CALLWAVE INC
Form S-1
May 13, 2004
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As filed with the Securities and Exchange Commission on May 13, 2004

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

CALLWAVE, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**4822**	**77-0490995**
(State or other jurisdiction of incorporation or organization)	**(Primary Standard Industrial Classification Code Number)**	**(I.R.S. Employer Identification Number)**

136 West Canon Perdido Street, Suite A

Santa Barbara, CA 93101

(805) 690-4000

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

David F. Hofstatter

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Santa Barbara, CA 93101

(805) 690-4000

(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ¨

Calculation of Registration Fee

Title of Each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price(1)(2)	Amount of Registration Fee
Common Stock, $0.0001 per share par value	$ 69,000,000	$ 8,743

(1) Includes offering price of shares that the underwriters have the option to purchase to cover over-allotments, if any.
(2) Estimated solely for the purpose of computing the amount of the registration fee, in accordance with Rule 457(o) promulgated under the Securities Act of 1933.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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Subject to Completion, Dated May 13, 2004

CallWave, Inc.

Shares

Common Stock

This is the initial public offering of CallWave, Inc. We are offering shares of our common stock. We anticipate that the initial public offering price will be between $ and $ per share. We have applied to list our common stock on the Nasdaq National Market under the symbol CALL.

Investing in our common stock involves risk. See Risk Factors beginning on page 5.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	$	$
Underwriting discount and commissions		
Proceeds, before expenses, to CallWave, Inc.		

We have granted the underwriters the right to purchase up to additional shares of common stock to cover any over-allotments.

Deutsche Bank Securities

Piper Jaffray

First Albany Capital

WR Hambrecht + Co

The date of this prospectus is , 2004.

The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

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PROSPECTUS SUMMARY

This summary highlights selected information contained in greater detail elsewhere in this prospectus. This summary does not contain all the information you should consider before investing in our common stock. You should read the entire prospectus carefully before making an investment decision, including Risk Factors and the consolidated financial statements and the related notes. References in this prospectus to CallWave, we, our and us refer to CallWave, Inc. and our consolidated subsidiaries.

Our Business

We provide affordable communications application services on a subscription basis to mainstream consumers and small and home offices. Our software-based services are delivered on our proprietary Enhanced Services Platform that allows subscribers to bridge calls across existing landline, mobile and Internet networks, without requiring them to purchase or install additional hardware. Our platform acts as a network-independent communication interface layer, and is presently used for bridging important landline calls to our subscribers through their mobile telephones or through their Internet-connected personal computers using voice-over-IP technology. Our services allow subscribers to see and hear who is calling before deciding whether to take the call, enabling them to receive more of their important calls and to manage other calls at their convenience. These capabilities enable our mass-market subscribers to more effectively manage their personal communications.

As of March 31, 2004, we had more than 780,000 paying subscribers. By bridging incoming calls across subscribers existing landline, mobile and Internet networks, our subscribers realize greater value from their existing communications services. Our services extend the functionality of networks and devices that our subscribers already use by offering easy to use, enhanced communications features such as real-time voicemail, call screening, and virtual phone and fax numbers. Because our services improve the utilization of existing communications networks, 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.

The emergence of mobile telephones and the Internet has reshaped the communications market. A decade ago, households and small and home offices, or SOHOs, typically used a landline telephone as their primary means of communication. Today, households and SOHOs commonly use both mobile telephones and the Internet in addition to traditional landline telephones. Mobile telephones and the Internet, which penetrated early adopter markets in the 1990s, have now reached mass-market acceptance with cost-conscious consumers and SOHOs the mainstream market by delivering to users compelling value at affordable prices. IDC estimates that there were over 106 million households and over 19 million SOHO firms in the United States at the end of 2003. Mainstream users increasingly subscribe to multiple communications services, including landline telephones, mobile telephones and the Internet, but do not have an effective means of managing communications across these networks. We provide mainstream users with solutions that allow them to bridge inbound communications across their existing networks and devices.

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Our objective is to be the leading provider of solutions that help mainstream consumers and SOHOs utilize their existing communications services more efficiently and cost-effectively. The key elements of our strategy are to:

- maintain focus on the needs of the mainstream market;
- continue our subscriber-driven approach to product development and marketing;
- provide affordable communications solutions for mainstream users;
- extend and enhance component applications and service levels; and
- extend our reach through strategic relationships with network service providers.

Corporate Information

We were incorporated in California in 1998. We intend to reincorporate in Delaware prior to this offering. Our principal executive offices are located at 136 West Canon Perdido Street, Suite A, Santa Barbara, California, and our telephone number at this address is (805) 690-4000. Our website is www.callwave.com. The information on our website is not part of this prospectus.

Our registered trademarks include CallWave, our CallWave logo, ECallerID, Fax2Email, FaxWave, our FaxWave name design, Liberty Telecom, The Future of Faxing and Internet Answering Machine.

We have applied for trademarks for our CW logo and Take The Call. This prospectus contains other trade names, trademarks and service marks of ours and of other companies.

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THE OFFERING

Type of securities	Common stock
Shares to be offered	shares
Shares outstanding after this offering	shares
Use of proceeds	We anticipate that we will use the net proceeds of this offering for general corporate purposes, including working capital and potential acquisitions. See the section titled Use of Proceeds.
Proposed Nasdaq National Market symbol	CALL
Risk factors	See Risk Factors beginning on page 5 for a discussion of factors that you should consider carefully before deciding to purchase our common stock.

The common stock outstanding after the offering is based on the number of shares outstanding as of December 31, 2003, and excludes:

- 2,969,093 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.01 per share;
- 1,863,300 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.31 per share, which do not expire upon the consummation of this offering;
- 2,800,000 shares reserved for issuance under our 2004 Stock Incentive Plan; and
- 200,000 shares reserved for issuance under our Employee Stock Purchase Plan.

Unless otherwise indicated, all information in this prospectus assumes:

- the conversion of all outstanding shares of our convertible preferred stock into shares of our common stock, on a one-for-one basis, immediately prior to the closing of this offering; and
- no exercise by the underwriters of their option to purchase additional shares of common stock in this offering.

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SUMMARY CONSOLIDATED FINANCIAL DATA

(in thousands, except per share data)

The following tables provide summary consolidated financial data for the periods presented. This summary consolidated financial data should be read together with the sections titled Selected Consolidated Financial Data, and Management s Discussion and Analysis of Financial Condition and Results of Operations, and our consolidated financial statements and the related notes appearing elsewhere in this prospectus. The pro forma balance sheet data gives effect upon the closing of this offering to the automatic conversion of all outstanding shares of convertible preferred stock into common stock as if it had occurred on June 30, 2003. The pro forma as adjusted balance sheet data gives further effect to the application of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commission and estimated offering expenses. See the sections titled Use of Proceeds and Capitalization for additional information.

	Fiscal Year Ended June 30,					Six Months Ended December 31,	
	1999	2000	2001	2002	2003	2002	2003
	(unaudited)					(unaudited)	
Statement of Operations Data:							
Revenues	$	$ 487	$ 2,883	$ 16,383	$ 22,488	$ 10,440	$ 18,254
Operating income (loss)	(1,340)	(9,624)	(14,498)	(3,010)	1,601	810	5,185
Net income (loss)	(1,338)	(9,642)	(16,054)	(3,050)	1,636	827	5,216
Net income (loss) per share:							
Basic	$ (0.22)	$ (1.07)	$ (1.77)	$ (0.33)	$ 0.18	$ 0.09	$ 0.56
Diluted	(0.22)	(1.07)	(1.77)	(0.33)	0.06	0.03	0.21
Pro forma (unaudited)					0.07		0.22
Shares used in net income (loss) per share:							
Basic	5,983	9,009	9,060	9,167	9,270	9,257	9,295
Diluted	5,983	9,009	9,060	9,167	25,484	25,495	25,357
Pro forma (unaudited)					23,501		23,526

	As of December 31, 2003		
		(unaudited)	
	Actual	Pro Forma	Pro Forma As Adjusted
Balance Sheet Data:			
Cash and cash equivalents	$ 8,418	$ 8,418	$
Working capital	6,304	6,304	
Total assets	13,928	13,928	
Convertible preferred stock	28,761		
Accumulated deficit	(23,232)	(23,232)	
Total stockholders equity	8,157	8,157	

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RISK FACTORS

You should carefully consider the risks described below together with all of the other information included in or incorporated by reference into this prospectus before making an investment decision. The risks and uncertainties described below are not the only ones we face. If any of the following risks actually occur, our business could be harmed. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks Related To Our Business

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

A large portion of our current subscriber base generally obtains access to the Internet through dial-up connection network service providers. The market for communications services is competitive, and many service providers attempt to attract and retain subscribers by offering a collection of services. While service providers that provide Internet call waiting and call-bridging 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 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.

If we do not attract and retain subscribers, we will not be able to expand our business.

We must continue to attract new subscribers to our communications applications services in order to significantly increase our revenues. Our ability to cost-effectively attract new subscribers will depend in part on our ability to consistently provide our subscribers a high-quality experience for filtering, managing and delivering calls and to successfully market and sell those services to the mainstream market. If mainstream consumers and SOHOs do not perceive that our services provide value, or if we introduce new services that are not favorably received by our existing and potential subscribers, or if we do not effectively market our services, we may not be able to attract or retain subscribers. In addition, some new subscribers originate from referrals from existing subscribers. If we do not continue to satisfy our existing subscribers, then we may not continue to attract new subscribers through such referrals. If we are unable to attract new subscribers on a cost-effective basis, our business will not grow and our results of operations may be adversely affected.

Subscribers cancel their subscriptions for our services for many reasons, including a perception that they do not use the service often enough to justify the monthly fees, delivery of the service takes too long, the service is not worth the monthly fees and subscriber service issues are not satisfactorily resolved. If our subscribers cancel subscriptions at an increased rate, we may have to incur significantly higher marketing expenditures to attract large numbers of new subscribers. We cannot be certain that these investments would maintain or improve subscriber retention. If our subscribers cancel subscriptions at a significant rate, or if we are not able to cost-effectively attract and retain sufficient subscribers to offset such cancellations and grow our business, our operating results would be adversely affected.

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If we are unable to continue to attract and retain subscribers as the Internet access market transitions from dial-up to broadband, our ability to generate revenues may be adversely affected.

The majority of our subscribers currently access the Internet through a dial-up connection. Those subscribers are often attracted to our enhanced services because our services allow those subscribers to monitor their incoming telephone calls while their main telephone line is busy accessing the Internet. We believe that over time many dial-up subscribers will switch to broadband that allows subscribers to use the Internet while simultaneously receiving telephone calls on their primary telephone lines. Although we have not generated substantial revenues from broadband access subscribers, we expect the growth of our business to depend upon our ability to expand and market our services successfully to broadband access subscribers. We may be required to develop additional technologies or make improvements to our existing technologies in order to market our services effectively to users that have broadband Internet access. If we are unable to expand our services and market our services effectively to broadband access subscribers, then the trend toward broadband Internet access would likely have a material adverse effect on our business, prospects and results of operations.

We face competition from well-capitalized hardware vendors, software vendors and service providers that may cause our business to suffer.

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 but have technologies similar to ours, including 8X8, Net2Phone and Vonage. If these or other companies provide services similar to ours, we may not be able to compete effectively and our results of operations would be adversely affected.

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 a knowledge of the communications and information services industries could compete with us without facing significant capital expenditures or other barriers to entry. For example, some companies are creating networks that will provide access to the Internet through local telephone calls that may enable us and others to avoid the need to integrate long-distance services to provide our enhanced offerings. That development may allow other companies to compete with us without having to purchase, install or maintain the relatively more complicated hardware currently necessary to utilize the underlying public switched telephone network. 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. We cannot assure you that we will be able to remain competitive, or that competition will not have a material adverse effect on our business and results of operations.

