteria are met. We record install fees as deferred revenues and amortize them to revenue over the expected period of performance, or the average customer subscription life.

In addition to the direct relationship that we have with the majority of our paid subscribers, we also have indirect relationship agreements with Internet service providers (ISPs) and other companies whereby those companies customers are offered a co-branded subscription service. When the agreement provides that we are the party responsible for providing the service, we have control over the fees charged to customers and bear the credit risk, we record the gross amount billed as revenue in accordance with Emerging Issues Task Force 99-19 (EITF 99-19), *Reporting Revenues Gross as a Principal Versus Net as an Agent*. When the agreement provides that we receive a net payment from those companies, based upon the number of their customers registered for our services, we record the net amount received from those companies as revenue in accordance with EITF 99-19.

In the third quarter of fiscal 2005, we purchased prepaid phones and phone cards with the intention of reselling them with a 30-day free trial of our application-based services and entered into an agreement to sell the prepaid phones and a portion of the phone cards to a distributor. Revenue from the sale of prepaid phones and phone cards is recognized when the SAB 104 criteria are met. We recognize sales to distributors on a sell-through basis when we collect the cash from the distributor. We have recognized $92,000 of revenue related to the sale to this distributor in the quarter ended December 31, 2005.

In the fourth quarter of fiscal 2005, we began selling prepaid phones embedded with our technology to our subscriber base. These transactions contain multiple elements, including the phone, the minutes, and our service, to which we have applied EITF 00-21, *Revenue Arrangements with Multiple Deliverables.* The various elements of the arrangement are separable and each element is recognized separately in accordance with SAB 104. In accounting for multiple deliverables, management s judgment is necessary when identifying the nature of deliverables in an arrangement as well as measuring and allocating fair value to the multiple deliverables.

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In the second quarter of fiscal 2006, we changed our marketing strategy for the CallWave for Mobile services to give prepaid cell phones to customers at no cost if they register for a one month trial subscription to CallWave services and reimburse our shipping and handling costs. The phones are charged to cost of sales to generate subscription services revenue in accordance with EITF 01-9, *Accounting for Consideration Given by a Vendor to a Customer.* The reimbursement of shipping and handling costs is recorded as an offset to cost of sales.

Allowances for Doubtful Accounts

We record an allowance for doubtful accounts based on our historical experience with bad debts. We periodically review and negotiate bad debt reserves held by the local telephone companies and the third party that manages our billing relationship with the telephone companies. Judgment is required when we assess the realization of receivables, including assessing the probability of collection. Our allowance for doubtful accounts totaled $371,000 as of December 31, 2005, approximately equal to the balance as of June 30, 2005. Our allowance for doubtful accounts is correlated with our aggregate billings through the local telephone companies.

Investments in minority owned companies We account for investments in minority interests of other companies over which we do not exercise significant influence on the cost method in accordance with *Accounting for Certain Investments in Debt and Equity Securities (SFAS 115).* Under the cost method, an investment is carried at cost until it is sold or there is evidence that changes in the business environment or other facts and circumstances suggest it may be other than temporarily impaired based on the criteria outlined in FAS Staff Position Nos. FAS 115-1 and FAS 124-1 and on EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.*

Inventories

Inventories consist of finished goods and are stated at the lower of cost or net realizable cost, cost being determined under the first-in, first-out method. As described above, we changed our marketing strategy for the CallWave for Mobile services to give prepaid cell phones to customers at no cost if they register for a one month trial subscription and reimburse our shipping and handling costs. As we are no longer selling these phones, they are not included in inventory. At December 31, 2005, the inventory balance approximates $60,000 and consists of phone cards sold to a distributor and accounted for on a sell-through basis. We have recorded an impairment allowance against inventory in an equal amount as very few of these cards have been sold through to customers. Management s judgment is required in determining net realizable value and the extent of any impairment to our inventory. Judgment is also required in determining the collectibility of amounts that are due from our distributors as a result of selling our inventory through to end customers.

Accounting for Income Taxes

We account for income taxes using the asset and liability method in accordance with SFAS 109, *Accounting for Income Taxes*, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and tax bases of the assets and liabilities. At December 31, 2005, we had deferred tax assets of $5.3 million. Due to the uncertainty of realizing these deferred tax assets, we have maintained a full valuation allowance as an offset against the deferred tax assets. Such uncertainty primarily relates to the potential for future taxable income as well as the amount, limitation, and expiration of loss carryforwards and tax credits which begin expiring in 2009. In addition, pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of our net operating loss carryforwards may be limited in the event of a cumulative change in ownership of more than 50% within a three-year period. Management has determined that it is more likely than not that the no deferred tax assets will be realized within the 2006 and 2007 fiscal years. We will continue to assess the likelihood of realization of such assets. As future events and estimates change, we will adjust the valuation allowance pursuant to SFAS 109, if necessary, which may impact the tax provision or equity or both.

Share-Based Compensation We adopted FAS 123(R), *Share-Based Payment,* on July 1, 2005, using the modified- prospective-transition-method. Historically, we elected to account for employee stock compensation under the fair value method in accordance with SFAS 123, *Accounting for Stock-Based Compensation,* and had reflected compensation expense related to the fair value of options issued to employees in the statement of operations. Under FAS 123(R), stock-based compensation is recorded based upon the fair value of the awards granted, using a Black-Scholes option pricing model, which includes the fair value of the underlying shares on the date of grant, an estimate of the options to be forfeited and the exercise price. Adoption of FAS 123(R) had an immaterial impact on our financial statements as we have been recording share-based compensation expense under FAS 123 since inception and as we have net operating loss carryforwards which prevent us from recognizing excess tax benefits until the excess tax benefits are used to offset income taxes payable.

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Results of Operations

The following tables set forth our statement of operations data for each of the periods indicated.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	2004	2005	2004
Statement of Operations Data:				
Revenues	$ 9,538	$ 11,669	$ 20,109	$ 22,714
Cost of sales	3,390	2,942	7,151	6,144
Gross profit	6,148	8,727	12,958	16,570
Operating expenses:				
Sales and marketing	2,026	2,857	4,135	4,974
Research and development	1,320	1,608	2,536	3,276
General and administrative	2,501	1,806	4,683	3,081
Impairment of long-lived assets			243	
Total operating expenses	5,847	6,271	11,597	11,331
Operating income	301	2,456	1,361	5,239
Interest income (expense), net	578	266	1,083	317
Income before income taxes	879	2,722	2,444	5,556
Income tax expense (benefit)	2,296	(1,643)	2,929	(1,709)
Net income (loss)	$ (1,417)	$ 4,365	$ (485)	$ 7,265

Three Months Ended December 31, 2005 and December 31, 2004

Revenues. Revenues were $9,538,000 for the three months ended December 31, 2005, compared to $11,669,000 for the three months ended December 31, 2004, a decrease of $2,131,000, or 18%. Direct subscription revenues were $8,813,000 for the three months ended December 31, 2005, representing 92% of revenues, compared to $11,194,000 for the three months ended December 31, 2004, representing 96% of revenues, a decrease of $2,318,000, or 21%. The decrease in our subscription revenues for the three months ended December 31, 2005 was attributable primarily to a decrease in the number of total subscribers from approximately 862,000 at December 31, 2004 to approximately 787,000 at December 31, 2005 and the fact that we have shifted our focus to indirect channel partnerships which results in recording revenues net rather than gross. Revenues from indirect channel partnerships were $580,000 or 6% of total revenue for the three months ended December 31, 2005 compared to $394,000 for the comparable period in 2004, an increase of 47%. Revenues from sales to distributors were $92,000 for the quarter ended December 31, 2005.

