

CALLWAVE INC  
Form 10-Q  
November 14, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the Quarterly Period Ended September 30, 2008

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50958

**CallWave Inc.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of

**77-0490995**  
(I.R.S. Employer

incorporation or organization)

Identification Number)

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

(Address of principal executive offices)

(Zip code)

**(805) 690-4100**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

At October 31, 2008, the number of shares outstanding of the registrant's common stock, no par value, was 21,175,971.

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**CALLWAVE INC.**

**Form 10-Q**

**For the Quarter Ended September 30, 2008**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CALLWAVE, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

|  | As of<br>September 30,<br>2008<br>(unaudited) | As of<br>June 30,<br>2008 |
|--|---|---------------------------|
| <b>Assets</b>  |   |                           |
| Current assets:  |   |                           |
| Cash and cash equivalents  | \$ 19,206                                     | \$ 29,839                 |
| Restricted cash  | 1,800   |                           |
| Marketable securities, available for sale, at fair value   | 7,913   | 8,768                     |
| Accounts receivable; net of allowance for doubtful accounts of \$247 and \$285, respectively   | 1,605   | 1,774                     |
| Other current assets   | 409   | 581                       |
| Total current assets   | 30,933  | 40,962                    |
| Property and equipment, net  | 2,029   | 2,355                     |
| Intangible assets, net   | 12,453  | 5,652                     |
| Auction rate securities, available for sale, at fair value   | 4,250   | 7,492                     |
| Other assets   | 118   | 129                       |
| Total assets   | \$ 49,783                                     | \$ 56,590                 |
| <b>Liabilities And Stockholders Equity</b>   |   |                           |
| Current liabilities:   |   |                           |
| Accounts payable   | \$ 683  | \$ 710                    |
| Accrued payroll  | 590   | 583                       |
| Deferred revenue   | 530   | 600                       |
| Other current liabilities  | 1,660   | 1,754                     |
| Short term debt  |   | 1,000                     |
| Total current liabilities  | 3,463   | 4,647                     |
| Commitments and contingencies  |   |                           |
| Stockholders equity:   |   |                           |
| Common stock, no par value; 100,000 shares authorized at September 30, 2008 and June 30, 2008; 21,176 and 21,176 shares issued and outstanding at September 31, 2008 and June 30, 2008, respectively | 75,148  | 74,948                    |
| Other comprehensive loss   | (5,884)                                       | (2,537)                   |
| Accumulated deficit  | (22,944)                                      | (20,468)                  |
| Total stockholders equity  | 46,320  | 51,943                    |
| Total liabilities and stockholders equity  | \$ 49,783                                     | \$ 56,590                 |

See accompanying notes.



**Table of Contents****CALLWAVE, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)****(unaudited)**

|   | <b>For the Three Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2008</b>   | <b>2007</b> |
| Revenue                                     | \$ 4,342  | \$ 5,352    |
| Cost of sales                               | 1,778   | 1,932       |
| Gross profit                                | 2,564   | 3,420       |
| Operating expenses (1):                     |   |             |
| Sales and marketing                         | 1,236   | 1,581       |
| Research and development                    | 1,636   | 1,609       |
| General and administrative                  | 1,661   | 2,162       |
| Restructuring charges                       | 787   | 1,095       |
| Total operating expenses                    | 5,320   | 6,447       |
| Operating loss                              | (2,756)   | (3,027)     |
| Interest income                             | 280   | 700         |
| Loss before income taxes                    | (2,476)   | (2,327)     |
| Income tax expense                          |   |             |
| Net loss                                    | \$ (2,476)  | \$ (2,327)  |
| Net loss per share:                         |   |             |
| Basic and diluted                           | \$ (0.12)   | \$ (0.11)   |
| Weighted average common shares outstanding: |   |             |
| Basic and diluted                           | 21,176  | 20,899      |

(1) Includes stock-based compensation as follows:

|                            |       |       |
|----------------------------|-------|-------|
| Sales and marketing        | \$ 40 | \$ 87 |
| Research and development   | 32    | 56    |
| General and administrative | 119   | 112   |
| Restructuring charges      | 9     | 370   |

See accompanying notes.