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We rely upon the networks of numerous long-distance and local carriers and if we are not able to purchase telephone services from them at reasonable rates, we may not be able to profitably provide our services to our subscribers.

In providing services to our subscribers, we incur a number of telecommunications costs which are beyond our control. In order to deliver our services to our subscribers, our services re-route certain telephone calls from their telephone lines to toll-free numbers that we have leased, from that toll-free number to our software-based switching facility, and then from that facility to the number that the subscribers designate. The re-routing of calls from our subscribers lines, relies, in part, upon the toll-free network, as well as upon long-distance and local services that we purchase from network service providers. The cost of these services, which we integrate into our service offerings, 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 services and access, on a reliable basis and at reasonable prices. If we are unable to effectively manage the cost of our network services, then our pricing structure with a significant number of our subscribers would be materially changed, which would have a material adverse effect on our ability 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 were to terminate our existing contractual relationships, we cannot assure you that we could 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 enhanced services to our subscribers and our operating results would be materially adversely affected.

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We rely upon the Internet and other networks controlled by third parties to 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 materially harmed.

Because a significant portion of our subscribers are price sensitive, we may not be able to increase the charges for our services without adversely affecting our ability to attract and retain paying subscribers.

Our subscribers are generally price sensitive. In response to that sensitivity, we have attempted to control our costs in order to be able to charge low subscription rates, which generally range from $1.50 to $7.95 per month, and are as high as $9.95 per month in limited circumstances. We expect that recruiting new subscribers may become more expensive on average if we increase our marketing efforts. If we experience significant cost increases or otherwise want to increase our margins, we may be unable to increase our monthly charges by an amount sufficient to allow us to maintain margins or our profitability, and our business and operating results could be adversely affected.

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, which would have a material adverse effect on our business and results of operations.

Because the secondary facility for our subsidiary s existing telephone switching equipment is not yet 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 developing a secondary call-switching facility, we cannot assure you if the second facility will be 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 have a material adverse impact on our business and operating results.

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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. We cannot assure you that our existing and planned precautions will be adequate to prevent a significant interruption in the operation of our network. 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 have a material adverse effect on our business, prospects, financial condition and results of operations.

Our subscriber acquisition costs vary depending upon prevailing market conditions and may increase significantly in the future.

Our subscriber acquisition costs 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 paying subscribers. Historically, we have used Internet advertising as the primary means of marketing our services. In the future, we expect to expand to other more expensive forms of advertising, such as television, radio and direct mail, which would increase our subscriber acquisition costs. Our sales and marketing and other costs of acquiring new subscribers are substantial relative to the monthly fees derived from subscriptions. Based on historical trends, we expect those costs to continue to rise. If we are not able to reduce our other operating costs, increase our subscriber base and increase revenue per subscriber to offset these anticipated increased subscriber acquisition costs, our business and results of operations would be adversely affected.

If we do not successfully anticipate the service demands of our subscribers, our business and results of operations will suffer.

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, which would have a material adverse effect on our results of operations.

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 may claim that we infringe or misappropriate their intellectual property rights. From time to time, third parties have contacted us, asserting that we

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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 offering to negotiate a nonexclusive license to certain patents that the infrastructure company believed to be relevant to our service. We are in the process of evaluating those letters, which have been provided to us indirectly by that distributor. A determination that we have infringed the intellectual property rights of a third party 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. While to date these assertions have not materially affected our business, we cannot assure you that any such assertions would not have a material adverse effect on our business, prospects, financial condition and results of operations. Any efforts to defend ourselves from assertions of infringement or misappropriation of a third party s intellectual property rights would be expensive and time-consuming, would divert management resources and may not ultimately be successful.

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. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business prospectus financial condition and results of operations.

We might 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 use or a third party, would be expensive and time-consuming, would divert management resources and could materially and adversely affect our business, whether or not such litigation results in a determination favorable to us.

We have a limited operating history, which will make it difficult to predict our future results.

We were formed in August 1998, some of our free services became commercially available in October 1999, and we began charging for certain of our services in April 2001. Because of our

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limited operating history, there is limited operating and financial data about us upon which to base an evaluation of our potential future performance and an investment in our common stock. You should consider our business and prospects in light of the risks and difficulties we may encounter, including those frequently encountered by new companies competing in rapidly evolving markets. If we are unable to execute our plans and grow our business, either as a result of the risks identified in this section or for any other reason, our results of operations may suffer.

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, and may have a material adverse effect on our business, results of operations and profitability.

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 have a material adverse effect on our business, prospects, financial condition and results of operations.

We are dependent upon billing arrangements with regional telephone companies for collecting fees from many of our 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. As of March 31, 2004, approximately 80% of our paying subscribers were billed through their local telephone company. 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

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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 paying 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, either of which could have a material adverse effect on our business.

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, calls to our subscribers were 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 link calls to our subscribers to and from our centralized platform increasingly through the Internet or third-party managed IP networks, which 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 IP network services. 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.

We are installing a new accounting software system, and we may encounter technical or operational difficulties during the transition that could disrupt our operations.

We currently are installing a new financial accounting system, and we may encounter technical and operating difficulties during the installation of and transition to that new system. The software that we have purchased may not operate as we intend it to operate. In addition, we may experience problems in implementing the new system as our financial employees learn the new system, transfer data from our existing system to the new system and operate with the new system. We cannot assure you that the transition will be completed either promptly or at all. Any difficulties that we encounter in implementing the new system may disrupt our ability to deal effectively with our employees, subscribers, vendors and other companies with which we have commercial relationships and also may prevent us from effectively closing a quarterly period and reporting our financial results in a timely manner. Any such disruptions may adversely affect our business, prospects, financial condition and results of operations.

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, in particular David F. Hofstatter, our chief executive officer. 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 cannot assure you that we can retain our key employees or that we can 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 have a material adverse effect on our business.

We may be unable to manage growth effectively.

If we are successful in implementing our business plan, our operations should expand over time. This expansion will require substantial financial, operational and management resources

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and could place a significant strain on such resources. As the number of our subscribers and the volume of their calls increase, we will need to be able to continue to expand and adapt our network systems. Our ability to manage future growth, if it occurs, will depend upon our ability to scale the capacity, reliability and security of our network systems. If we are not able to effectively manage our growth, our business and results of operations may be harmed.

We may need to raise additional capital to support the growth of our operations, but we cannot assure you that such additional funds will be available.

Our future capital needs are difficult to predict. We may require additional capital in order to take advantage of opportunities, including strategic alliances and potential acquisitions, or to respond to changing business conditions and unanticipated competitive pressures. Additionally, funds generated from our operations may be less than anticipated. Should we need to raise additional funds either by borrowing money or issuing additional equity, we cannot assure you that we will be able to raise such funds on favorable terms, if at all. If we are unable to obtain additional funds, then we may be unable to take advantage of new opportunities or take other actions that otherwise might be important to our business or 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.

We may attempt to acquire other businesses or license technologies in the future. 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 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 have a material adverse effect upon our business and results of operations.

We may expand internationally in the future, which would subject us to unpredictable regulatory, economic and political situations.

We may expand internationally, and we cannot assure you that we will be able to successfully manage such expansion. In addition to the uncertainty regarding our ability to generate revenue from foreign operations and establish our international presence, there are certain risks inherent in doing business internationally that may affect our operating margins, including:

- changing regulatory requirements, which vary widely from country to country;
- action by foreign governments or foreign telecommunications companies to limit access to our services;
- increased bad debt and risk of fraudulent accounts;

cultural, behavioral and socioeconomic differences;

telecommunication costs that may not be comparable to the costs we currently pay;

legal uncertainty regarding liability, tariffs and other trade barriers;

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economic and political instability; and

potentially adverse tax consequences.

In countries where we may offer our services, we may not fully understand the laws that relate to our services. We cannot be certain that our subscribers, resellers or other affiliates will be in compliance with regulatory or other legal requirements in their respective countries or that they or we will be able to comply with existing or future requirements. Our failure, or the failure of those with whom we transact business, to understand and comply with those requirements could adversely affect our business.

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 adversely affected.

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. 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 offer services similar to ours and other aspects of

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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 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, any of which would materially harm our business.

Future legislation or regulation of the Internet or Internet telephony 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 Internet protocol-based telephony and other IP-enabled services. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning the Internet may have on our business and results of operations. Regulations may involve, among other things, assessing access or settlement charges, imposing taxes related to Internet communications, imposing tariffs or regulations based on encryption concerns or the characteristics and quality of products and services. The increasing growth of the IP-enabled services market and popularity of Internet telephony products and services, for example, may heighten the risk that governments or other legislative bodies will seek to regulate these industries. Many legislative and regulatory actions are underway or are being contemplated by federal and state authorities, including the FCC and other state regulatory agencies. For example:

- On November 1, 2003, a federal law expired that had barred certain multiple or discriminatory state and local taxes on electronic commerce and certain taxes on Internet access. Legislation is currently pending in the United States Congress retroactively to extend and make permanent that ban, with modifications. It is not clear whether such legislation will be enacted. If such legislation is not enacted, our products and services could be subject to additional state and local taxes.

- On March 10, 2004, the Federal Communication Commission released a notice of proposed rulemaking (Docket 04-36) and sought public comment regarding the regulatory classification, rights and obligations of certain communications services offered by means of the Internet-based networks.

- On March 12, 2004, the FCC sought 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, on an expedited basis, various outstanding issues associated with the implementation of CALEA.

- 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.

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Regulatory proceedings, legislative efforts and adjudications such as these may lead to the imposition of additional regulatory obligations 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, requirements to provide free access to certain users, consumer protection requirements and certain minimum service levels. The effects of federal or state regulatory actions may increase our costs, negatively impact how we conduct our business and have a material adverse effect on our financial condition and results of operations.

Risks Related To This Offering And 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 82.7% of our common stock immediately prior to the closing of this offering, including shares subject to options and warrants that confer beneficial ownership of the underlying shares and will own approximately % of our common stock after the sale of the shares in this offering, assuming no exercise of the underwriters over-allotment option. Accordingly, these stockholders will continue to have significant influence over our affairs. 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.

Existing stockholders will hold a significant number of shares that will be eligible for future sale.

Sales of substantial amounts of shares of our common stock in the public market, or the prospect of such sales, could adversely affect the market price of our common stock. Upon completion of this offering, we will have outstanding shares of common stock. Of the shares outstanding prior to this offering, all shares of common stock held by current stockholders are subject to lock-up agreements under which the holders of such shares have agreed not to sell or otherwise dispose of any of their shares for a period of 180 days after the date of this prospectus without the prior written consent of Deutsche Bank Securities Inc. and us. After the 180-day period, 16,560,591 shares held by current stockholders will be eligible for sale under Rule 144, Rule 144(k) or Rule 701. The remaining 8,278,892 shares held by existing stockholders will become eligible for sale from time to time in the future under Rule 144, Rule 144(k) or Rule 701. Certain existing stockholders holding approximately 14,391,641 shares of common stock are also entitled to certain registration rights with respect to their shares of common stock. See the sections titled Shares Eligible for Future Sale and Description of Capital Stock Registration Rights for additional information.

There may be a limited market for our common stock, and you may not be able to resell your shares at or above the initial public offering price.