Cost of sales. Cost of sales was $3,390,000 for the three months ended December 31, 2005, compared to $2,942,000 for the three months ended December 31, 2004, an increase of $448,000, or 15%. Cost of sales increased as mobile customer acquisition costs, such as the cost of mobile phones and fulfillment expenses, are charged to cost of sales. As a result, our gross margins decreased from 75% for the three months ended December 31, 2004 to 64% for the three months ended December 31, 2005.

Sales and marketing. Sales and marketing expenses were $2,026,000, or 21% of revenues, for the three months ended December 31, 2005, compared to $2,857,000, or 24% of revenues, for the three months ended December 31, 2004, a decrease of $831,000. Sales and marketing expenses decreased due to reduced customer acquisition spend of $1,513,000 offset by increased personnel costs of $122,000 and additional expenses related to our call center of $490,000. Previously, the call center performed a technical support role and its expenses were allocated across all three operating expense categories. The focus of our call center has shifted from technical support to landline customer retention and mobile sales and the related costs are now charged to sales and marketing.

Research and development. Research and development expenses were $1,320,000, or 14% of revenues, for the three months ended December 31, 2005, compared to $1,608,000, or 14% of revenues, for the three months ended December 31, 2004, a decrease of $288,000, or 18%. The decrease in research and development expenses was due to the shift in focus and in costs of the call center to sales and marketing which reduced research and development costs by $363,000. This decrease was partially offset by the write-off of the unamortized cost of a license totaling $102,000 as a determination was made not to pursue use of the technology.

General and administrative. General and administrative expenses were $2,501,000, or 26% of revenues for the three months ended December 31, 2005, compared to $1,806,000, or 15% of revenues, for the three months ended December 31, 2004, an increase of

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$694,000, or 38%. The increase in general and administrative expenses was due primarily to an increase in legal, bad debt, outside services, investor relations, employee-related and Board of Directors costs. Specifically, personnel costs increased $118,000, legal costs increased $248,000 and bad debts expense increased $157,000 in the three months ended December 31, 2005 as compared to the same period in 2004. The increase in bad debts expense is attributable to a higher local exchange carrier (LEC) reject rate in the current quarter.

Income tax provision. We recognized an income tax provision for the three months ended December 31, 2005 and an income tax benefit for the three months ended December 31, 2004 of $2,296,000 and $(1,643,000), respectively. In prior periods we have recognized a tax provision benefit related to the reduction of the valuation allowance associated with the deferred tax asset. The total deferred tax asset is $5.3 million and has been completely offset by a valuation allowance as we are currently projecting six quarters of losses due to investing in the indirect channel partnership opportunity so it is not more likely than not that we will not be able to use our deferred tax assets to offset income taxes payable during the next two years. We will continue to assess the likelihood of realization of our net deferred tax assets and will adjust the balance accordingly.

Net income (loss). The net loss was $(1,417,000) for the three months ended December 31, 2005, compared to net income of $4,365,000 for the three months ended December 31, 2004, a decrease of $5,781,000 or 132%. This decrease in net income was primarily the result of an increase in cost of sales related to our entry into the mobile phone market, increased general and administrative expenses related to operating as a public company and a tax provision of $2,296,000 in the three months ended December 31, 2005, an increase of $3,939,000 over the same period in 2004. During the three months ended December 31, 2005, our revenues decreased by $2,131,000, while our cost of sales increased by $448,000 and operating expenses increased by $424,000. Our (net loss) net margin was (15%) and 37% for the three months ended December 31, 2005 and 2004, respectively.

Six months Ended December 31, 2005 and December 31, 2004

Revenues. Revenues were $20,109,000 for the six months ended December 31, 2005, compared to $22,714,000 for the six months ended December 31, 2004, a decrease of $2,604,000, or 11%. Direct subscription revenues were $18,686,000 for the six months ended December 31, 2005, representing 93% of revenues, compared to $21,878,000 for the six months ended December 31, 2004, representing 96% of revenues, a decrease of $3,192,000, or 15%. The decrease in our subscription revenues for the six months ended December 31, 2005 was attributable primarily to a decrease in the number of total subscribers from approximately 862,000 at December 31, 2004 to approximately 787,000 at December 31, 2005 and the fact that we have shifted our focus to indirect channel partnerships which result in recording revenues net rather than gross. Revenues from indirect channel partnerships were $1,091,000 or 5% of total revenue for the six months ended December 31, 2005 compared to $727,000 for the comparable period in 2004, an increase of 50%. Revenues from sales to distributors were $225,000 for the six months ended December 31, 2005.

Cost of sales. Cost of sales was $7,151,000 for the six months ended December 31, 2005, compared to $6,144,000 for the six months ended December 31, 2004, an increase of $1,007,000, or 16%. Cost of sales increased as mobile customer acquisition costs, such as the cost of mobile phones and fulfillment expenses, are charged to cost of sales. Cost of sales also includes an impairment charge of $36,000 to reduce to fair value the cost of mobile phones in inventory at September 30, 2005 as a result of the change in marketing strategy to give the phones away rather than to sell them. As a result, our gross margins decreased from 73% for the six months ended December 31, 2004 to 64% for the six months ended December 31, 2005.

Sales and marketing. Sales and marketing expenses were $4,135,000, or 21% of revenues, for the six months ended December 31, 2005, compared to $4,974,000, or 22% of revenues, for the six months ended December 31, 2004, a decrease of $838,000. Sales and marketing expenses decreased due to reduced customer acquisition spend of $2,474,000 (net of an increase to customer acquisition costs due to recording an impairment allowance on phone cards in the amount of $201,000) offset by additional expenses related to the reclassification of costs related to our call center of $989,000, increased personnel costs of $529,000 and increased public relations costs of $95,000. Previously, the call center performed a technical support role and its expenses were allocated across all three operating expense categories. The focus of our call center has shifted from technical support to landline customer retention and mobile sales and the related costs are now charged to sales and marketing.

Research and development. Research and development expenses were $2,536,000, or 13% of revenues, for the six months ended December 31, 2005, compared to 3,276,000, or 14% of revenues, for the six months ended December 31, 2004, a decrease of $740,000, or 23%. The decrease in research and development expenses was due primarily to the shift in focus and in costs of the call center to sales and marketing which reduced research and development costs by $724,000.

General and administrative. General and administrative expenses were $4,683,000, or 23% of revenues for the six months ended December 31, 2005, compared to $3,081,000, or 14% of revenues, for the six months ended December 31, 2004, an increase of $1,601,000, or 52%. The increase in general and administrative expenses was due primarily to an increase in accounting and legal, bad debt, insurance, investor relations, and employee-related costs. Specifically, personnel costs increased $169,000, insurance costs increased $173,000 (primarily directors & officers liability insurance), litigation related legal costs increased $397,000 and bad debts expense increased $509,000 in the six months ended December 31, 2005 as compared to the same period in 2004. The increase in bad debts expense is attributable to a higher local exchange carrier (LEC) reject rate in the six months ended December 31, 2005, and the increase in personnel costs is due to increased finance staff necessary to meet the needs of a public company.

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Impairment loss. In the six months ended December 31, 2005, we determined based on an analysis of future cash flows that our investment in and receivable from a company in which we had a minority interest was other than temporarily impaired. Accordingly, we recorded an impairment loss in the amount of $253,000 which was partially offset by a gain of $10,000 on the sale of an asset that had previously been written off.

Income tax provision. We recognized an income tax provision for the six months ended December 31, 2005 and an income tax benefit for the six months ended December 31, 2004 of $2,929,000 and $(1,709,000), respectively. In prior periods we have recognized a tax provision benefit related to the reduction of the valuation allowance associated with the deferred tax asset. The total deferred tax asset is $5.3 million and has been fully offset by a valuation allowance reflecting the fact that we have not determined that it is more likely than not that we will be able to use our deferred tax assets to offset income taxes payable as we currently project six quarters of losses due to investing in the indirect channel partnership opportunity. We will continue to assess the likelihood of realization of our net deferred tax assets and will adjust the balance accordingly.