**Table of Contents****CALLWAVE, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

|   | <b>Three Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2008</b>                                 | <b>2007</b> |
| <b>Cash flows from operating activities:</b>                                |   |             |
| Net loss  | \$ (2,476)                                  | \$ (2,327)  |
| Adjustments to reconcile net loss to net cash used in operating activities: |   |             |
| Depreciation and amortization   | 592   | 262         |
| Stock based compensation  | 200   | 625         |
| Bad debt expense  | 135   | 222         |
| Loss on sale of marketable securities                                       |   | 18          |
| Loss on disposal of fixed assets  | 280   |             |
| Changes in operating assets and liabilities:                                |   |             |
| Accounts receivable, net of bad debt expense                                | 34  | (96)        |
| Other assets  | 183   | 52          |
| Accounts payable  | (27)  | (221)       |
| Accrued payroll and other liabilities                                       | (88)  | 394         |
| Deferred revenue  | (70)  | 9           |
| Net cash used in operating activities                                       | (1,237)                                     | (1,062)     |
| <b>Cash flows from investing activities:</b>                                |   |             |
| Purchases of intangible assets  | (7,200)                                     |             |
| Funding of purchase escrow  | (1,800)                                     |             |
| Purchases of marketable securities  |   | (13,009)    |
| Sales of marketable securities  | 748   | 9,245       |
| Purchases of property and equipment   | (146)                                       | (310)       |
| Net cash provided by (used in) investing activities                         | (8,398)                                     | (4,074)     |
| <b>Cash flows from financing activities:</b>                                |   |             |
| Repayment of short term debt  | (1,000)                                     |             |
| Proceeds from exercises of stock options and warrants                       |   | 118         |
| Net cash provided by (used in) financing activities                         | (1,000)                                     | 118         |
| Effect of exchange rate changes on cash and cash equivalents                | 2   |             |
| Net decrease in cash and cash equivalents                                   | (10,633)                                    | (5,018)     |
| Cash and cash equivalents at beginning of the period                        | 29,839                                      | 20,299      |
| Cash and cash equivalents at end of the period                              | \$ 19,206                                   | \$ 15,281   |

See accompanying notes.

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**CALLWAVE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company and Basis of Presentation**

The accompanying condensed consolidated interim financial statements of CallWave, Inc., and its wholly owned subsidiaries (CallWave, or the Company ) have been prepared in conformity with accounting principles generally accepted in the United States and are consistent in all material respects with those applied in the Company's annual report on Form 10-K for the year ended June 30, 2008. The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Examples include the estimate of useful lives of property and equipment, the valuation of stock-based compensation instruments, the allowance for doubtful accounts, net realizable value of investments, and the recognition and measurement of income tax assets and liabilities. The actual results experienced by the Company may differ from management's estimates.

The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth therein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's 2008 annual report on Form 10-K filed with the Securities and Exchange Commission on September 26, 2008. Interim results are not necessarily indicative of the results for a full year.

*Principles of consolidation* The Condensed Consolidated Financial Statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated.

*Share-Based Compensation* The Company accounts for stock-based compensation in accordance with the provisions of SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R). Under the fair value recognition provision of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the award. The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option pricing model and a single option award approach. The fair value is amortized on a straight-line basis over the requisite service period of the awards, which is generally the vesting period. See Note 5 for further discussion.

*Revenue recognition* The Company earns revenues primarily from paid subscriber services and to a lesser extent, fees earned from local exchange carrier call termination access charges and the offering of third-party products and services to subscribers.

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States and with Securities and Exchange Commission Staff Accounting Bulletin 104 (SAB 104), *Revenue Recognition*, which clarifies certain existing accounting principles for the timing of revenue recognition and classification of revenues in the financial statements. Revenue is recognized beginning when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the fees are fixed and determinable and collection is reasonably assured. Subscriber revenues consist mainly of monthly recurring subscription fees. Revenue is recognized ratably over the subscription period when the SAB 104 criteria are met. Revenues and associated expenses are deferred and recognized over the service period. Associated expenses are deferred only to the extent of such deferred revenue.

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

*Deferred revenue* Deferred revenue consists of customer prepayments of subscription fees, which will be earned in the future under agreements existing at the balance sheet date. Deferred revenue is amortized ratably over the period in which services are provided. In addition, install fees are recorded as deferred revenues and amortized to revenue over the expected period of performance, or the estimated average customer subscription life.



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*Cost of sales* Cost of sales consists of billing and collection costs, long-distance telephone service expenses used to deliver the Company's services, and systems and telecommunications infrastructure.

*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.

*Advertising* Advertising costs are expensed as incurred. Advertising expense was \$250,000 and \$524,000 for the quarters ended September 30, 2008 and 2007, respectively.