There has not been a public market for our common stock. We cannot assure you that an active trading market for our common stock will develop following this offering. You may not be able to sell your shares quickly or at the market price if trading in our stock is not active. The initial public offering price for the shares will be determined by negotiations between us and the representatives of the underwriters and may not be indicative of prices that will prevail in the trading market. See the section titled Underwriting for more information regarding our

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arrangement with the underwriters and the factors considered in setting the initial public offering price.

The price of our common stock may fluctuate significantly, which could lead to losses for stockholders.

The trading prices of securities of technology companies have been highly volatile. Accordingly, the trading price of our common stock is likely to be subject to wide fluctuations. Further, our common stock has no prior trading history. Factors, some of which are beyond our control, that could affect the trading price of our common stock may include:

- variations in our results of operations;
- announcements of technological innovations, new services or service enhancements, strategic alliances or significant agreements by us or by our competitors;
- recruitment or departure of key personnel;
- litigation, legislation, regulation or technological developments that adversely affect our business;
- changes in the estimates of our results of operations, changes in recommendations and the research and reports that may be published by any securities analyst that elects to follow our company or industry; and
- market conditions in our industry, the industries of our subscribers and the economy as a whole.

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.

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.

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Our management may not effectively use the proceeds of this offering.

Our management has broad discretion over the use of proceeds from the sale of our stock in this offering. In addition, our management has not designated a specific use for a substantial portion of the proceeds of this offering. Accordingly, it is possible that our management may allocate the proceeds in ways that do not improve our business and results of operations.

If we are successful in completing our initial public offering, we will incur increased costs as a result of being a public company.

As a public company, we will incur 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, have required changes in corporate governance practices of public companies. We expect these new rules and regulations to further increase our legal and financial compliance costs and to make certain compliance and reporting activities more time-consuming. We also expect it to be more difficult and more expensive for us to obtain and maintain director and officer liability insurance, 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 have a material adverse effect on our business and results of operations.

Purchasers in this offering will incur immediate and substantial dilution in the book value of their investment.

Our initial public offering price will be substantially higher than the $0.34 in net tangible book value per share of our common stock as of December 31, 2003. Therefore, if you purchase our shares in this offering you will incur immediate and substantial net tangible book value dilution of $ per share from the price you paid, based on the initial public offering price of $ per share. Additional dilution will result if holders of stock options, whether currently outstanding or subsequently granted, exercise their options or if warrant holders exercise their warrants to purchase common stock. For a further description of the dilution that you could experience immediately after this offering, please see the section titled Dilution.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements that include information relating to future events, future financial performance, strategies, expectations, competitive environment, regulation and availability of resources. These forward-looking statements include, without limitation, statements regarding: proposed new applications and services; development of additional strategic relationships; our market opportunity; our strategy; our expectations concerning litigation, regulatory developments or other matters; statements concerning projections, predictions, expectations, estimates or forecasts for our business, financial and operating results and future economic performance; statements of management s goals and objectives; and other similar expressions concerning matters that are not historical facts. Words such as may, will, should, could, would, predicts, potent continue, expects, anticipates, future, intends, plans, believes, estimates, and similar expressions, as well as statement tense, identify forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by which, that performance or those results will be achieved. Forward-looking statements are based on information available at the time they are made and management s good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements. Important factors that could cause these differences include, but are not limited to:

- our ability to maintain and expand our user base;
- industry competition;
- our ability to continue to execute our growth strategies;
- litigation, legislation, regulation or technological developments affecting our business;
- general economic conditions; and
- other factors discussed in the sections titled Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business.

Forward-looking statements speak only as of the date they are made. You should not put undue reliance on any forward-looking statements. We assume no obligation to update forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except to the extent required by applicable securities laws. If we do update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements.

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USE OF PROCEEDS

We estimate that the net proceeds to us from the sale of the shares of common stock offered by us will be approximately $, or approximately $ if the underwriters over-allotment option is exercised in full, based on an assumed initial public offering price of $ per share and after deducting this estimated underwriting discount and commissions and estimated offering expenses. The principal purposes of this offering are to increase our working capital, to create a public market for our common stock and to facilitate future access to the public capital markets.

We have not made specific plans with respect to the net proceeds of this offering and, therefore, cannot specify with certainty the particular uses for the net proceeds. Our management will have significant flexibility in applying the net proceeds. We will use the net proceeds of this offering for working capital and general corporate purposes, including increased sales and marketing, research and development and capital expenditures. We may also use a portion of the net proceeds to acquire or invest in complementary businesses or technologies, although we have no present commitments or agreements with respect to any material acquisition or investment. Pending the application of the net proceeds, we intend to invest those proceeds in short-term, interest-bearing, investment-grade securities.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our common stock and do not intend to pay any cash dividends in the foreseeable future. We anticipate that we will retain all of our future earnings for use in the development of our business and for general corporate purposes. Any determination to pay dividends in the future will be at the discretion of our board of directors.

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CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2003:

- on an actual basis;
- on a pro forma basis to give effect to the automatic conversion of all outstanding shares of convertible preferred stock into common stock upon the closing of this offering, as if it had occurred on December 31, 2003; and
- on a pro forma as adjusted basis to give further effect to the application of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commissions and estimated offering expenses.

You should read this table together with the sections titled Selected Consolidated Financial Data and Management s Discussion and Analysis of Financial Condition and Results of Operations, and our consolidated financial statements and the related notes appearing elsewhere in this prospectus.

	As of December 31, 2003		
	Actual	Pro Forma	Pro forma as Adjusted
	(unaudited, in thousands, except share data)		
Cash and cash equivalents	$ 8,418	$ 8,418	$
Stockholders equity:			
Preferred Stock, $0 par value; 17,511,594 shares authorized, 14,230,941 shares issued and outstanding, actual; 10,000,000 authorized, 0 shares issued and outstanding, pro forma; 10,000,000 shares authorized, 0 shares issued and outstanding, pro forma as adjusted	28,761		
Common stock, $0.0001 par value; 40,000,000 shares authorized, 9,816,951 shares issued and outstanding, actual; 100,000,000 authorized, 24,047,892 shares issued and outstanding, pro forma; 100,000,000 shares authorized, shares issued and outstanding, pro forma as adjusted	2,796	31,557	
Deferred stock-based expense	(168)	(168)	(168)
Accumulated deficit	(23,232)	(23,232)	(23,232)
Total stockholders equity	$ 8,157	$ 8,157	$

In the table above, the number of shares outstanding on a pro forma and pro forma as adjusted basis as of December 31, 2003, does not include:

2,969,093 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.01 per share;

1,863,300 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.31 per share, which do not expire upon the consummation of this offering;

2,800,000 shares reserved for issuance under our 2004 Stock Incentive Plan; and

200,000 shares reserved for issuance under our Employee Stock Purchase Plan.

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DILUTION

If you invest in our common stock, your interest will be diluted immediately to the extent of the difference between the public offering price per share of our common stock and the pro forma net tangible book value per share of our common stock after this offering. As of December 31, 2003, our pro forma net tangible book value was approximately $8,157,000, or $0.34 per share of common stock. Pro forma net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of common stock outstanding after giving effect to the automatic conversion of all outstanding shares of convertible preferred stock into common stock.

Dilution in pro forma net tangible book value per share represents the difference between the amount per share paid by buyers of shares of our common stock in this offering and the pro forma net tangible book value per share of our common stock immediately following this offering.

After giving effect to the receipt of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share and after deducting estimated underwriting discounts and commissions and the estimated offering expenses, our pro forma net tangible book value as of December 31, 2003, would have been approximately $ million, or $ per share of common stock. This represents an immediate increase in pro forma net tangible book value of $ per share to existing stockholders and an immediate dilution of $ per share to new investors purchasing shares at the initial public offering price. The following table illustrates the per share dilution:

Assumed initial public offering price per share		$
Pro forma net tangible book value per share as of December 31, 2003	0.34	
Increase in pro forma net tangible book value per share attributable to new investors		
Pro forma net tangible book value per share after this offering		
Dilution per share to new investors		$

The following table summarizes, as of December 31, 2003, on the pro forma basis described above, the number of shares of common stock purchased from us, the total consideration paid to us and the average price per share paid by existing stockholders and by new investors purchasing shares of common stock in this offering, before deducting estimated underwriting discounts and commissions and estimated offering expenses (in thousands, except per share data):

	Shares Purchased		Total Consideration		Average Price Per Share
	Number	Percent	Amount	Percent	
Existing stockholders	24,048	%	$ 28,924	%	$ 1.20
New investors					
Total		100%	$	100%	

If the underwriters over-allotment option is exercised in full, the following will occur:

- the number of shares of common stock held by existing stockholders will decrease to approximately % of the total number of shares of our common stock outstanding after this offering; and
- the number of shares held by new investors will be increased to , or approximately %, of the total number of our shares of our common stock outstanding after this offering.

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In the discussion and table above, the number of shares outstanding as of December 31, 2003, does not include:

- 2,969,093 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.01 per share;
- 1,863,300 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.31 per share, which do not expire upon the consummation of this offering;
- 2,800,000 shares reserved for issuance under our 2004 Stock Incentive Plan; and
- 200,000 shares reserved for issuance under our Employee Stock Purchase Plan.

If any of these are exercised, there will be further dilution to new public investors.

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SELECTED CONSOLIDATED FINANCIAL DATA

(in thousands, except per share data)

The following selected consolidated financial data should be read in conjunction with, and are qualified by reference to, our consolidated financial statements and related notes and the section titled Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this prospectus. The statement of operations data for the years ended June 30, 2001, 2002 and 2003 and the balance sheet data as of June 30, 2002 and 2003 are derived from, and are qualified by reference to, our consolidated financial statements, which are included elsewhere in this prospectus. The statement of operations data for the years ended June 30, 1999 and 2000 and the balance sheet data at June 30, 1999, 2000 and 2001 are derived from our consolidated financial statements, which are not included elsewhere in this prospectus. The interim statement of operations data for the six months ended December 31, 2002 and 2003 and the balance sheet data as of December 31, 2002 and 2003 are derived from our unaudited interim consolidated financial statements, which are included elsewhere in this prospectus.

	Fiscal Year Ended June 30,					Six Months Ended December 31,	
	1999	2000	2001	2002	2003	2002	2003
Statements of Operations Data:							
Revenues	$	$ 487	$ 2,883	$ 16,383	$ 22,488	$ 10,440	$ 18,254
Cost of sales		1,565	5,222	6,568	8,467	3,607	5,658
Gross profit		(1,078)	(2,339)	9,815	14,021	6,833	12,596
Operating expenses:							
Sales and marketing	397	5,004	6,215	4,180	3,959	2,247	2,746
Research and development	302	2,090	3,965	4,382	4,894	2,311	2,397
General and administrative	641	1,452	1,979	4,263	3,376	1,465	2,268
Impairment of long-lived assets					191		
Total operating expenses	1,340	8,546	12,159	12,825	12,420	6,203	7,411
Operating income (loss)	(1,340)	(9,624)	(14,498)	(3,010)	1,601	810	5,185
Interest income (expenses), net	2	(17)	(1,555)	(39)	36	18	32
Net income before income taxes	(1,338)	(9,641)	(16,053)	(3,049)	1,637	828	5,217
Income tax provision		1	1	1	1	1	1
Net income (loss)	$ (1,338)	$ (9,642)	$ (16,054)	$ (3,050)	$ 1,636	$ 827	$ 5,216
Net income (loss) per share:							
Basic	$ (0.22)	$ (1.07)	$ (1.77)	$ (0.33)	$ 0.18	$ 0.09	$ 0.56
Diluted	(0.22)	(1.07)	(1.77)	(0.33)	0.06	0.03	0.21
Pro forma (unaudited)					0.07		0.22
Shares used in net income (loss) per share:							
Basic	5,983	9,009	9,060	9,167	9,270	9,257	9,295
Diluted	5,983	9,009	9,060	9,167	25,484	25,495	25,357
Pro forma (unaudited)					23,501		23,526

As of June 30,

						As of December 31,	
	1999	2000	2001	2002	2003	2002	2003
Consolidated Balance Sheet Data:							
Cash and cash equivalents	$ 32	$ 222	$ 198	$ 1,446	$ 2,380	$ 3,468	$ 8,418
Working capital (deficit)	(44)	(5,239)	(3,039)	(1,601)	685	(686)	6,304
Total assets	331	2,784	3,761	4,882	7,439	7,092	13,928
Convertible preferred stock	1,463	7,323	25,706	28,761	28,761	28,761	28,761
Accumulated deficit	(1,338)	(10,980)	(27,034)	(30,084)	(28,448)	(29,257)	(23,232)
Total stockholders equity (deficit)	255	(3,066)	(463)	977	2,725	1,879	8,157

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MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and related notes that appear elsewhere in this prospectus. The following discussion contains forward-looking statements that involve risks and uncertainties and reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this prospectus, particularly in the section titled Risk Factors beginning on page 5.