Net income (loss). The net loss was $(485,000) for the six months ended December 31, 2005, compared to net income of $7,265,000 for the six months ended December 31, 2004, a decrease of $7,751,000 or 107%. This decrease in net income was primarily the result of an increase in cost of sales related to our entry into the mobile phone market, increased general and administrative expenses related to operating as a public company and a tax provision of $2,929,000 in the six months ended December 31, 2005, an increase of 4,638,000 over the same period in 2004. During the six months ended December 31, 2005, our revenues decreased by $2,605,000, while our cost of sales increased by $1,007,000 and operating expenses increased by $266,000. Our net margin was (2%) and 32% for the six months ended December 31, 2005 and 2004, respectively.

Liquidity and Capital Resources

Cash, cash equivalents and marketable securities increased $5,114,000 over the comparable balance at June 30, 2005. This increase was caused primarily by cash from operating activities of $3,776,000 and proceeds from exercises of options and warrants of $1,535,000. Although we are currently forecasting losses for the next six quarters of approximately $10 million in the aggregate as a result of investment in indirect channel partnership opportunities, we expect that our cash, cash equivalents and marketable securities of $61.9 million at December 31, 2005 will be adequate to fund our operations for at least the next twelve months. However, we will reexamine our cash requirements periodically in light of changes in our business.

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Risks Related To Our Business

Our ability to successfully generate increased revenues and profits will be dependent upon our success in entering into and managing indirect distribution relationships.

We grew our business by directly marketing our services to consumers and small businesses through Internet advertising. We intend to attempt to grow our business by promoting our services to users through indirect distribution arrangements in which we enter into distribution agreements with telecommunications service providers, which agree to distribute our services to their subscribers. We do not have significant experience in developing and managing those indirect relationships. There typically is a long lead time required to conclude agreements for such arrangements, additional time is thereafter required to implement each agreed-upon arrangement, and the actual pace of implementation is dependent upon cooperation and support from the companies with which we enter into those arrangements. In addition, even if we are able to put such indirect distribution relationships in place, the extent to which the service provider s customers subscribe for our services will be dependent in substantial part upon the pace and manner in which the service provider implements and promotes our services, which are outside of our control. If we are unable to successfully implement those indirect distribution relationships, then we may not realize substantial growth in our subscribers for our services, we will not realize substantial growth in revenues or profitability, and our results of operations and financial condition will be adversely affected.

We may suffer losses from operations and reduce our accumulated cash reserves as we shift resources from our profitable direct distribution business and focus our business and investments on indirect distribution of our services.

We have elected to reduce the amount of resources that we are devoting to our legacy business in which we had marketed and distributed our services directly to users, and instead to expand the resources that we are investing in the development and marketing of our services through indirect distribution arrangements. As a result, we expect to realize lower revenues from our legacy business. However, we do not expect to begin generating substantial revenues from indirect distribution arrangements for at least several quarters. That delay in generating substantial revenues is attributable to a number of factors, including the time period required to develop indirect distribution relationships with telecommunications carriers, the time required to implement technological changes to our services in order to make them compatible with the communications infrastructure of carriers with which we enter into indirect distribution relationships, and the time required to successfully market our services to those carriers customers and persuade those customers to subscribe for our services. As we undergo this transition from a business based upon our traditional landline services sold directly to the consumer, to one based primarily upon the delivery of services through indirect distribution relationships, we are likely to realize losses from operations and reduce our accumulated cash reserves.

Our ability to successfully implement indirect distribution arrangements is dependent upon our ability to integrate our technology with that of the companies that distribute our services.

In order for our indirect distribution arrangements to be successful, the companies with whom we enter into indirect distribution arrangements must be able to integrate our services with their own service offerings. That integration process requires that our technology operate effectively with the service platforms from which those companies deliver telecommunications services to their customers and meet the technical specifications and operating parameters imposed by companies with which we are seeking indirect distribution relationships. The integration of our services with the service platform of those other companies is a complex process that requires not only that our respective technology platforms operate together, but also that our engineering departments work effectively together at a technical level in integrating our respective services. Those tasks require time, and we may encounter technical difficulties that occasion delay. We also may encounter some technical difficulties that adversely affect the customer s ability to fully utilize our services or even our ability to integrate our services at all. If we are unable to overcome those challenges, then our indirect distribution strategy may be adversely affected, and we may not be able to achieve the revenue and profitability gains that we are seeking to achieve.

The use of indirect distribution arrangements may cause us to realize lower revenues and profitability than we traditionally have realized from direct distribution of our services.

We expect that the principal growth in subscribers will come primarily from the implementation of indirect distribution arrangements. While these arrangements typically deliver subscribers to us at a lower subscriber acquisition cost than our traditional sources of subscribers, they also tend to generate a lower average revenue per user, or ARPU, than the traditional direct sources of subscribers. In order to achieve substantial future revenue growth from these indirect distribution arrangements, we will need to implement indirect distribution arrangements that afford us broad exposure to significant numbers of potential subscribers, and we will need the other parties to those arrangements to cooperate with us in distributing our services to their customers. If we are unable to accomplish those objectives, then we may not achieve future revenue growth, and our results of operations will be adversely affected.

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If telecommunications customers integrate their landline and mobile services at a rate that is slower than what we predict, then we may experience delays in realizing growth in revenues and profitability from our services.

Our services allow users to integrate their landline telephone services with their other telecommunications services (*e.g.* mobile). We believe that there is an opportunity for the marketing and distribution of our services because of that integration, or convergence, of telecommunication services. We therefore have decided to devote substantial resources to indirect marketing and distribution of our services. If the pace of that convergence of landline and other telecommunications services unfolds more slowly than we currently foresee it occurring, then the proportion of mass market consumers who are ready to subscribe for our mobile services may be much smaller than is necessary to support substantial growth in our revenues and profitability. If the proportion of consumers who subscribe for our services is correspondingly lower, then our results of operations and financial condition will be adversely affected.

Because we are unable to predict with precision the rate at which we will acquire paying subscribers for our services through the indirect distribution relationships that we will be emphasizing, our results of operations may be correspondingly less predictable, our stock price therefore may be more volatile, and our stockholders may suffer losses.

From our legacy business, which involved the direct marketing and distribution of our services to customers, we have assembled a substantial amount of data that allowed us to predict our subscriber counts, revenues, and profits in that legacy business with some reliability. As our business increasingly emphasizes the delivery of our services through indirect distribution relationships, however, we will be operating without historical data that would allow us to predict with any precision the rate at which our services will be accepted by consumers or the prices at which consumers may be willing to subscribe for those services. Consequently, we may experience significantly greater swings in our revenues and profitability than in the past, our stock price may become increasingly volatile, and our stockholders may realize losses in the value of their shares.

If network service providers elect to bundle services similar to ours that they obtain from other providers or to develop such services themselves as part of their product offering, we could lose many of our paid subscribers.

The market for communications and information services is competitive, and many service providers attempt to attract and retain subscribers by offering a variety of services. While service providers that provide Internet call waiting and call management services generally impose a separate charge, those service providers may in the future bundle such services with their other service offerings, thereby effectively offering these services for no incremental fee. If we lose subscribers to those network service providers that bundle services that are competitive with ours and we are unable to find replacement subscribers willing to pay for our services, our business, revenues and profitability would be adversely affected.

Increased marketing costs for Internet advertising may cause further erosion in our traditional landline business.