**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

*Foreign currency translation* The Company's foreign operations are subject to exchange rate fluctuations and foreign currency transaction costs. All foreign operations use the local currency as the functional currency and are principally related to research and development activities. The Company's foreign operations do not currently generate revenue. Local currency denominated assets and liabilities are translated at the period-end exchange rate. Expenses are translated at the average exchange rates during the period. Gains or losses resulting from foreign currency translation are included as a component of Other Comprehensive Loss in the condensed consolidated balance sheet. The Company does not currently use forward contracts to hedge foreign currency exposure.

*Comprehensive loss* The components of comprehensive loss are as follows:

|  | <b>Three Months Ended<br/>September 30,<br/>2008      2007<br/>(in thousands)</b> |                   |
|--|---|-------------------|
| Net loss   | \$ (2,476)  | \$ (2,327)        |
| Other comprehensive income:                          |   |                   |
| Net unrealized loss on available for sale securities | (3,349)   | 37                |
| Change in accumulated translation adjustments        | 2   |                   |
| <b>Total comprehensive loss</b>                      | <b>\$ (5,823)</b>   | <b>\$ (2,290)</b> |

*Software development costs* Costs of software developed to be sold or licensed to the external market are accounted for under Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*. Under SFAS No. 86, the Company expenses the costs of research, including pre-development 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 technological feasibility and product release, and the insignificant amount of cost incurred during such period, the Company has not capitalized any software development costs to date.

*Impairment of long-lived assets* The Company accounts for the impairment and disposition of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. In accordance with SFAS No. 144, long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

*Cash equivalents* All highly liquid investments with original maturities of three months or less at date of purchase are considered to be cash equivalents.

*Accounts Receivable* Accounts receivable consists of trade receivables arising in the normal course of business. The Company does not charge interest on its trade receivables. The allowance for doubtful accounts is the Company's best estimate of the amount of probable non-paying customer accounts in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts monthly and determines the allowance based upon historical bad debt experience and payment history. If estimated allowances for uncollectible accounts subsequently prove insufficient, an additional allowance may be required.

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

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During the quarter ended December 31, 2007, certain auction rate securities began to fail auction due to sell orders exceeding buy orders. Of the Company's \$12.2 million marketable securities portfolio at September 30, 2008, \$4.3 million is currently associated with failed auctions, all of which have been in a loss position for less than 12 months. The funds associated with failed auctions will not be accessible until a successful auction occurs or a buyer is found outside of the auction process. All of the auction rate securities were AAA quality and were in compliance with the Company's investment policy at the time of acquisition. The Company currently has the ability and intent to hold these investments until a recovery of the auction process or until maturity. Based on third party valuation models and an analysis of other-than-temporary impairment factors, the Company has determined that these securities are not permanently impaired. However, the Company recorded an unrealized loss related to these auction rate securities within Other Comprehensive Loss of approximately \$5.7 million pre-tax at September 30, 2008, related to these auction rate securities.

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**CALLWAVE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The Company's auction rate securities were held with a bank that declared bankruptcy during the quarter ended September 30, 2008. It is now uncertain whether liquidity will be restored to these securities in the near future. Accordingly, the auction rate securities were reclassified to non-current assets as of June 30, 2008. We analyze these securities each reporting period for impairment, including other-than-temporary impairment factors. Auction failures related to this type of security are symptomatic of current conditions in the broader debt markets and are not unique to CallWave.

*Fixed assets* Fixed assets are stated at cost less accumulated depreciation. Fixed assets are depreciated using the straight-line method over their estimated useful lives.

*Fair value of financial instruments* Financial instruments consist of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities. The carrying values of these instruments approximate fair value due to their short-term nature.

*Concentrations of credit risk* Financial instruments that subject the Company to credit risk consist primarily of trade accounts receivable. Concentration of credit risk is generally diversified due to the large number of customers composing the Company's customer base. The Company has a concentration of credit risk from an agreement with a vendor for billing and collection services provided for a portion of the Company's paid users. The Company would be subject to sustaining a loss relative to its current receivable balance if the vendor failed to perform under the terms of the agreement. The net receivable from the vendor at September 30, 2008 and June 30, 2008 was \$805,000 and \$984,000, respectively.

The Company maintains its cash balances in financial institutions located in California and Nevada. The balances are insured by the Federal deposit Insurance Corporation up to \$250,000. The Company's cash balances exceed the maximum amount insured.

*Income taxes* Income taxes are recorded in accordance with SFAS No. 109, *Accounting for Income Taxes*. SFAS No. 109 requires the recognition of deferred tax assets and liabilities to reflect the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of the Company's assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such assets. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or the entire deferred tax asset will not be realized.