Overview

We provide affordable communications application services on a subscription basis to mainstream consumers and SOHOs. Our software-based services are delivered on our proprietary Enhanced Services Platform that allows subscribers to bridge calls across existing landline, mobile and Internet networks, without requiring them to purchase or install additional hardware. Our services extend the functionality of networks and devices our subscribers already use by offering easy-to-use, enhanced communications features such as real-time voicemail, call screening, and virtual phone and fax numbers. Because our services improve the utilization of existing communications networks, 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.

We first marketed our services in February 1999. We initially offered our services for free, partially supported by advertising revenues. In April 2001, we transitioned our business model from an advertising-based model to a paid subscription-services model. As of March 31, 2004, we delivered our services to more than 780,000 paying subscribers, and have been profitable since the quarter ended March 31, 2002. However, because our near-term focus is to grow our subscriber base and market share, we expect to increase our customer acquisition expenses significantly and, as a result, may sacrifice operating margins and profitability in order to develop our long-term growth prospects.

We currently derive substantially all of our revenues from subscription fees at rates generally ranging from $1.50 per month for CallWave Alert to $7.95 per month for CallWave Connect, our most feature-rich level of service. We also provide an enhanced version of CallWave Connect at $9.95 per month to a limited number of subscribers. For the quarter ended March 31, 2004, our average subscription fee per subscriber was approximately $4.50. Currently, we offer new subscribers a 30-day free trial of our CallWave Connect service, with charges starting for the service level selected by the subscriber after that 30-day period. We market our software and services directly to consumers through our website and online advertising, and indirectly through our channel relationships with EarthLink and several smaller service providers.

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Our revenues increased in recent quarters. We became profitable for the first time in the quarter ended March 31, 2002, and have remained profitable in each quarter since. However, we have a limited history of revenue growth and profitability, and we cannot be certain that our revenues will continue to grow or that we will maintain profitability in the future. We cannot accurately predict our future growth rate, if any, or the ultimate size of our market. Our ability to increase revenues and maintain profitability depends on a number of factors outside of our control, including the extent to which:

- our services are able to gain market acceptance, particularly as broadband Internet access increases penetration in the mainstream market;
- we are able to acquire and retain subscribers on a cost-effective basis;
- we are able to establish strategic relationships with network service providers;
- we are able to obtain the required communications network services on reasonable terms;
- we are able to successfully identify, develop and market enhanced applications for the mainstream market;
- network service providers develop or bundle competing services; and
- we become subject to increased regulatory burdens.

We have historically been able to carry forward our net operating losses to offset our earnings and have had no significant tax liability to date. However, we anticipate that if we do maintain our profitability, our earnings will likely be fully taxed in the future.

Fiscal Year

Our fiscal year ends on June 30. References to fiscal 2003, for example, refer to the fiscal year ended June 30, 2003.

Sources of Revenue

We earn revenues primarily from subscription services, and to a much lesser extent, fees earned from local exchange carrier call termination access charges. We also historically earned limited revenues from advertisements placed by third parties within our service. Subscription revenues accounted for 99% of total revenues in the six-month period ended December 31, 2003, 94% of our total revenues in fiscal 2003, 86% of our total revenues in fiscal 2002 and 2% of our total revenues in fiscal 2001. Subscription revenues are driven primarily by the number of paying subscribers for our service and the average subscription price, which in turn is driven by the composition and pricing of our service levels. We define paying subscribers as those subscribers who have made a payment to us within the past 45 days for subscribers who pay by credit card or through their local telephone company or within the past 60 days for subscribers who pay us by check, or who have a balance due of less than the payment increment on their selected

subscription plan. We also include subscribers acquired through our relationship with EarthLink as paying subscribers if they have completed their 30-day free trial period and their service has not been cancelled. None of our customers accounted for more than 10% of our revenues in any fiscal year.

We have not had any advertising revenues since June 2003 and, while we do not expect to have any advertising revenues in the near term, we may decide to seek advertising revenues in the future. We expect that our nominal revenues from access termination charges will be flat to declining in the near term.

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Cost of Sales and Operating Expenses

Cost of sales. Cost of sales consists primarily of billing and collection costs, long-distance telephone service expenses incurred to deliver our services, and systems and communications infrastructure costs. Sales expenses related to advertising revenues were also included in cost of sales in those historical periods when we had such expenses, which consisted primarily of sales commissions and related expenses. The two most significant components of our cost of sales are our billing costs and network service provider costs.

Our primary method of billing our customers, which we implemented in November 2002, allows our customers to be billed for our services through their local telephone company. Alternatively, our subscribers may elect to be billed by us directly, in which case they can pay us either by check or through a credit card. Billing customers through their local telephone company is more expensive than the 900 toll number billing system we relied on previously due to increased per-transaction charges from local telephone companies and fees charged by a third party that manages the billing relationships for us. However, we believe the increased expense is offset by our improved ability to retain subscribers and collect revenues. As of March 31, 2004, approximately 80% of our paying subscribers were billed through their local telephone company. We expect our billing costs per subscriber to remain relatively stable.

We recently entered into a contractual relationship with a network service provider that we expect would permit us to increasingly route our subscribers calls over the Internet instead of over long-distance carrier lines. We believe that routing more of our subscribers calls over the Internet could allow us to decrease our communications costs per subscriber. However, we cannot assure you that we will be able to successfully route traffic over the Internet in order to achieve the anticipated cost benefits. If we are unable to do so, our costs of sales may increase at a rate greater than anticipated, which could adversely affect our operating margins and profitability.

Sales and marketing. Sales and marketing expenses consist primarily of payroll and related expenses for marketing personnel and consultants, promotional fees and media costs related to customer acquisition. We expect our sales and marketing costs to increase as we will need to identify and market to potential subscribers who are willing to begin paying for our services following a free trial. We intend to continue marketing our services to potential subscribers through Internet-based advertising and referrals by our affiliates. These channels will likely be more expensive and we expect it will be more difficult to measure the exact costs of acquiring customers through those channels. In the future, we expect sales and marketing expenses to increase as a percentage of revenue. We may also use non-Internet channels to acquire customers in the future.

Research and development. Research and development expenses consist principally of payroll and related expenses for research and development personnel and consultants. Research and development costs are expensed as incurred. We expect research and development costs to increase due to additional staffing requirements as we continue to maintain existing offerings and develop new products and services.

General and administrative. General and administrative expenses consist primarily of payroll and related expenses for administrative personnel and consultants, legal and accounting fees, bad debt expense, compliance, insurance, rent and other administrative costs. We expect general and administrative expenses to increase due to increased bad debt expense as our subscriber base grows and an increase in legal, accounting, staffing and insurance costs associated with being a public company and increased lease expenses.

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Stock-based Compensation

We have granted to our employees options to purchase our common stock at exercise prices equal to the fair market value of the underlying stock, as determined by our board of directors, on the date of the option grant. In limited cases, we also have granted options to purchase our common stock at less than the fair market value of the underlying common stock. For financial accounting purposes we apply hindsight to arrive at deemed values for the shares underlying our options. We record deferred stock-based compensation 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 and the exercise price. We recognize compensation expense as we amortize the deferred stock-based compensation amounts over the related vesting periods. In addition, we have awarded to non-employees options and warrants to purchase our common stock. Stock-based compensation related to non-employees is calculated on a fair-value basis using the Black-Scholes option pricing model as the options and warrants vest or are earned. See the section titled Critical Accounting Policies and Use of Estimates Accounting for Stock-Based Awards below.

We currently expect to record stock-based compensation expenses, assuming no forfeiture of awards, of $547,000 in fiscal 2004, $106,000 in fiscal 2005 and $73,000 in fiscal 2006. These amounts do not include stock-based compensation-related to options or warrants that we may grant or issue subsequent to April 30, 2004.

Critical Accounting Policies and the Use of Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ from these estimates.

Our significant accounting policies are described in Note 1 of the notes to our consolidated financial statements, and of those policies, we believe that the following accounting policies involve the greatest degree of judgment and complexity. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our financial condition and results of operations.

Revenue recognition. We earn revenues from paid subscriber services, and to a lesser extent fees earned from local exchange carrier call termination access charges. We historically also earned revenues from advertising.

Our subscription revenues consist of monthly recurring subscription fees, which are paid in advance in one of three ways: a charge placed on the customer s telephone bill, credit card or paper invoice. In accordance with accounting principles generally accepted in the United States and with the Securities and Exchange Commission Staff Accounting Bulletin 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 when there is persuasive evidence of an arrangement, our software has been successfully downloaded, the fees are fixed and determinable and collection is reasonably assured. We defer the portion of subscription fees collected in advance and recognize that portion over the subscription period, beginning at the time the fee becomes due and collection is reasonably assured.

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We determine when collection is reasonably assured for our subscription services based on payment type. For subscribers billed through their local telephone company, collection is deemed to be reasonably assured when we receive confirmation from the third party that manages our billing relationship with the telephone companies that the charge has been successfully sent to the telephone company. For subscribers billed through their credit card, collection is deemed to be reasonably assured when we receive confirmation from the transaction-processing vendor that a sales transaction has been successfully processed. For subscribers who pay for their services by remitting payment by check to us, collection is deemed to be reasonably assured when we receive the check. In addition, with one of our channel relationships, we record the net amount received as revenue in accordance with Emerging Issues Task Force 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*.

Local exchange carrier call termination access revenues consist of access charges paid by long-distance carriers to our wholly-owned subsidiary, Liberty Telecom, when it terminates a call from that long-distance carrier. Termination access revenue is recognized as call termination services are provided, since collectibility is reasonably assured at that time.

Advertising revenues are recognized as advertising is displayed based upon the contractual terms with our advertisers.

Allowances for Doubtful Accounts

We record an allowance for doubtful accounts based on our historical experience with bad debts. Judgment is required when we assess the realization of receivables, including assessing the probability of collection. Our allowance for doubtful accounts totaled $381,000 as of December 31, 2003, $272,000 as of June 30, 2003 and $42,000 as of June 30, 2002. Our allowance for doubtful accounts is primarily driven by our aggregate billings through the local telephone companies. The increase in our allowance for doubtful accounts from June 30, 2002 to June 30, 2003 was principally as a result of the commencement of our billing arrangements with local telephone companies.