Our subscriber acquisition costs for our traditional land-line customers are dependent largely upon our ability to purchase multiple types of advertising at a reasonable cost. Our advertising costs vary over time, depending upon a number of factors, some of which are beyond our control, such as seasonality, the particular mix of advertising we use and the rate at which we convert potential subscribers into paid subscribers, and consolidation among companies that control advertising channels. We have experienced an increase in subscriber acquisition costs in the recent periods. Given our belief that our revenues from our traditional landline business will decline over time, we have decided not to increase the amount of money that we spend on Internet advertising for our landline services. As a result, we are realizing both reduced marketing expenditures and a higher unit cost for the advertising services that we purchase. We expect that those two factors will occasion an acceleration in the decline of our landline business over time.

We are dependent upon billing arrangements with regional telephone companies for collecting fees from many of our landline subscribers.

We currently collect the majority of our revenues through billing arrangements in which our subscribers regional telephone companies collect our service fees from our subscribers and forward those fees to us. We collect the remainder of our revenues through our subscribers credit cards and checks. If the telephone companies terminated those billing arrangements, or if the cost of those arrangements increased significantly, we may be unable to continue to collect a significant portion of our revenues in this manner, and instead would have to collect those revenues through use of subscribers credit cards, by having subscribers mail checks to us, or by other means. Because many subscribers prefer to pay for our services through their telephone bills, any need to rely upon alternative means to collect a significant portion of our revenues may lead to a loss of a substantial portion of the subscribers who currently pay for our services as part of their monthly bill from their telephone company, a decline in the rate at which we increase the number of our paid subscribers, or significant delinquencies in payments by our subscribers. If we are not able to successfully manage and maintain these billing relationships, our bad debt reserves may increase and we may lose subscribers that prefer paying for our services on their local telephone bill.

If we fail to maintain effective internal financial and managerial systems and procedures, our results of operations may be adversely affected.

As we expand our operations and offer new services, there is a risk that our systems and procedures may not be adequate to support our operations or ensure proper identification of and proper accounting treatment for our activities. Our failure to maintain and implement such adequate systems and procedures could adversely affect the information on which we base our decisions, thereby causing us to make inappropriate business decisions. Those incorrect decisions in turn, could adversely affect our business, financial condition, and results of operation.

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We face competition from well-capitalized hardware vendors, software vendors and service providers against whom we may not be able to successfully compete.

Competition in the communications and information services industries is intense. We face competition for our offerings from Internet service providers, such as AOL, landline and wireless telephone companies, such as AT&T, cable companies and other communications hardware, software and services vendors. These companies are better capitalized, have greater name recognition and significantly larger existing subscriber bases than we do. We may also face competition in the future from communications hardware and software companies that are currently focused on other markets. If these or other companies provide services similar to ours, we may not be able to compete effectively, which would harm our results of operations and financial condition.

There are limited barriers to entry for other companies to provide services that compete with ours.

Telecommunications services were historically provided by companies that made substantial capital investments in their networks. The size of those investments and the time required to deploy those networks served as significant barriers to entry into such markets. In contrast, we provide software-based enhanced services that do not require substantial capital expenditures to deploy and maintain. As a result, other companies with strong technical staffs and knowledge of the communications and information services industries could compete with us without facing significant capital expenditures or other barriers to entry. As a result, we may face increasing competition from companies with significantly greater resources than we have, which may force us to reduce our prices and increase our operating expenses to remain competitive. If we are not able to compete successfully with these companies, we may lose customers or fail to grow our business as we anticipate, either of which could harm our financial condition, results of operations and prospects.

We rely upon the networks of numerous long-distance and local carriers to provide services to our subscribers. If the cost of these services were to increase, we may not be able to profitably provide our services to our subscribers.

In providing services to our subscribers, we incur a number of underlying telecommunications costs which are beyond our control. In order to deliver our services to our subscribers, our customers must subscribe to certain ancillary services from their telecommunications providers that re-route certain telephone calls from our subscribers telephone lines to toll-free numbers that we have leased at our software-based switching facility, which facilitates the receipt of the call by the number that the subscribers designate. Our services rely in part upon the toll-free long-distance and local services that we purchase from network service providers. The cost of these services, which we integrate into our service offerings, or which subscribers assume directly, is beyond our control and may increase for a number of reasons, including:

- a general increase in wholesale long-distance rates or charges for call forwarding services;
- an election by service providers to implement a new pricing structure on the services that we currently purchase;
- an election by third-party service providers to impose charges for services which are currently toll-free; and
- an increase in subscriber usage patterns that increases the cost of the services that we purchase

Our ability to offer services to our subscribers at competitive rates is partially dependent upon our ability to use that toll-free telephone network and our subsidiary s ability to procure telephone network access and services on a reliable basis and at reasonable prices. If we are unable to effectively manage the cost of our underlying network services, then our pricing structure with a significant number of our subscribers would increase, which could make it difficult to conduct business at attractive margins.

There are a limited number of long-distance and interconnection service providers that are able to provide the services on which we rely.

We currently have contracts with four service providers for long-distance services, and our wholly-owned subsidiary, Liberty Telecom, LLC also has interconnection agreements with other telecommunications companies, which together provide us with services that we integrate into our enhanced offerings. Each of those contracts may be terminated without cause by the service provider upon advance written notice. The required notice period, in each instance, is less than the amount of time that we would likely need to negotiate a contract with a successor provider and modify our system to re-route our subscribers inbound calls to that successor s network. In addition, there are only a limited number of service providers with which we can contract to provide these services. As a result, if one or more of the service providers from which we currently procure long-distance or interconnection services

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were to terminate our existing contractual relationships, we may not be able to locate a substitute provider on a timely basis and upon reasonable terms, if at all, in order to avoid a disruption or loss of service to our subscribers. If we are not able to purchase access to sufficient long-distance and interconnection services at reasonable prices, we may not be able to profitably provide our services to our subscribers and our operating results and financial condition would be harmed.

We rely upon the Internet and other networks controlled by third parties to provide our services, and if we are not able to maintain access to these networks at reasonable rates, we may not be able to profitably provide our services.

We provide our services by integrating and enhancing underlying services on other companies networks that rely on the public switched telephone network, across the private networks constructed and owned by other companies such as those in the cable industry, and across the Internet. If the owners of any one or more of those networks were either to refuse to transport calls to our subscribers, or were to impose significantly higher charges for those calls, or if applicable regulations were to impose significantly higher charges for those calls, we would likely face increased operating costs, our profitability could suffer and our business could be harmed.

We are dependent upon the availability of reasonably priced call-forwarding services to provide our services to the majority of our subscribers in a cost-effective manner.

Customers who subscribe to certain of our services typically subscribe to call-forwarding services from their local telephone service provider. Generally, these call-forwarding services are available to our subscribers at a reasonable price. If the service providers do not provide these services at a reasonable price, the overall price of obtaining our services may exceed the amount that our current and potential subscribers are willing to pay. If the prices for these services increase, a significant number of our subscribers may terminate their subscriptions for our services.

Because the secondary facility for our subsidiary s existing telephone switching equipment is not yet fully operational, a catastrophic event at Liberty Telecom s primary facility would cause the disruption of our services to subscribers.

Our enhanced services currently depend on telecommunications services from our subsidiary, Liberty Telecom, which are provided using a single call-switching facility in Reno, Nevada. A catastrophic event, such as an earthquake or a fire, that destroys part or all of the facility would disrupt our business and prevent us from providing services to our subscribers for an extended period of time. While Liberty Telecom is nearing completion of our secondary call-switching facility and we already are using this facility to provide some data and voice services to our subscribers, the second facility may not be fully operational on a timely basis, or at all. Because our subscribers expect our services to match the high reliability that characterizes services in the communications and information services industries generally, any failure in our ability to service our subscribers could cause us to lose significant numbers of subscribers, and make it more difficult to obtain new paid subscribers.

A system failure or a breach of our network security could delay or interrupt service to our subscribers or lead to a misappropriation of our confidential information.