Effective at the beginning of the fiscal year ended June 30, 2008, the Company adopted FIN 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes*. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement. The adoption of FIN 48 did not have a material impact on the Company's consolidated financial statements.

*Valuation of acquired intangible assets* Intangible assets are accounted for under Statement of Financial Accounting Standards SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires the Company to record intangible assets at their fair value. Historically, the Company has used the cash purchase price at the time of acquisition as the best indicator of fair value. SFAS No. 142 also requires the Company to periodically evaluate the carrying value of intangible assets to determine if an impairment loss should be recorded under SFAS No. 144. In accordance with SFAS 144, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value.

*Net loss per share* The Company computes net loss per share in accordance with SFAS No. 128, *Earnings per Share*. Under the provisions of SFAS No. 128, basic net loss per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of shares issuable upon exercise of stock options and warrants. The dilutive effect of outstanding stock options and warrants is reflected in diluted loss per share by application of the treasury stock method.



**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

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

|  | <b>Three Months Ended<br/>September 30,<br/>2008      2007<br/>(in thousands except<br/>per share data)</b> |            |
|--|---|------------|
| Basic and diluted net loss per share:                              |   |            |
| Net loss attributable to common stockholders                       | \$ (2,476)  | \$ (2,327) |
| Weighted-average common shares outstanding                         | 21,176  | 20,899     |
| Effect of dilutive securities:                                     |   |            |
| Stock options and warrants   |   |            |
| Convertible preferred shares                                       |   |            |
| Weighted-average common shares outstanding for diluted calculation | 21,176  | 20,899     |
| <b>Net loss per share:</b>   |   |            |
| Basic and diluted  | \$ (0.12)   | \$ (0.11)  |

Options to purchase 3,586,000 and 4,440,000 shares were outstanding at September 30, 2008 and 2007, respectively, and warrants to purchase 24,000 shares were outstanding at September 30, 2007. These options and warrants were excluded from the computation of diluted earnings per share because their effect would be anti-dilutive due to the net loss.

**2. Fair Value of Marketable Securities and Auction Rate Securities***Fair Value Hierarchy*

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs are obtained from independent sources and can be validated by a third party whereas unobservable inputs reflect assumptions regarding what a third party would use in pricing an asset or liability. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS No. 157 establishes three levels of inputs that may be used to measure fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

In accordance with SFAS 157, the Company measures its cash equivalents and marketable securities at fair value within Level 1. Auction rate securities are measured at fair value within Level 3. Fair value measurements for auction rate securities have been estimated using an income approach (discounted cash-flow analysis). When estimating fair value, we consider both observable market data and non-observable factors, including credit quality, duration, insurance wraps, collateral composition, comparable trading instruments, and likelihood of redemption. Significant assumptions used in the analysis include estimates for interest rates, spreads, cash flow timing and amounts, and holding periods of

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the securities.

### *Assets Measured at Fair Value on a Recurring Basis*

Assets measured at fair value on a recurring basis consisted of the following types of instruments at September 30, 2008 (in thousands):

| <b>Description</b>           | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total<br/>Balance</b> |
|------------------------------|----------------|----------------|----------------|--------------------------|
| Cash and cash equivalents    | \$ 19,206      | \$             | \$             | \$ 19,206                |
| Marketable securities        | 7,913          |                |                | 7,913                    |
| Auction rate securities      |                |                | 4,250          | 4,250                    |
| Total measured at fair value | \$ 21,119      | \$             | \$ 4,250       | \$ 31,369                |

**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3).

|                                       | Auction rate<br>securities<br>(in thousands) |
|---------------------------------------|--|
| Beginning balance (July 1, 2008)      | \$ 7,492                                     |
| Total gains or (losses):              |  |
| Included in earnings                  |  |
| Included in other comprehensive loss  | (3,242)                                      |
| Purchases, issuances, and settlements |  |
| Transfers in and/or out of Level 3    |  |
| Ending balance (September 30, 2008)   | \$ 4,250                                     |

**3. Intangible Assets**

In January 2006, the Company entered into a license agreement with an independent software company to use certain software programs and related intellectual property in CallWave's products. In March 2006, the Company entered into a license agreement with Web Telephony, Inc., to use certain patent rights. In March 2007, the Company entered into a license agreement with j2 Global Communications and Catch Curve for a fully paid-up nonexclusive license to use certain licensed patents for non-fax services. These up front license payments were classified as intangible assets. The Company is amortizing the cost of the intangible assets on a straight-line basis over the life of the underlying patents. In addition, the Company purchased software from Intelligent Gadgets for \$1.6 million in June 2008, and the Company purchased software from WebMessenger, Inc for \$9.0 million in August 2008, \$1.8 million of which is being held in escrow for a period of up to one year to secure the seller's obligations under the purchase agreement. This software is being amortized over its estimated useful life of five years. The weighted average amortizable life of the intangible assets is 7 years. Amortization expense for the quarters ended September 30, 2008 and 2007, was \$396,000 and \$87,716, respectively.