Billing and Collection Costs

Our management team s judgment is required to assess the amounts of our billing and collection costs. Because the local telephone companies do not report their fees to us for a given period until after we have closed that period of our financial statements, we must make estimates as to what our billing and collection costs are for such period. Such estimates are based upon known transaction volumes for the current period and also upon historical pricing information from these vendors for prior periods. Our billing and collection costs were $3,309,000 for the six months ended December 31, 2003, $3,215,000 in fiscal 2003, $1,460,000 in fiscal 2002 and $0 in fiscal 2001.

Accounting for Internally-Developed Software

Costs of software developed to be sold or licensed to the external market are accounted for under Statement of Financial Accounting Standards 86, or SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Under SFAS 86, we expense the costs of research, including predevelopment efforts prior to establishing technological feasibility and costs incurred for training and maintenance. Software development costs are capitalized when technological feasibility has been established and anticipated future revenues assure recovery of the capitalized amounts. Because of the relatively short time

period between

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technological feasibility and product release, and the insignificant amount of cost incurred during such period, no amount of software development costs has been capitalized to date. If in the future, we determine that technological feasibility has been established and anticipated future revenues assure recovery of expenses related to internally-developed software, we may capitalize such costs, which will reduce our research and development costs in the period in which we capitalize such costs and increase our expenses when such capitalized costs are amortized. If we do capitalize these costs, we will amortize such capitalized costs over the estimated useful life of the asset.

Accounting for Stock-Based Awards

The Financial Accounting Standards Board issued SFAS 123, *Accounting for Stock-Based Compensation*. SFAS 123 requires that an entity account for employee stock compensation under a fair-value-based method. However, SFAS 123 also allows an entity to continue to measure compensation cost for employee stock-based compensation arrangements using the intrinsic-value-based method of accounting prescribed by APB Opinion 25, *Accounting for Stock Issued to Employees*. We have elected to account for employee stock-based compensation under SFAS 123 and, accordingly, all compensation expense related to the fair value of options issued to employees has been reflected in the accompanying statements of operations.

We have granted nonqualified stock options and warrants to non-employees. For these options and warrants, we recognize the stock-based expense as the options and warrants vest based on an estimate of their fair value as of the date of grant using the Black-Scholes option pricing model.

In estimating the value of employee stock options, we have used the minimum-value option pricing model, assuming no expected dividends, an expected life of four years and 0% volatility. In estimating the value of non-employee stock options and warrants, we use the Black-Scholes option pricing model. As a public company, we will use a volatility factor greater than 0%, which will cause our compensation expense to increase on a per share basis.

Accounting for Income Taxes

We account for income taxes using the asset and liability method, 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. In accordance with the provisions of SFAS 109, *Accounting for Income Taxes,* we record a valuation allowance to reduce deferred tax assets to the amount expected to more likely than not be realized in our future tax returns. As of the end of fiscal 2003, we had a valuation allowance that reduced our deferred tax asset to zero. Should we determine in the future that we will more likely than not be able to realize all or part of our net deferred tax assets, we will adjust the valuation allowance so that we will have a deferred tax asset for the amount we determine to be more likely than not to be realized in our future tax returns.

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Results of Operations

The following tables set forth our statement of operations data, operations data as a percent of revenues and supplemental revenue data for each of the periods indicated, as well as paying subscriber data as of each of the dates indicated.

	Fiscal Year Ended June 30,			Six Months Ended December 31,	
	2001	2002	2003	2002	2003
		(in thousands)		(unaudited, in thousands)	
Statement of Operations Data:					
Revenues	$ 2,883	$ 16,383	$ 22,488	$ 10,440	$ 18,254
Cost of sales	5,222	6,568	8,467	3,607	5,658
Gross profit	(2,339)	9,815	14,021	6,833	12,596
Operating expenses:					
Sales and marketing	6,215	4,180	3,959	2,247	2,746
Research and development	3,965	4,382	4,894	2,311	2,397
General and administrative	1,979	4,263	3,376	1,465	2,268
Impairment of long-lived assets			191		
Total operating expenses	12,159	12,825	12,420	6,023	7,411
Operating income (loss)	(14,498)	(3,010)	1,601	810	5,185
Interest income (expense), net	(1,555)	(39)	36	18	32
Income (loss) before income taxes	(16,053)	(3,049)	1,637	828	5,217
Income tax provision	1	1	1	1	1
Net income (loss)	($ 16,054)	($ 3,050)	$ 1,636	$ 827	$ 5,216

	Fiscal Year Ended June 30,			Six Months Ended December 31,	
	2001	2002	2003	2002	2003
				(unaudited)	
Percent of Revenues:					
Revenues	100%	100%	100%	100%	100%
Cost of sales	181	40	38	35	31
Gross profit	(81)	60	62	65	69
Operating expenses:					
Sales and marketing	216	26	18	22	15
Research and development	138	27	22	22	13
General and administrative	69	26	15	14	12
Impairment of long-lived assets			1		

Total operating expenses	422	78	55	58	41
Operating income (loss)	(503)	(18)	7	8	28
Interest income (expense), net	(54)	0	0	0	0
Income (loss) before income taxes	(557)	(19)	7	8	29
Income tax provision	0	0	0	0	0
Net income (loss)	(557%)	(19%)	7%	8%	29%

	Fiscal Year Ended June 30,			Six Months Ended December 31,	
	2001	2002	2003	2002	2003
	(in thousands)			(unaudited, in thousands)	
Supplemental Revenue Data:					
Subscription	$ 55	$ 14,137	$ 21,190	$ 9,666	$ 18,093
Advertising	2,698	2,024	965	620	
Termination access fees	130	222	333	154	161
Revenues	$ 2,883	$ 16,383	$ 22,488	$ 10,440	$ 18,254

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	As of June 30,		As of December 31,	
	2002	2003	2002	2003
	(unaudited, in thousands)			
Subscriber Data:				
Paying subscribers	389	673	440	740

Six Months Ended December 31, 2003 and December 31, 2002

Revenues. Revenues were $18,254,000 in the six months ended December 31, 2003, compared to $10,440,000 in the six months ended December 31, 2002, an increase of $7,814,000, or 75%. Subscription revenues were $18,093,000 in the six months ended December 31, 2003, representing 99% of revenues, compared to $9,666,000 in the six months ended December 31, 2002, representing 93% of revenues, an increase of $8,427,000, or 87%. The increase in our revenues in the six months ended December 31, 2003 was attributable primarily to an increase in the number of paying subscribers from approximately 440,000 at December 31, 2002 to approximately 740,000 at December 31, 2003 and, to a lesser extent, because the increases to our paying subscriber base during the six months ended December 31, 2002 were all in the three months ended December 31, 2002, partially offset by the elimination of advertising revenues as we phased this revenue stream out of our business model.

Cost of sales. Cost of sales was $5,658,000 in the six months ended December 31, 2003, compared to $3,607,000 in the six months ended December 31, 2002, an increase of $2,051,000, or 57%. The increase in our cost of sales in the six months ended December 31, 2003 was primarily attributable to the increase in our paying subscriber base, as well as our transition to billing our customers through their local telephone bills. The increase in our customer billing costs was partially offset by a decrease in our communications costs due to a reduction in the number of free subscribers using our services and the related communications charges. As a result, our gross margins increased from 65% for the six months ended December 31, 2002, to 69% for the six months ended December 31, 2003.

Sales and marketing. Sales and marketing expenses were $2,746,000, or 15% of revenues, in the six months ended December 31, 2003, compared to $2,247,000, or 22% of revenues, in the six months ended December 31, 2002, an increase of $499,000, or 22%. The increase in sales and marketing expenses was primarily due to a $777,000 increase in spending on media channels for the six months ended December 31, 2003, partially offset by a reduction in staffing costs, consultants fees and promotional fees. The decrease as a percentage of revenues was primarily attributable to increased efficiencies in our subscriber acquisition process.

Research and development. Research and development expenses were $2,397,000, or 13% of revenues, in the six months ended December 31, 2003, compared to $2,311,000, or 22% of revenues, in the six months ended December 31, 2002, an increase of $86,000, or 4%. The increase in research and development expenses was due to increased staffing costs. Although research and development expenses increased on an absolute basis, these expenses decreased as a percentage of revenues due to an increase in the number of paying subscribers.

General and administrative. General and administrative expenses were $2,268,000 in the six months ended December 31, 2003, compared to $1,465,000 in the six months ended December 31, 2002, an increase of $803,000, or 55%. The increase in general and administrative expenses was due primarily to an increase in bad debt expense proportionate to our increased revenues and an increase in legal, accounting, staffing and insurance costs.

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Income tax provision. Our income tax provision was $1,000 in the six months ended December 31, 2003 and the six months ended December 31, 2002. The difference between the statutory tax rate and our effective tax rate is due to the utilization of operating loss carry forwards and tax credits. As of December 31, 2003, our net deferred tax asset balance was $14,152,000, which is unchanged from the end of fiscal 2003, and was fully offset by a valuation allowance of $14,152,000 due to the uncertainty surrounding the timing of realizing the benefits of our favorable tax attributes in future tax returns.

Fiscal Years Ended June 30, 2003 and June 30, 2002

Revenues. Revenues were $22,488,000 in fiscal 2003, compared to $16,383,000 in fiscal 2002, an increase of $6,105,000, or 37%. Subscription revenues were $21,190,000 in fiscal 2003, representing 94% of revenues, compared to $14,137,000 in fiscal 2002, representing 86% of revenues, an increase of $7,053,000, or 50%. The increase in our revenues in fiscal 2003 was primarily attributable to an increase in our paying subscriber base from approximately 389,000 as of June 30, 2002 to approximately 673,000 as of June 30, 2003, a majority of whom were added in the quarter ended June 30, 2003. The increase in our paying subscribers in fiscal 2003 was largely driven by our campaign to convert free subscribers to paying subscribers and, to a lesser extent, our transition to local telephone billing, which allowed us to increase the percentage of our subscribers from whom we were able to collect subscription revenues.

Cost of sales. Cost of sales was $8,467,000 in fiscal 2003, compared to $6,568,000 in fiscal 2002, an increase of $1,899,000, or 29%. The increase in our cost of sales in fiscal 2003, was primarily attributable to an increase in our paying subscriber base and, to a lesser extent, from our beginning to collect the majority of our revenues from those subscribers through their local telephone bills. Our communications services costs per user remained relatively constant from fiscal 2002 to fiscal 2003. Our gross margins increased from 60% in fiscal 2002 to 62% in fiscal 2003.

Sales and marketing. Sales and marketing expenses were $3,959,000, or 18% of revenues, in fiscal 2003, compared to $4,180,000, or 26% of revenues, in fiscal 2002, a decrease of $221,000, or 5%. The decrease in sales and marketing expenses was primarily due to the termination of a distribution relationship in late fiscal 2002, which had accounted for more than $1,600,000 of our fiscal 2002 sales and marketing expenses. In fiscal 2003, these savings were offset in part by increased spending on direct media buys. The decrease as a percentage of revenues was primarily attributable to increased efficiencies in our customer acquisition process.

Research and development. Research and development expenses were $4,894,000, or 22% of revenues, in fiscal 2003, compared to $4,382,000, or 27% of revenues, in fiscal 2002, an increase of $512,000, or 12%. The increase in research and development expenses was due to increased staffing costs. Although research and development expenses increased on an absolute basis, these expenses decreased as a percentage of revenues due to an increase in the number of paying subscribers.

General and administrative. General and administrative expenses were $3,376,000, or 15% of revenues, in fiscal 2003, compared to $4,263,000, or 26% of revenues, in fiscal 2002, a decrease of $887,000, or 21%. The decrease in general and administrative expenses was due to certain compensation-related charges against earnings in fiscal 2002. In fiscal 2002, our board of directors elected to extend the expiration date of certain warrants, and we recognized a corresponding non-cash charge of $1,228,000 against earnings in accordance with applicable accounting guidance. We had no corresponding charge in fiscal 2003. This decrease was

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partially offset by an increase in bad debt expense as our revenues increased and an increase in legal, accounting and staffing costs and insurance.