Our operations are dependent upon our ability to protect our computer network from interruption, unauthorized entry, computer viruses and other similar events. In the past, we experienced one outage of our entire system which occurred following the failure of redundant components and lasted approximately two hours. From time to time, we have also experienced limited system interruptions. While these interruptions did not significantly harm our business, our existing and planned precautions may not be adequate to prevent a significant interruption in the operation of our network in the future. Despite the implementation of security measures, our infrastructure also may be vulnerable to computer viruses, hackers or similar disruptive problems caused by our subscribers, employees or other Internet users who attempt to invade public and private data networks. A system failure or a breach of our security measures may lead to a disruption in service, or the misappropriation of confidential information, which may result in significant liability to us and also may deter current and potential subscribers from using our services. Any system failure or security breach that causes interruptions or data loss in our operations or in the computer systems of our subscribers could cause us to lose paid subscribers and harm our business, prospects, financial condition and results of operations.

If we do not successfully anticipate the service demands of our subscribers, we may be unable to successfully attract and retain subscribers.

We must accurately forecast the features and functionality required by our current and potential subscribers. In addition, we must design and implement service enhancements that meet subscriber requirements in a timely and efficient manner. We may not successfully determine subscriber requirements and, therefore, may not be able to satisfy subscriber demands. Furthermore, as our current subscribers needs change, we may not be able to identify, design and implement in a timely and efficient manner services incorporating the type and level of features desired by our subscribers. If we fail to accurately determine or effectively market subscriber feature requirements or service enhancements, we may lose current subscribers or fail to attract new subscribers, and may be unable to grow our revenues.

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Other persons may assert claims that our business operations or technology infringe or misappropriate their intellectual property rights, which could increase our costs of operation and distract management and could result in expensive settlement costs.

Other companies or individuals, including our competitors, may claim that we infringe or misappropriate their intellectual property rights. From time to time, third parties have contacted us, asserting that we may infringe their intellectual property rights. For example, in December 2003 and April 2004, a major communications infrastructure company delivered to one of our distributors two letters, in which we were not named, offering to negotiate with our distributor a nonexclusive license to certain patents that the infrastructure company believed to be relevant to our service and implying that our service may infringe those patents. As part of this process, we have received a legal opinion from our intellectual property counsel that our services do not infringe the patents of this infrastructure company, although there is no assurance that a court would agree with that opinion.

We received a letter from America Online, Inc., or AOL, in September 2004 in which AOL offered to discuss with us a license to U. S. Patent No. 5,809,128, Method and apparatus permitting notification and control of blocked incoming calls over a data network, or the `128 patent, and implying that our services may infringe the `128 patent. In 2000 and 2001, we had periodically discussed a license for the `128 patent with Infointeractive Services, the company that owned the `128 patent and was subsequently acquired by AOL. We have received an opinion of counsel that our operations did not and do not infringe the `128 patent, although we can offer no assurance that a court would agree with that opinion. AOL has substantial resources, and may elect to assert a claim that our operations infringe the `128 patent. If such a claim is asserted and we are unable to resolve the matter by agreement, then we would likely incur substantial attorneys fees to defend against any such claim. The outcome of any such claim is uncertain, and an adverse judgment would likely have a material adverse impact upon our business and results of operations.

On August 24, 2004, j2 Global Communications, Inc., or j2, filed a complaint against the Company in the United States District Court for the Central District of California alleging that the Company s operations infringe U. S. Patent No. 6,350,066, or the `066 patent. j2 s complaint seeks unspecified damages and permanent injunctive relief, among other relief. On December 30, 2004, j2 filed a first amended complaint, alleging that in addition to infringing the 066 patent, the Company infringes U. S. Patent Nos. 6,564,321, or the `321 patent, and 6,208,638, or the `638 patent. On January 31, 2005, the Company filed its response to the first amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On April 21, 2005, j2 filed a second amended complaint, alleging that the Company infringes the claims of U.S. Patent No. 6,857,074, or the `074 patent. On May 10, 2005, the Company filed its response to the second amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On December 15, 2006, a Markman hearing was held in the case. Before any order issued from that hearing, however, on January 11, 2006, the Court stayed the action pending reexamination of some of the patents in the United States Patent and Trademark Office, or USTPO. It is unclear what the duration of that stay will be. Although the Company is confident that it does not infringe the asserted patents, if the USPTO affirms the validity of the patents and trial resumes, then the Company s efforts to defend against j2 s assertions will be expensive and time-consuming.

The Company in October 2004 received a letter from counsel to Web Telephony, LLC, or Web Telephony, implying that our operations infringe certain claims in U.S. Patent No. 6,445,694, Internet Controlled Telephone System, or the `694 patent, and U.S. Patent No. 6,785,266, Internet Controlled Telephone System, or the `266 patent. On January 19, 2005, the Company filed in the United States District Court for the Central District of California an action for declaratory relief, in which the Company is seeking to have the court declare that the Company does not infringe the `694 patent or the `266 patent. The Company has received an opinion of counsel that the Company s operations do not infringe `694 patent or `266 patent, although the Company can offer no assurance that a court would agree with that opinion. Web Telephony has filed a motion to dismiss the complaint, alleging that the court lacks personal jurisdiction over Web Telephony. The Company filed a First Amended Complaint on May 2, 2005, adding a cause of action for interference with prospective economic advantage. Web Telephony filed an Answer to the First Amended Complaint on September 6, 2005, and counterclaimed, alleging infringement of the `694 and `266 patents. A trial date of June 6, 2006, has been set in this case, and the parties are proceeding with discovery. Given the proximity of that trial date, the Company expects that its efforts to defend against Web Telephony s assertions will be expensive and time-consuming in the current fiscal year.

On July 1, 2005, Catch Curve, Inc., a Delaware corporation, or Catch Curve, filed a complaint against the Company in the United States District Court for the Central District of California (Action No. CV05-4819) alleging that the Company s operations infringe U.S. Patents No 6,785,021, or the `021 Patent, U.S. Patent No. 6,643,034, or the `034 Patent, U.S. Patent No. 5,291,302, or the `302 Patent, and U.S. Patent No. 4,994,926, or the `926 Patent. The Company in thereafter filed its answer, denying the allegations and asserting certain counterclaims and affirmative defenses. Catch Curve thereafter filed its answer to those counterclaims, denying the Company s allegations. A trial date of October 2, 2007, has been set in this case. The Company has received from intellectual property counsel opinions that the Company s present operations do not infringe the claims of the `021 patent, the `034 patent, the `302 patent, or the `926 patent. By reason thereof, the Company believes that it does not infringe the asserted patents of Catch Curve.

A determination that we have infringed the intellectual property rights of a third party, including in any of the above-referenced matters, could expose us to substantial damages, restrict our operations or require us to procure costly licenses to the intellectual property that is the subject of the infringement claims. Such a license may not be available to us on acceptable terms or at all. Any effort to defend ourselves from assertions of infringement or misappropriation of a third party s intellectual property rights, whether or not we are successful, would be expensive and time-consuming and would divert management resources. Any adverse determination

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that we have infringed the intellectual property rights of a third party, or the costs we incur to defend ourselves against such claims, whether or not we are successful, would have a material adverse impact on our business and results of operations.

Our customers or other companies with whom we have a commercial relationship could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger support and indemnification obligations, which could result in substantial expenses, including the payment by us of costs and damages relating to patent infringement. In addition to the time and expense required for us to meet our support and indemnification obligations, any such litigation could hurt our relations with our customers and other companies. Thus, the sale of our services could decrease. Claims for indemnification may be made by third parties with whom we do business and such claims may harm our business, prospects, financial condition and results of operations.

We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our services.

We rely primarily upon a combination of trademark, trade secret, copyright and patent law protections, and contractual restrictions to protect our proprietary technology. Those measures may not provide meaningful protection. For example, any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us. Such patents could be challenged or circumvented by our competitors or declared invalid or unenforceable in judicial or administrative proceedings. The failure of any patents to adequately protect our technology would make it easier for our competitors to offer similar services. With respect to our proprietary rights, it may be possible for third parties to copy or otherwise obtain and use our proprietary technology or marks without authorization or to develop similar technology independently. Monitoring unauthorized use of our proprietary technology or marks is difficult and costly. We may not be able to detect unauthorized use of, or to take appropriate steps to enforce, our intellectual property rights, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If we commence an action to terminate a third party s authorized use of our intellectual property rights, we may face challenges to the validity and enforceability of our proprietary rights and may not prevail in any litigation regarding those rights. Any efforts to enforce or determine the scope of our intellectual property rights, whether initiated by us or a third party, would be expensive and time-consuming, would divert management resources and could adversely affect our business, whether or not such litigation results in a determination favorable to us.

If we are unable to obtain additional telephone numbers, we may not be able to grow our subscriber base.

Our future success will depend in part upon our ability to procure sufficient quantities of telephone numbers in area codes where our subscribers are located at costs we can afford. The ability of telecommunications carriers to provide us with telephone numbers to be used in conjunction with our services depends on applicable regulations, the practices of telecommunications carriers that provide telephone numbers, and the level of demand for new telephone numbers. In addition, the Federal Communications Commission, or FCC, has regulations concerning numbering resource utilization. If Liberty Telecom does not sufficiently utilize the numbers assigned to it, it may have to relinquish control of those unused numbers. Furthermore, the FCC and state public utility commissions periodically review numbering utilization, and may in the future propose additional changes to regulations governing number assignment and availability. Failure to have access to telephone numbers in a timely and cost-effective manner, or the loss of use of numbers we have accessed or may access, could prevent us from entering some markets or slow our growth in the markets in which we currently sell our services.

Our Enhanced Services Platform is a complex hardware and software system that could fail and cause service interruptions to our subscribers.

Our hardware and software systems are complex and are critical to our business. If our systems fail, our subscribers might experience reduced levels of service or service interruptions. Software-based services, such as ours, may contain undetected errors or failures when introduced or when new versions are released. Errors may be found in our software before or after commercial release, and, as a result, we may experience development delays or a disruption of our services. Failures in our system or interruptions to our service could cause us to lose paid subscribers and harm our business, prospects, financial condition and results of operations.

If we are unable to maintain access to national IP-protocol based networks, then our business and results of operations may be adversely affected.

Historically, to obtain our services, our subscribers had their calls routed on long-distance circuits through the public switched telephone network to our software switching facilities in Nevada. That structure requires that we often pay for long-distance telephone service. We expect to increasingly rely upon the public Internet or third-party managed Internet protocol networks, which would not change how we provision services to our subscribers, but would allow us to reduce our cost of sales by using more of the less expensive Internet and local telephone network minutes and fewer of the more expensive long-distance telephone network minutes. We recently entered into a contract with a provider of these Internet and managed Internet protocol network services, which is a privately managed Internet where access is controlled to ensure quality of service. If we are unable to establish and effectively manage such relationships on a cost-effective basis, or if the costs associated with Internet and local telephone network minutes increase, then our ability to manage our costs may be adversely affected and our results of operations may suffer.

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Our success depends in large part upon our retention of our executive officers and our ability to hire and retain additional key personnel.

Our future performance depends in large part upon the continued services of our executive officers and other key technical, operations and management personnel. Our future success also depends on our continuing ability to attract and retain highly qualified technical, operations and managerial personnel. Competition for such personnel is intense, and we may not be able to retain our key employees or attract or retain other highly qualified technical, operations and management personnel in the future. The loss of the services of one or more of our executive officers or other key employees or our inability to attract and retain additional qualified personnel could harm our business and prospects.

We may acquire other businesses or license technologies, and if we do, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.

Our business strategy in the future may include the acquisition of other businesses or licensing of technologies. We may not be able to identify, negotiate, integrate or finance any such future acquisition or license successfully. We have not acquired any companies to date and have no arrangements or agreements with respect to any potential acquisition and, therefore, have no experience with integrating other business operations or technologies with ours. If we engage in any such strategic transaction, then we may encounter unforeseen operating challenges and expenses that may require a significant amount of management time that otherwise would be devoted to running our operations. If we undertake acquisitions or other strategic transactions, then we may issue shares of stock that dilute the interests of existing stockholders; and we may incur debt, assume contingent liabilities, or create additional expenses related to amortizing intangible assets, any one or more of which may harm our business and results of operations.

Risks Related To Our Industry

We may not be able to respond to the rapid technological change of the communications and information services industries and, as a result, our business may be adversely affected.

The communications and information services industries are undergoing rapid and significant technological change. We cannot predict the effect of technological changes on our business. We expect that new services and technologies will emerge in the markets in which we compete. Those new services and technologies may be superior to the services and technologies that we provide or those new services may render our services and technologies obsolete. In addition, those services and technologies may not be compatible with ours. If we are not able to effectively respond to technological changes, the services we provide may no longer be attractive to our current and potential subscribers and our business, prospects, financial condition and results of operations may be harmed.

We may be required to incur significant costs to modify our systems in order to meet the requirements of the Communications Assistance to Law Enforcement Act.

The Communications Assistance to Law Enforcement Act, or CALEA, requires telecommunications carriers to have the capability to perform wiretaps and to record other call identifying information. There is substantial uncertainty within the industry as to how to implement these requirements with respect to packet-switched networks, such as that operated by Liberty Telecom. As Liberty Telecom expands its service offerings, further modifications to its local switching equipment may be necessary to comply with applicable laws and regulations. On

March 12, 2004, the FCC issued a public notice seeking public comment with respect to a Petition for Rulemaking (Docket RM-10865) filed by the Department of Justice, Federal Bureau of Investigation and U.S. Drug Enforcement Agency, seeking to resolve various outstanding issues associated with the implementation of CALEA. In response to the issues raised by the Department of Justice, the Federal Bureau of Investigation, and other law enforcement agencies, the FCC, on August 12, 2004, issued a Notice of Proposed Rulemaking and Declaratory Ruling addressing various outstanding issues associated with the implementation of CALEA. That proceeding could result in additional regulatory burdens for us and for Liberty Telecom. Complying with CALEA and rules implementing CALEA may require us to incur substantial costs, which could negatively impact our results of operations.

Our services may become subject to burdensome regulations that could increase our costs or restrict our service offerings.

We provide our services through data transmissions over public telephone lines and other facilities provided by telecommunications companies. The underlying transmissions are typically subject to regulation by the FCC, state public utility commissions and, in the future, could become subject to regulation by foreign governmental authorities. These regulations affect the prices that we pay for transmission services, the competition we face from communications service providers that may choose to offer enhanced services similar to ours and other aspects of our market. As a software-based provider of enhanced services, we believe we are not currently subject to direct regulation by the FCC or generally by state public utility commissions, although our wholly-owned subsidiary, Liberty Telecom, is a telecommunications carrier subject to state and federal regulation as a Competitive Local Exchange Carrier. As communications services increasingly are delivered over the Internet and as we expand the services that we offer, our business may become increasingly regulated. Liberty Telecom is required to have a certificate of public convenience and necessity in order to operate in the state of Nevada as a Competitive Local Exchange Carrier. If Liberty Telecom were to lose its certificate, we may not be able to obtain access to telecommunications services at rates or on other terms and conditions that are as favorable as those that we

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currently have. As we introduce new offerings, it is possible that some of them may fall within existing telecommunications regulations, increasing our costs. Changes in the federal and state regulatory rules, or developments in the interpretation of existing regulations, could decrease our revenue, increase our costs or restrict our service offerings.