Impairment of long-lived assets. Impairment of long-lived assets was $191,000 in fiscal 2003, compared to $0 in fiscal 2002. The impairment of long-lived assets in fiscal 2003 represented the writing down to net realizable value of certain fixed assets that were not being utilized and had no realizable value.

Income tax provision. Our income tax provision was $1,000 in fiscal 2003, and $1,000 in fiscal 2002. The difference between the statutory tax rate and our effective tax rate is due to the utilization of operating loss carry forwards and tax credits. Our net deferred tax asset balance was $14,152,000 at June 30, 2003, and was fully offset by a valuation allowance of $14,152,000 due to the uncertainty surrounding the timing of realizing the benefits of our favorable tax attributes in future tax returns.

Fiscal Years Ended June 30, 2002 and June 30, 2001

Revenues. Revenues were $16,383,000 in fiscal 2002, compared to $2,883,000 in fiscal 2001, an increase of $13,500,000, or 468%. Subscription revenues were $14,137,000 in fiscal 2002, compared to $55,000 in fiscal 2001, an increase of $14,082,000. Advertising revenues were $2,024,000 in fiscal 2002, compared to $2,698,000 in fiscal 2001, a decrease of $674,000, or 25%. Fees earned from local exchange carrier call termination access fees were $222,000 in fiscal 2002, compared to $130,000 in fiscal 2001, an increase of $92,000, or 71%. In late fiscal 2001, we transitioned our business model from an advertising-based model to a paid subscription services model. The decrease in advertising revenues in this period was primarily attributable to our transitioning business model and an overall decline in advertising rates. The increase in our subscription revenues was primarily attributable to an increase in our paying subscriber base following the introduction of our new business model.

Cost of sales. Cost of sales was $6,568,000 in fiscal 2002, compared to $5,222,000 in fiscal 2001, an increase of $1,346,000, or 26%. The increase in our cost of sales in fiscal 2002 was primarily attributable to increased billing and communications costs related to the increase in our paying subscriber base.

Sales and marketing. Sales and marketing expenses were $4,180,000 in fiscal 2002, compared to $6,215,000 in fiscal 2001, a decrease of $2,035,000, or 33%. The decrease in sales and marketing expenses was primarily due to an overall decrease in customer acquisition spending while we focused our marketing resources on converting free subscribers in our subscriber base to paid status and, to a lesser extent, to the termination in the three months ended June 30, 2002 of a distribution relationship.

Research and development. Research and development expenses were $4,382,000 in fiscal 2002 compared to $3,965,000 in fiscal 2001, an increase of $417,000, or 11%. The increase in research and development expenses was due to increased staffing costs.

General and administrative. General and administrative expenses were $4,263,000 in fiscal 2002, compared to $1,979,000 in fiscal 2001, an increase of $2,284,000, or 115%. The increase in general and administrative expenses was primarily due to certain compensation and legal charges in fiscal 2002 as well as an increase in the number of management and administrative employees. In fiscal 2002, we extended the expiration date of certain warrants, and we recognized a corresponding non-cash charge of

$1,228,000 against earnings. In addition, our legal costs increased in fiscal 2002, due mainly to the termination of a distribution relationship.

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Interest income (expense). Net interest expense was $39,000 in fiscal 2002, compared to $1,555,000 in fiscal 2001, a decrease of $1,516,000, or 97%. The decrease in net interest expense was due to the conversion of certain debt into equity during fiscal 2001 and, to a lesser extent, an increase in interest income as our cash balances increased in fiscal 2002. Substantially all of our convertible debt financing was converted into preferred stock, with the remainder having been repaid in full. The majority of these conversions took place in the three months ended June 30, 2001, and the remainder took place in the three months ended September 30, 2001.

Selected Quarterly Operating Results

The following tables set forth the unaudited quarterly statements of operations data, operations data as a percent of revenues and supplemental revenues data for the ten quarters ended December 31, 2003, as well as the paying subscribers as of the dates indicated. The unaudited quarterly information in the ten quarters ended December 31, 2003 has been prepared on substantially the same basis as the audited financial statements included elsewhere in this prospectus and, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, except as otherwise indicated, necessary for the fair presentation of the results of operations for such periods. This data should be read in conjunction with the audited financial statements and the related notes included elsewhere in this prospectus. These quarterly operating results are not necessarily indicative of our operating results for any future period.

	Three Months Ended									
	Sep. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	Jun. 30, 2002	Sep. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003
	(unaudited, in thousands)									
Statement of Operations Data:										
Revenues	$ 2,044	$ 4,170	$ 4,610	$ 5,559	$ 5,074	$ 5,366	$ 5,649	$ 6,399	$ 8,697	$ 9,557
Cost of sales	1,863	1,608	1,488	1,609	1,752	1,855	2,228	2,632	2,724	2,934
Gross profit	181	2,562	3,122	3,950	3,322	3,511	3,421	3,767	5,973	6,623
Operating expenses:										
Sales and marketing	1,434	1,028	840	878	1,077	1,170	881	831	1,212	1,534
Research and development	1,067	999	1,108	1,208	1,126	1,185	1,352	1,231	1,260	1,137
General and administrative	903	1,983	601	776	681	784	901	1,010	1,218	1,050
Impairment of long-lived assets								191		
Total operating expenses	3,404	4,010	2,549	2,862	2,884	3,139	3,134	3,263	3,690	3,721
Operating income (loss)	(3,223)	(1,448)	573	1,088	438	372	287	504	2,283	2,902
Interest income (expense), net	(47)	(1)	5	4	4	14	9	9	12	20
Net income (loss) before income taxes	(3,270)	(1,449)	578	1,092	442	386	296	513	2,295	2,922
Income tax provision	1				1				1	
Net income (loss)	$ (3,271)	$ (1,449)	$ 578	$ 1,092	$ 441	$ 386	$ 296	$ 513	$ 2,294	$ 2,922

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	Three Months Ended									
	Sep. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	Jun. 30, 2002	Sep. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003
	(unaudited)									
Percent of Revenues:										
Revenues	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Cost of sales	91	39	32	29	35	35	39	41	31	31
Gross profit	9	61	68	71	65	65	61	59	69	69
Operating expenses:										
Sales and marketing	70	25	18	16	21	22	16	13	14	16
Research and development	52	24	24	22	22	22	24	19	14	12
General and administrative	44	48	13	14	13	15	16	16	14	11
Impairment of long-lived assets								3		
Total operating expenses	167	96	55	51	57	58	55	51	42	39
Operating income (loss)	(158)	(35)	12	20	9	7	5	8	26	30
Interest income (expense), net	(2)	(0)	0	0	0	0	0	0	0	0
Net income (loss) before income taxes	(160)	(35)	13	20	9	7	5	8	26	31
Income tax provision	0				0				0	
Net income (loss)	(160%)	(35%)	13%	20%	9%	7%	5%	8%	26%	31%

	Three Months Ended									
	Sep. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	Jun. 30, 2002	Sep. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003
	(unaudited, in thousands)									
Supplemental Revenue Data:										
Subscriptions	$ 1,364	$ 3,584	$ 4,094	$ 5,095	$ 4,676	$ 4,990	$ 5,328	$ 6,196	$ 8,611	$ 9,482
Advertising	643	534	456	391	326	294	241	104		
Termination access fees	37	52	60	73	72	82	80	99	86	75
Revenues	$ 2,044	$ 4,170	$ 4,610	$ 5,559	$ 5,074	$ 5,366	$ 5,649	$ 6,399	$ 8,697	$ 9,557

	As of									
	Sep. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	Jun. 30, 2002	Sep. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003
	(unaudited, in thousands)									
Subscriber Data:										
Paying subscribers	205	304	382	389	386	440	474	673	708	740

Revenues. Our quarterly revenues increased from $2,044,000 to $9,557,000 over the course of the ten quarters presented, an increase that was parallel with the increase in the number of our paying subscribers from approximately 205,000 at September 30, 2001 to approximately 740,000 at December 31, 2003. We experienced a significant increase in the number of our paying subscribers from the quarter ended March 31, 2003, when we had approximately 474,000 paying subscribers, to the quarter ended June 30, 2003, when we had approximately 673,000 paying subscribers. This increase occurred primarily as a result of our campaign to convert our free subscribers to paying subscribers, and we ceased offering subscribers the opportunity to utilize our service on a no-cost basis indefinitely. We experienced a one-time increase in recognized revenues during the quarter ended June 30, 2002, because we initiated the use of paper invoices with many of those subscribers from whom we had been unable to collect via 900 billing and other methods. This one-time increase in revenues was not repeated in the subsequent quarter ending September 30, 2002.

Cost of sales. The increase in our cost of sales during the ten quarters presented was in line with the increase in the number of our paying subscribers and our transition in January 2003 to collecting the majority of our revenues through charges on our subscribers local telephone bills, which is more expensive than methods we had used in the past.

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Sales and marketing. Sales and marketing expenses decreased in the quarter ended March 31, 2003, primarily due to a decrease in customer acquisition spending. With that one exception, our quarterly spending on sales and marketing remained relatively constant from January 1, 2002 through June 30, 2003, and by the end of that period we had completed several campaigns to convert our free subscribers to paying customers. The increased sales and marketing expenses in the quarters ended September 30, 2003 and December 31, 2003 reflect a shift in our sales and marketing efforts to focus on attracting new subscribers that previously had not used our service rather than converting existing subscribers who had been using our free service.

Research and development. Research and development expenses remained relatively constant in the ten quarters presented, except for a slight increase in the quarter ended March 31, 2003 when we paid certain non-recurring compensation expenses in connection with the elimination of certain research and development positions.

General and administrative. General and administrative expenses remained relatively constant in the ten quarters presented. The increase in our general and administrative expenses in the quarter ended December 31, 2001 was primarily due to the extension of the expiration date of certain warrants, which caused us to recognize a non-cash charge of $1,228,000 against earnings.

Liquidity and Capital Resources

At December 31, 2003, our principal sources of liquidity were cash and cash equivalents of $8,418,000 and accounts receivable net of allowance for doubtful accounts of $3,657,000.

From inception through August 2001, we funded our operations primarily through issuance of convertible preferred stock and debt financing convertible into convertible preferred stock. In calendar years 1999, 2000 and 2001, we issued an aggregate of five series of preferred stock, raising a total of $28,761,000 in paid-in capital. Since that time, the principal source of our working capital has been the cash flow that we derive from our paying subscribers.

Net cash provided by operating activities was $5,977,000 in the six months ended December 31, 2003, $1,312,000 in fiscal 2003, and $1,059,000 in fiscal 2002 and net cash used in operating activities was $16,279,000 in fiscal 2001. Cash flow provided by operating activities during the six-month period ended December 31, 2003 was primarily due to $5,216,000 of net income, an $862,000 increase in deferred revenue and a $351,000 increase in depreciation and amortization, offset by a $638,000 increase in accounts receivable.

The cash flow provided by operating activities in fiscal 2003 was primarily due to $1,636,000 of net income, a $1,025,000 increase in depreciation and amortization and impairment loss on other long-lived assets, a $585,000 increase in deferred revenues and a $120,000 increase in other accrued liabilities, offset by a $2,161,000 increase in accounts receivable.

The cash flow provided by operating activities during fiscal 2002 was primarily due to a $2,026,000 increase in deferred revenues, a $1,248,000 increase in non-employee equity based compensation and a $722,000 increase in depreciation and amortization, offset by a $3,050,000 net loss.