Future legislation, regulation, or legal decisions affecting the Internet, Internet telephony or IP-enabled services could restrict our business, prevent us from offering our services or increase our cost of doing business.

At present there are few laws, regulations or rulings that specifically address access to or commerce on the Internet, including the provision of Internet protocol-based telephony and other IP-enabled services. We are unable to predict the impact, if any, that future legislation, regulations or legal decisions may have on our business. However, the growth in the market for IP-based telephony and other IP-enabled communications, and the popularity of these services, create the risk that governments and agencies increasingly will seek to regulate services such as our current offerings. Many legislative and regulatory actions are underway or are being contemplated by federal and state authorities, including the FCC and various state regulatory agencies. For example:

On March 10, 2004, the FCC released a notice of proposed rulemaking (Docket 04-36) and sought public comment regarding the regulatory classification, rights and obligations of services supported by IP technologies.

On April 21, 2004, the FCC released a narrow declaratory ruling finding that certain Internet protocol telephony services are telecommunications services upon which interstate access charges may be assessed. Prior to this decision, the FCC had never ruled that a service relying on Internet-protocol technology was a telecommunications service. The ruling illustrates that certain Internet-protocol based services may become subject to costs and regulations that, previously, were not thought to be applicable. This ruling, however, is not likely to have any direct effect on us in the near future.

At an open meeting on August 5, 2005, the FCC unanimously adopted an order reclassifying wireline broadband Internet access services as information services, thereby placing wireline broadband Internet access services within the same general regulatory framework as cable modem services. As an information service, wireline broadband Internet access, like cable modem service, no longer is subject to regulation under Title II of the Communications Act of 1934, as amended, or the FCC s Computer Inquiry rules, but is subject to specific obligations imposed under Title I of the Act. Until the Commission releases the text of the decision, many important details regarding the decision will remain unclear. However, the decision could potentially could enable ILECs to (1) refuse to permit subscribers to their broadband transmission services to use our enhanced services, (2) charge higher rates for underlying broadband transmission service to subscribers to our enhanced services, or (3) bundle enhanced services that are similar to our enhanced services with their broadband transmission services at such a rate that it becomes economically unfeasible for us to compete with the ILEC. If one or more ILECs take any of those actions with explicit or tacit permission from the FCC, then it could have a material adverse impact upon our profitability and the results of our operations.

November 12, 2004, the FCC released an order preempting the September 11, 2003 order of the Minnesota Public Utilities Commission. In the preempted Minnesota Order, the Minnesota Commission had asserted regulatory jurisdiction over Vonage s DigitalVoice service and ordered Vonage to comply with all state statues and regulations relating to the offering of telephone service in Minnesota, which could have required Vonage, among other things, to obtain operating authority, file tariffs, and provide and fund 911 emergency services. In addition to preempting the Minnesota Order, the FCC concluded that comparable regulations of other states must likewise yield to important federal objectives, although the agency did not identify, or preempt, any specific state regulations or orders apart from the Minnesota Order. Specifically, the FCC explained that, to the extent that other VoIP services are not the same as Vonage s but share similar basic characteristics, we believe it highly unlikely that the Commission would fail to preempt state regulation of those services to the same extent. The FCC, however, did not determine whether DigitalVoice or any other IP-enabled service is an information or telecommunications service, and thus the regulatory classification of these services under the Act remains an open issue. An appeal of the FCC s preemption order is currently pending.

The specific services at issue in the FCC s preemption order referenced above were offered to the public as substitutes for, or as substantially equivalent to, existing telecommunications services. In contrast, the services that we currently offer are not offered to the public as substitutes for, or as substantially equivalent to, existing telecommunications services. Our IP-enabled services allow our customers to manage calls which are initiated by third parties to our customers and completed over the local service facilities of our customers existing telecommunications service providers. As such, our customers could not use our service unless they are also separately receiving telecommunications services from their own service provider. Certain decisions adopted by state commissions before the FCC issued its preemption order suggested an increased interest by some state commissions in regulating services that may be perceived as the functional equivalent of local phone service. If state regulators attempt to regulate the enhanced services that we provide or determine that the enhanced services that we provide are currently subject to their regulatory provisions, then we may be faced with substantially increased regulatory burdens and costs.

Regulatory proceedings, legislative efforts and adjudications, including but not limited to some of those described above, may lead to the imposition of additional regulatory obligations and requirements on us in the provision of our services, including but not limited to certification requirements, interstate or intrastate access charges, regulatory fees, payments to universal service support funds, taxes related to Internet or IP-enabled communications, requirements to provide free access to certain users, regulations based on encryption concerns, consumer protection requirements and certain minimum service levels. We could conceivably become subject to requirements and obligations not only at the federal level, but also in any of the states in which we have customers or from which third persons initiate communications to call our customers, as well as in any of those jurisdictions in which facilities exist or activities occur which support our offerings. Further, if we expand into additional lines of business or make new service offerings, we could become subject to existing or future regulation or other legal requirements, including but not limited to those which apply to telecommunications services and the providers of such services. The impact of federal or state legislative, regulatory, or adjudicatory actions or requirements may include an increase in our costs, adversely affect how we conduct our business, and adversely affect our financial condition and results of operations.

Risks Related To Our Common Stock

Our executive officers, directors and 5% stockholders own a significant percentage of our stock and will be able to exercise significant influence over stockholder votes.

Our executive officers, directors and 5% stockholders together beneficially own approximately 63.6% of our common stock, including shares subject to options and warrants that confer beneficial ownership of the underlying shares. Accordingly, these stockholders, for the foreseeable future will continue to have significant influence over our affairs including the election of directors and significant corporate transactions, such as a merger or other sale of our company or its assets. This concentrated control will limit the ability of shareholders to influence corporate matters and, as a result, we may take actions that our stockholders do not view as beneficial. For example, this concentration of ownership could have the effect of delaying or preventing a change in control or otherwise discouraging a potential acquirer from attempting to obtain control of us, which in turn could cause the market price of our common stock to decline or prevent our stockholders from realizing a premium over the market price for their shares of our common stock.

Provisions in Delaware law and our charter documents may make it difficult for a third party to acquire us and could depress the price of our common stock.

Provisions of Delaware law, our certificate of incorporation and our bylaws could make it more difficult for a third party to acquire control of us. For example:

- we are subject to Section 203 of the Delaware General Corporation Law, which would make it difficult for another party to acquire us without the approval of our board of directors;

our certificate of incorporation authorizes our board of directors to issue preferred stock without requiring stockholder approval, and preferred stock could be issued as a defensive measure in response to a takeover proposal; and

our certificate of incorporation or bylaws:

creates a classified board of directors;

prohibits cumulative voting in the election of directors

limits the persons who may call special meetings of our stockholders; and

imposes advance notice requirements for nominations for election to our board of directors and for proposing matters to be acted upon by our stockholders.

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These and other provisions of Delaware law, our certificate of incorporation and our bylaws may make it more difficult for a third party to acquire us even if an acquisition might be in the best interests of our stockholders, and the price at which shares of our common stock are purchased and sold therefore may be depressed.

We are incurring increased costs as a result of being a public company.

As a public company, we are incurring significant additional legal, accounting and other expenses. The Sarbanes-Oxley Act of 2002, as well as new rules subsequently implemented by the Securities and Exchange Commission and the Nasdaq National Market, require changes in corporate governance practices of public companies. These new rules and regulations have resulted in increased legal and financial compliance costs and management efforts and we expect those costs and efforts to continue to increase. It has become more expensive for us to obtain director and officer liability insurance, and it may become more difficult to obtain such insurance in the future, which may cause us to accept reduced policy limits and reduced coverage or to incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. We cannot predict or estimate the amount of additional costs we may incur, but these additional costs and demands on management time and attention may harm our business and results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign currency exchange risk. We do not currently do any business denominated in foreign currencies and, therefore, are not subject to any significant foreign currency exchange risk.