Net cash used in investing activities was $118,000 in the six months ended December 31, 2003, $389,000 in fiscal 2003, $897,000 in fiscal 2002 and $715,000 in fiscal 2001. These amounts related to the purchases of property and equipment.

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Net cash provided by financing activities was $179,000 in the six months ended December 31, 2003, $11,000 in fiscal 2003, $1,086,000 in fiscal 2002 and $16,970,000 in fiscal 2001. These amounts related primarily to proceeds from the issuance of preferred stock, and to a lesser extent, to proceeds from notes payable, and exercises of stock options and warrants.

In August 2001, we put an accounts receivable purchase agreement in place with an institutional lender for a maximum amount of $2,500,000. We made only limited use of that agreement, however, and cancelled it in January 2003.

Contractual Payment Obligations

A summary of our contractual commitments and obligations as of April 30, 2004 is as follows:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**3-5 Years**	**More than 5 Years**
			(in thousands)		
Operating lease obligations	$ 607	$ 412	$ 162	$ 33	$
Purchase obligations	3,236	2,561	675		
Total	$ 3,843	$ 2,973	$ 837	$ 33	$

In addition to the contractual obligations described in the table above, we also enter into short-term commitments for the purchase of advertising, public relations support, affiliate channel management and other vendor-supplied services related to the acquisition of subscribers. These obligations are typically shorter in duration than 30 days, and the majority of these purchases are cancelable by us with no more than 72 hours advance written notice. For the six months ended December 31, 2003, these short-term contractual obligations averaged $272,000 per month.

We currently expect that our subscription revenues, along with the proceeds from this offering, will be sufficient to satisfy our working capital needs for at least the next 12 months and for the foreseeable future.

Recent Accounting Pronouncements

In December 2003, the Securities and Exchange Commission released Staff Accounting Bulletin 104, or SAB 104, *Revenue Recognition*. SAB 104 revises or rescinds portions of the interpretative guidance related to revenue recognition included in Topic 13 of the codification of the staff accounting bulletins. We have adopted SAB 104 and it did not have a material impact on our financial position or results of operations.

In November 2002, the Emerging Issues Task Force reached a consensus on Issue 00-21, or EITF 00-21, *Multiple Deliverable Revenue Arrangements*. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. It also addresses when and how an arrangement involving multiple deliverables should be divided into separate units of accounting. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early application permitted. Our current accounting is consistent with the provisions of EITF 00-21 and the adoption of EITF 00-21 had no impact on our results of operations or financial position.

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Qualitative and Quantitative 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 $8,418,000 at December 31, 2003, and $2,380,000 at June 30, 2003. These amounts were held for working capital purposes in depository accounts at FDIC-regulated banking institutions. 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 as a result of changes in interest rates. Declines in interest rates, however, will reduce our future interest income.

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BUSINESS

Overview

We provide affordable communications application services on a subscription basis to mainstream consumers and SOHOs. Our software-based services are delivered on our proprietary Enhanced Services Platform that allows subscribers to bridge calls across existing landline, mobile and Internet networks, without requiring them to purchase or install additional hardware. Our platform acts as a network-independent communications interface layer, and is presently used for bridging important landline calls to our subscribers through their mobile telephones or through their Internet-connected personal computers using voice-over-IP technology. Our services allow subscribers to see and hear who is calling before deciding whether to take the call, enabling them to receive more of their important calls and to manage other calls at their convenience. These capabilities enable our mass-market subscribers to more effectively manage their personal communications.

As of March 31, 2004, we had more than 780,000 paying subscribers. By bridging calls across subscribers existing landline, mobile and Internet networks, our subscribers realize greater value from their existing communications services. Our services extend the functionality of networks and devices that our subscribers already use by offering easy-to-use, enhanced communications features such as real-time voicemail, call screening, and virtual phone and fax numbers. Because our services improve the utilization of existing communications networks, 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.

Industry Background

The Status of the Communications Market

The emergence of mobile telephones and the Internet has reshaped the communications and information service markets. A decade ago, households and SOHOs typically used a landline telephone as their primary means of communication. Today, households and SOHOs commonly use both mobile telephones and the Internet, in addition to traditional landline telephones. Mobile telephones and the Internet, which penetrated early adopter markets in the 1990s, have now reached mass-market acceptance with cost-conscious consumers and SOHOs by delivering to users compelling value at affordable prices. A number of other technologies, such as broadband Internet access and wireless data have been introduced in the early adopter markets and are expected to be increasingly adopted by the mainstream over time as they become more affordable and easier to use.

Overview of the Mainstream Market

The mainstream market is cost-conscious and typically pays for only those products and services that are both necessary and affordable. Mainstream users tend to share technology and communications resources, such as traditional landlines, mobile telephones, personal computers and Internet access, both at home and in the office. Mainstream users are generally reluctant to adopt new technologies since they tend not to be technologically sophisticated and prefer proven and easy-to-use solutions. As a result, widespread and uniform use of technology by the mainstream market provides a stable platform for new value-added

services. Early adopters, in contrast, often are more technologically sophisticated and more eager to accept new technologies.

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According to Gartner Group estimates, there were 109 million households in the United States at the end of 2003. Additionally, International Data Corporation, or IDC, estimated in a May 2003 report that there were 6 million small businesses in the United States with fewer than 10 employees, representing over three-quarters of businesses in the United States, and 13 million home offices at the end of 2003. According to IDC, these 19 million firms collectively represent the SOHO market.

Adoption of the Internet in the Mainstream Market

Gartner Group estimated that 68 million households in the United States, representing 63% of all households, had Internet access in 2003, and projects that 83 million households, or 73% of all households, will have Internet access by 2007. Additionally, IDC estimates that 14 million SOHOs in the United States, representing 72% of all SOHOs, had Internet access in 2003.

Today, dial-up, which utilizes the existing landline, is the most common type of Internet access in the mainstream market. Dial-up offers basic access to the Internet at a lower price than broadband. Broadband offers benefits such as higher-speed Internet access and a continuous, always-on connection, without interfering with the user s landline. According to Gartner Group, 63% of online households in the United States used dial-up connections for their Internet access in 2003, with the remaining 37% using broadband access. SOHOs have been quicker to adopt broadband technology than consumers, with IDC estimating that 47% of home offices in the United States had high-speed Internet access in 2003 and that an additional 20% of home offices plan to add broadband within the next 12 months. The primary drawback of broadband services relative to dial-up is the cost of the service. As the cost of broadband declines, broadband access is expected to become more widespread.

Adoption of Mobile Telephones in the Mainstream Market

By the mid-1990s, mobile telephones were widely accepted in the early adopter market and began to penetrate the mainstream consumer and SOHO markets. According to IDC, as of the end of 2003, there were 154 million wireless subscribers in the United States, 107 million of which were consumers. Due to the cost of mobile telephone services, mainstream users often share an individual mobile telephone with other members of the household. To date, the majority of mainstream users of mobile telephones have retained their existing landlines for a variety of reasons, including the desire to retain their published telephone number, the familiar experience of a traditional telephone, the varying quality of mobile reception in some areas and access to the Internet.

In the mainstream SOHO market, mobile telephone adoption has been even more prevalent than in the mainstream consumer market. Cost-conscious SOHOs, particularly home offices, have tended to opt for mobile telephones over dedicated business lines largely to avoid the extra cost and low utilization of home business lines. According to IDC, 83% of home offices owned mobile telephones in 2003, while only 27% had a phone line used exclusively for business purposes.

Prevailing Environment for Network Service Providers

Technological advances and deregulation within the communications industry has created an intensely competitive environment for network service providers. These service providers have resorted to aggressive pricing strategies and marketing campaigns to attract and retain subscribers, leading to increased subscriber acquisition costs and high rates of customer churn. In addition, local number portability has further exacerbated the subscriber churn issue by

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enabling customers to maintain their telephone numbers when switching service providers. Competition has also led to commoditization of services, especially at the network layer where calls are transported, forcing service providers to differentiate their offerings through value-added services. These competitive dynamics, coupled with the capital-intensive nature of traditional switch-based networks, have made it difficult for network service providers to offer affordable enhanced services to the mainstream market.

Communications Challenges Faced by the Mainstream Market

Mainstream consumers are currently faced with a number of difficult challenges that are not addressed on a cost-effective basis by existing service offerings, including:

Shared telephone and fax lines. A shared line in a household or a small business typically serves multiple purposes, including telephone and fax, for multiple people but can be used for only one purpose at a time. When a shared line is in use, a communications bottleneck is created, restricting use for the entire household or small office. For example, in the SOHO environment, where mobile telephones are often used for both personal and professional communications, business calls can be missed due to personal use.

High cost of communication services. Mainstream users in the United States are faced with increased overall monthly charges for multiple services. The traditional solution to shared lines is purchasing additional lines. However, the cost of communications services has discouraged many mainstream users from purchasing additional lines. As a result, many mainstream consumers and SOHOs have tolerated shared lines. For example, while nearly two-thirds of SOHOs have fax machines, according to IDC, they do not typically have dedicated fax lines.

Missing important calls. Important telephone calls are often missed when the user is not at home, away from the office, already on the telephone or on the Internet using a dial-up connection. This problem could be rectified if there were better connectivity between users existing communications networks. The ability to redirect calls to alternative devices across networks would decrease missed call incidents. For example, if the landline telephone is not answered, a call could be redirected to a mobile telephone or through the Internet using a voice-over-IP connection.

Managing unwanted calls. Receiving unwanted calls is irritating, time-consuming and costly to the user. Mobile telephone and some landline telephone services have begun to give users rudimentary insight into the identity of a caller through display of callers telephone numbers, though these numbers are often blocked or are not recognized by users. Consumers are also being inundated with calls from telemarketers and, despite regulatory restrictions, there are few cost-effective mechanisms for eliminating these unwanted calls and protecting consumer privacy. The ability to better identify the source of incoming calls would improve users abilities to manage and control their existing communications services.

Inefficient use of existing communications networks and devices. Mainstream users increasingly subscribe to multiple communications services, including landline telephones, mobile telephones and the Internet, but do not have an effective means of managing communications across these networks. Connectivity among these communication devices would increase their utilization and decrease line congestion by redirecting inbound communications from devices that are currently in use for another purpose or not answered, to devices that are available, such as an idle mobile telephone or a broadband-connected personal computer.

Mainstream users require a solution that enables them to manage their existing communications services more efficiently and cost-effectively. The solution needs to enable users to receive their calls regardless of the type of network available to them at the time. Further, the solution needs to provide the user with better information about the call and the reason for the call so that the user can make an informed decision about accepting the call.

The CallWave Solution

We provide affordable communications application services on a subscription basis to mainstream consumers and SOHOs. Our software-based services are delivered on our proprietary Enhanced Services Platform that allows subscribers to bridge calls across existing landline, mobile and Internet networks, without requiring them to purchase or install additional hardware. Our platform provides a network-independent communication interface layer, which is presently used for bridging important landline calls to our subscribers through their existing mobile telephones or through Internet-connected personal computers using voice-over-IP technology. Our solutions allow subscribers to see and hear who is calling before deciding whether to take the call, enabling them to receive more of their important calls and to manage other calls at their convenience. These capabilities enable our mass-market subscribers to more effectively manage their personal communications in an easy-to-use manner. Our solutions extend the functionality of networks and devices that our subscribers already use by offering an easy-to-use approach to enhanced call-bridging features such as real-time voicemail, call screening, and virtual phone and fax numbers.

Key aspects of our solution include:

Affordable enhanced communications application services. Our solution delivers enhanced communications application services customized to meet the requirements of cost-conscious mainstream subscribers, without requiring them to purchase additional hardware or telephone lines. We offer flexible service levels, enabling our subscribers to pay for only those services they need.

Ease of installation and use. We designed our solution to be easy to install on a personal computer and easy to use with minimal behavioral changes. During registration and installation, our software is automatically configured, based on subscribers existing communications services. The registration and installation process typically takes only a few minutes. In most cases, we automatically provision our services without subscribers having to call their existing network service providers. Our call-bridging services are delivered over subscribers existing communication networks and require no additional hardware. As a result, our subscribers realize the value of our services without any significant changes to their behavior or that of the people who call them.

Optimized use of existing communications networks and devices. Our software-based solution enables real-time connectivity among subscribers existing communications networks and devices by allowing them to choose where a call is delivered. Our solution also provides users with detailed caller identification information, giving subscribers the choice to take the call or direct it to an answering device. The ability to better manage inbound communications enables subscribers to receive more of their important calls that they want on a network device available at the time and manage their other calls at their convenience.

Scalable, reliable and flexible software platform. Our software platform has been designed to scale to support millions of users, to deliver carrier-class reliability and to be sufficiently flexible to address the changing market needs. Our software-based infrastructure and open

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architecture enable us to efficiently and economically identify and develop new solutions for our subscribers as they adopt new technologies and desire enhanced functionality from their communication services.

Complementary to network service providers. Our software platform integrates with and enhances the existing offerings of network service providers and, we believe, enables landline, mobile and Internet service providers to reduce their cost of customer retention and acquisition. For example, we believe that both value-priced and premium-priced Internet service providers could reduce customer churn rates and increase customer loyalty by offering our enhanced services to their customers.

Our Strategy

Our objective is to be the leading provider of solutions that help mainstream consumers and SOHOs utilize their existing communications services more efficiently and cost-effectively.

Maintain our focus on the needs of the mainstream market. We endeavor to provide solutions that the mainstream market highly values and that we can provide to users at an affordable price. We believe that the market opportunity for addressing the communications needs of these cost-conscious mainstream users is large and growing. We intend to remain focused on the mainstream market and provide a range of enhanced communications services that meet the needs of this market.

Continue to follow a subscriber-driven approach to product development and marketing. We believe that our platform helps us gain a comprehensive and accurate understanding of the needs, desires and priorities of our subscribers, which is critical to the ongoing success of our business. We also conduct subscriber studies and focus groups to further increase our understanding of our subscribers needs, desires and priorities. The information captured through this ongoing research and analysis enables us to better identify subscriber requirements and behavioral patterns and continue to develop new and enhanced communications solutions that current and potential subscribers in the mainstream market value. Our disciplined approach helps us measure the effectiveness of our marketing initiatives, and enables us to continually refine and improve them. We intend to continue to follow a subscriber-driven approach to product development and marketing.

Provide affordable communications solutions for mainstream users. Our network-independent software-based platform bridges calls effectively across all mainstream forms of Internet access and across all landline, mobile and Internet service providers. This enables us to provide affordable, value-added communications services to mainstream users without the additional cost of changing providers or purchasing new hardware. We intend to continue to serve the cost-conscious mainstream market, regardless of the communications networks and devices they use.

Extend and enhance component applications and service levels. Our centralized software platform gives us the flexibility to design, deploy, test and enhance features and applications quickly and easily. We are able to bundle these component applications rapidly into new service levels. We intend to offer additional applications and service levels to meet the diverse and evolving needs of our existing and targeted subscribers and enhance existing applications and service levels to remain competitive. For example, as broadband and voice-over-IP become increasingly accepted in the mass market, we intend to develop and release additional applications and services to address the needs of mainstream users of those technologies.

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Extend our reach through strategic relationships with network service providers. Today, most of our sales come from direct acquisition of customers through our website. We also have a commercial relationship with EarthLink, through which we provide co-branded call-bridging services to its subscribers. In addition, we also maintain online distribution relationships with a number of smaller companies. We intend to develop similar relationships with other network service providers to help us reach a wider range of subscribers, particularly as broadband and voice-over-IP technology are adopted by the mainstream.

Technology

Our core technology is based on our proprietary Enhanced Services Platform. We have designed our call-bridging software to be highly configurable and flexible, enabling us to deliver customized services to each of our subscribers through a common software platform, and to quickly add or enhance applications and features to meet the evolving needs of the mainstream market.

We designed our Enhanced Services Platform to be:

Network independent. Our call-bridging platform is independent from the communications networks through which consumers and businesses communicate. Our platform interfaces with existing landline, mobile and Internet networks through industry-standard protocols. By remaining independent from this network transport layer, we are able to enhance existing communications services across distinct networks and devices.

Scalable and reliable. Our platform currently processes over 50 million calls per month, and is designed to handle significantly higher call volume under the current architecture. Our software platform has been designed to be fully redundant, with no single points of failure in our software switching facility. We use fully-redundant fault-tolerant components, redundant network connections and redundant copies of data. We also maintain spare parts on site for critical components.

Flexible. Since our platform is centralized and software-based, we are able to add or enhance applications and features easily and quickly. This flexibility enables us to efficiently design, deploy, test and enhance our applications and features. We expect that any new applications we develop could easily be incorporated into our proprietary billing system.

Configurable. During registration and installation, our software is automatically configured based on subscribers existing landline, mobile and Internet services. Our configurable software platform enables subscribers to choose the specific applications and features they desire either during the registration process or during ongoing use.

Secure. Our call-bridging infrastructure and customer data are housed within secure data centers to prevent intrusions and to ensure the privacy of customer data.

Our Enhanced Services Platform intercepts inbound calls, manages and filters calls and allows calls to be delivered to our subscribers. Within each primary function, our platform contains a number of component applications, or communications applets,

which we bundle into customized services to address the unique needs of our different target markets. The following diagram illustrates the primary functions and component applications of our Enhanced Services Platform.

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The following table describes the primary functions and component applications of our Enhanced Services Platform.

Function	Component Application	Description
Intercept	Call forward provisioning	We automate the provisioning of either busy or no answer call forwarding, to enable us to bridge missed calls. When automatic provisioning is not available, personalized instructions are given for self-provisioning of call forwarding through direct interactions with the telephone company.
	Automatic line testing	We automatically test that the call forwarding is working as intended. When problems are identified, tests are performed to diagnose the problem and simple corrective instructions are provided to the user.
	Virtual phone numbers	We issue standard 10-digit or toll-free telephone numbers to our users during the registration process through our wholly-owned subsidiary, Liberty Telecom.
	Virtual fax numbers	We issue standard 10-digit fax numbers to our users during the registration process through Liberty Telecom.
Filter and Manage	Caller identification	We provide rich caller identification information to users, including the caller s telephone number, name or company name, city and state. When calls are designated private , we automatically request callers to release their caller identification information.
	Telemarketer blocking	We automatically block calls from telemarketers. When a telemarketer call is blocked, the subscriber is notified.

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Function	Component Application	Description
	Automatic configuration	We enable subscribers to quickly and easily configure many aspects of their service, either during the initial registration process or throughout the ongoing use of our service.
	Real-time voicemail	We store and synchronize voice messages on our subscribers personal computers and our servers. Subscribers can access stored messages either through their personal computers or over the telephone while the message is being left.
Delivery	Fax-to-email	We enable users to receive faxes via email over the Internet in the widely-available Adobe Acrobat pdf format. Depending on the level of service, usage of this application may be on a limited or unlimited basis.
	Call notification	We notify users of inbound calls by sending a message with caller identification and available call information to a device of the subscriber s choosing, including mobile telephones using Short Message Service, or SMS, or via email.
	Telephone call screening	We allow users to listen to voice messages while they are being left through a landline or mobile telephone. This application mimics traditional answering machine style messaging, but is accessible on any communications device without requiring additional hardware.
	Voice-over-IP call screening	We allow users to listen to voice messages while they are being left through Internet-connected personal computers, using voice-over-IP technology. This application mimics traditional answering machine style messaging, but is accessible on any communications device without requiring additional hardware.
	Take-the-call	We allow users to pick up a call in real-time while they are listening to a message being left, regardless of which device the subscribers are using or to which device the call was originally placed.

Key elements of our Enhanced Services Platform include our centralized software switch that enables us to intercept and deliver calls across networks and our CallWave client software that resides on subscribers personal computers.

Centralized software switch. Our proprietary, centralized software switch is the core of our call-bridging infrastructure. Our software switch interacts with existing communications networks and enables us to perform the call intercept, management and delivery functions required to provide our services. Our switch is a network of servers that interfaces with the public switched telephone network through SS7, T1 and T3 signaling, and with the Internet through TCP/IP and RTP for voice delivery. We designed our software switch to be highly reliable with no single points of failure within our Reno, Nevada facility. We use redundant data storage, and we route calls across diverse network paths and multiple carriers for carrier-class availability.

CallWave client software. Our CallWave client software is installed and automatically configured on subscribers personal computers during the initial registration process. Our client software enables subscribers to manage their calls across multiple networks, block telemarketer calls, review calls, listen to messages and view faxes. Our client software runs on all major versions of Microsoft Windows and can be automatically upgraded, enabling us to keep the majority of our installed software at the latest supported revisions.

The CallWave Service

We provide communications applications services that help mainstream consumers and SOHOs better utilize their existing communications networks and devices. Our goal is to enable subscribers to receive more of their important calls and manage their

other calls at their

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convenience. We provide subscribers with enough information and functionality to filter out low-value calls and ensure delivery of high-value calls by delivering calls to any communications network that is available to them. We offer our services to customers as a flat-rate monthly or annual subscription. Subscribers have the flexibility to pay us for their subscriptions using credit cards, mail-in checks or through their telephone bills.

Our Enhanced Services Platform enables all of our services. We bundle groups of our communications applets together to deliver our services. Each of our service levels includes components of call intercept, management and delivery. The primary differences among our subscription service levels are the call delivery options that are available to subscribers.

We offer three principal levels of service: CallWave Alert, CallWave Messenger and CallWave Connect.

CallWave Alert. CallWave Alert is our lowest-priced subscription level. Our CallWave Alert service delivers notifications of calls placed to any of our subscribers telephone numbers, even when those lines are in use or is not answered by sending a message to a device of our subscribers choosing. CallWave Alert also includes additional telephone and fax numbers, provisioned during installation, as well as limited incoming fax capabilities for personal use.

CallWave Messenger. CallWave Messenger is our mid-level subscription level, providing all of the features of CallWave Alert, as well as caller identification and delivery of voice messages, even when subscribers lines are in use or are not answered. CallWave Messenger also includes additional telephone and fax numbers, as well as unlimited incoming fax functionality.

CallWave Connect. CallWave Connect is our most feature-rich and high-end service level currently offered. CallWave Connect service enables customers to screen, transfer or receive calls in real-time. Our CallWave Connect also includes additional telephone and fax numbers, as well as unlimited incoming fax functionality.

The following table summarizes the functions and applications that are available within each of our three principal service offerings.

Function	Component Applications	CallWave Alert	CallWave Messenger	CallWave Connect
Intercept	Call forward provisioning	ü	ü	ü
	Automatic line testing	ü	ü	ü
	Virtual phone numbers	ü	ü	ü
	Virtual fax numbers	ü	ü	ü
Filter and Manage	Caller identification	ü	ü	ü
	Telemarketer blocking	ü	ü	ü
	Automatic configuration	ü	ü	ü

	Real-time voicemail		ü	ü
Delivery	Fax-to-email	ü	ü	ü
	Call notification	ü	ü	ü