Interest rate sensitivity. We had cash and cash equivalents totaling $35.4 million and marketable securities totaling $26.6 million at December 31, 2005, and cash and cash equivalents totaling $27.3 million and marketable securities totaling $27.2 million at December 31, 2004. Cash and cash equivalents were held for working capital purposes in depository accounts at FDIC-regulated banking institutions. Marketable securities consist of investment grade securities, corporate bonds, and government and agency securities. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our cash and cash equivalents or marketable securities as a result of changes in interest rates. Declines in interest rates, however, will reduce our future interest income.

ITEM 4. CONTROLS AND PROCEDURES

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.*

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as of the end of the period covered by this report. The evaluation included certain internal control areas in which we have made and are continuing to make changes to improve and enhance controls. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

Our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective, in all material respects, to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) *Changes in internal controls over financial reporting.*

There were no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We have identified areas of our internal controls requiring improvement, and are in the process of designing enhanced processes and controls. Areas for improvement include streamlining our billing processes, further limiting internal access to certain data systems and continuing to improve coordination across business functions. We plan to continue this initiative as well as prepare for our first management report on internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002. As a result, we expect to make changes in our internal control over financial reporting.

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Item 9B. Other Information

None.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On July 1, 2005, Catch Curve, Inc., a Delaware corporation, or Catch Curve, filed a complaint against the Company in the United States District Court for the Central District of California (Action No. CV05-4819) alleging that the Company s operations infringe U.S. Patents No 6,785,021, or the `021 Patent, U.S. Patent No. 6,643,034, or the `034 Patent, U.S. Patent No. 5,291,302, or the `302 Patent, and U.S. Patent No. 4,994,926, or the `926 Patent. The Company thereafter filed its answer, denying the allegations and asserting certain counterclaims and affirmative defenses. Catch Curve thereafter filed its answer to those counterclaims, denying the Company s allegations. A trial date of October 2, 2007, has been set in this case. The Company has received from intellectual property counsel opinions that the Company s present operations do not infringe the claims of the `021 patent, the `034 patent, the `302 patent, or the `926 patent. By reason thereof, we presently do not believe it is probable that we will suffer a material loss. However, it is premature to reach any definitive conclusions in that regard.

On August 24, 2004, j2 Global Communications, Inc., or j2, filed a complaint against the Company in the United States District Court for the Central District of California alleging that the Company s operations infringe U. S. Patent No. 6,350,066, or the `066 patent. j2 s complaint seeks unspecified damages and permanent injunctive relief, among other relief. On December 30, 2004, j2 filed a first amended complaint, alleging that in addition to infringing the 066 patent, the Company infringes U. S. Patent Nos. 6,564,321, or the `321 patent, and 6,208,638, or the `638 patent. On January 31, 2005, the Company filed its response to the first amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On April 21, 2005, j2 filed a second amended complaint, alleging that the Company infringes the claims of U.S. Patent No. 6,857,074, or the `074 patent. On May 10, 2005, the Company filed its response to the second amended complaint, denying the allegations of the complaint and alleging affirmative defenses to the complaint. On December 15, 2006, a Markman hearing was held in the case. Before any order issued from that hearing, however, on January 11, 2006, the Court stayed the action pending reexamination of some of the patents in the United States Patent and Trademark Office, or USTPO. We have received from intellectual property counsel opinions that our present operations do not infringe the claims of the `066 patent, the `638 patent, the `321 patent, or the `074 patent. By reason thereof, we presently do not believe it is probable that we will suffer, by reason of such litigation, a material loss. However, it is premature to reach any definitive conclusions in that regard.

The Company in October 2004 received a letter from counsel to Web Telephony, LLC, or Web Telephony, implying that our operations infringe certain claims in U.S. Patent No. 6,445,694, Internet Controlled Telephone System, or the `694 patent, and U.S. Patent No. 6,785,266, Internet Controlled Telephone System, or the `266 patent. On January 19, 2005, the Company filed in the United States District Court for the Central District of California an action for declaratory relief, in which the Company is seeking to have the court declare that the Company does not infringe the `694 patent or the `266 patent. Web Telephony has filed a motion to dismiss the complaint, alleging that the court lacks personal jurisdiction over Web Telephony. The Company filed a First Amended Complaint on May 2, 2005, adding a cause of action for interference with prospective economic advantage. Web Telephony filed an Answer to the First Amended Complaint on September 6, 2005, and counterclaimed, alleging infringement of the `694 and `266 patents. A trial date of June 6, 2006, has been set in this case, and the parties are proceeding with discovery. Given the proximity of that trial date, the Company expects that its efforts to defend against Web Telephony s assertions will be expensive and time-consuming in the current fiscal year. Our intellectual property counsel has issued to us an opinion that our operations do not infringe the claims of the 266 or the 694 patents. By reason of the opinion of counsel that we have obtained, we presently do not believe it is probable that we will suffer a material loss by reason of this matter. However, it is premature to reach a definitive conclusion in that regard.

In September 2004, we received a letter from America Online, Inc., in which AOL offered to grant to us a license to U.S. Patent No. 5,809,128, or the `128 patent. We and AOL are engaged in business discussions at the present time, and it is unclear how those negotiations will be concluded. We have received from intellectual property counsel an opinion that our operations do not infringe the claims of the `128 patent. By reason thereof, we presently do not believe it is probable that we will suffer a material loss by reason of this matter, although it is premature to reach a definitive conclusion in that regard.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Sales of Unregistered Securities

None.

Use of Proceeds

On October 5, 2004, we closed the sale of 4,000,000 shares of our common stock in our initial public offering. The registration statement on Form S-1 (Reg. No. 333-115438) we filed to register our common stock in the offering was declared effective by the SEC on September 29, 2004. After deducting expenses of the offering, we received net offering proceeds of approximately $35.2 million. From the time of receipt, October 5, 2004, through December 31, 2005, we have not used the proceeds of this offering but have invested them into investment grade government agency and corporate debt securities.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At our 2005 Annual Meeting of Stockholders held on December 13, 2005 (the Annual Meeting), our stockholders: (i) elected two Class I Directors each to serve a term to expire in 2008 (Proposal No. 1); (ii) ratified the appointment of Ernst & Young LLP as independent auditors for the fiscal year ending June 30, 2006 (Proposal No. 2); and (iii) approved an amendment to the Company s Certificate of Incorporation to limit the liability of directors of the Company to the fullest extent permitted under the Delaware General Corporation Law (Proposal No. 3). The tabulation of votes for each of the proposals is set forth below:

Proposal No. 1

Election of two Class I Directors for a three-year term:

Directors-Class I	Votes For	Votes Withheld
Jeffrey O. Henley	14,400,320	342,616
Michael S. Noling	14,351,820	391,116

Proposal No. 2

Ratification of the appointment of Ernst & Young LLP as independent auditors of the Company for the 2006 fiscal year:

FOR	AGAINST	ABSTAIN
14,605,923	114,430	22,583

Proposal No. 3

Approval of the amendment to the Company s Certificate of Incorporation

FOR	AGAINST	ABSTAIN	Broker Non-Vote
14,259,053	364,556	119,327	

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit Number	Description
3.1	Certificate of Amendment to Amended and Restated Certificate of Incorporation.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

	CALLWAVE, INC.,
Date: February 14, 2006	By: /s/ David F. Hofstatter David F. Hofstatter, President and Chief Executive Officer
Date: February 14, 2006	By: /s/ C. Stephen Cordial C. Stephen Cordial Chief Financial Officer (principal financial and accounting officer)

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