Intangible assets consist of the following (in thousands):

|                                | As of<br>September 30,<br>2008 | As of<br>June 30,<br>2008 |
|--------------------------------|--------------------------------|---------------------------|
| Amortizable intangible assets: |                                |                           |
| Purchased licenses, at cost    | \$ 13,344                      | \$ 6,147                  |
| Less: accumulated amortization | (891)                          | (495)                     |
| Intangible assets, net         | \$ 12,453                      | \$ 5,652                  |

Estimated future amortization expense is as follows:

|  |          |
|--|----------|
| <b>Twelve months ending September 30, (in thousands)</b> |          |
| 2009   | \$ 2,097 |



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|            |       |
|------------|-------|
| 2010       | 2,093 |
| 2011       | 2,093 |
| 2012       | 2,093 |
| 2013       | 1,785 |
| Thereafter | 2,292 |

**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****4. Stockholders' Equity***Common Stock*

As of September 30, 2008 and June 30, 2008, the Company is authorized to issue 100,000,000 shares of common stock, of which 3,586,000 and 3,033,348 shares of common stock were reserved for stock options issued and outstanding, respectively.

**5. Share-Based Compensation**

As of September 30, 2008, the Company's stock option plans consist of the 2004 Option Plan, the 2000 Option Plan and the 1999 Option Plan. The maximum shares issuable under these plans at September 30, 2008, consist of 4,773,965 shares, 2,250,000 shares and 1,350,000 shares authorized of which 3,140,136, 293,179 and 152,430 options are outstanding under the 2004, 2000, and 1999 Option Plans, respectively.

The Company's Board of Directors grants options at an exercise price equal to the fair market value of the Company's common stock at the date on which the grant is approved by the Board. Stock option grants under the 2000 and 1999 Option Plans generally have a term of ten years from the date on which the grant is approved by the Board and option grants under the 2004 Plan generally have a term of five years from the date on which the grant is approved by the Board of Directors. Vesting terms for most options are one-fourth after twelve months, and one-forty-eighth per month thereafter, becoming fully vested in four years.

The Company accounts for stock-based compensation in accordance with the provisions of SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R). Under the fair value recognition provision of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the award. The fair value of stock options granted is estimated using the Black-Scholes-Merton option pricing model and a single option award approach. The fair value is amortized on a straight-line basis over the requisite service period of the awards, which is generally the vesting period.

Determining the appropriate fair value of stock-based awards at the grant date requires judgment, including estimating stock price volatility, forfeiture rates and expected term. The Company computes expected volatility based on a combination of both historical volatility and market-based implied volatility, as management believes that the combination provides a more accurate estimate of future volatility. The expected term represents the period of time that the stock-based awards are expected to be outstanding and is determined based on historical experience of similar awards. Expected forfeitures are based on historical experience per department. Due to the inherent uncertainty in valuing awards for publicly-traded stock as of the grant date, given that such awards will be exercised, purchased or sold at indeterminate future dates, the actual value realized by the recipients, if any, may vary significantly from the value of the awards estimated at the grant date.

|  | <b>Three Months Ended<br/>September 30,</b> |                 |
|--|---|-----------------|
|  | <b>2008</b>                                 | <b>2007</b>     |
| Weighted average fair value of stock options granted | \$ 1.00                                     | \$ 1.34         |
| Risk free interest rate                              | 3.08%                                       | 4.11% - 4.26%   |
| Expected life (in years)                             | 4.0   | 4.0             |
| Expected volatility                                  | 52.37%                                      | 54.29% - 54.51% |
| Expected dividend yield                              | 0.00%                                       | 0.00%           |
| Expected forfeiture rate                             | 10% - 63%                                   | 9% - 44%        |

**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

A summary of option activity under the Option Plans as of September 30, 2008, and changes during the three months then ended is presented below:

| Options  | Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (\$000) |
|--|-----------|---------------------------------|---|-----------------------------------|
| Outstanding at July 1, 2008                      | 3,033,348 | \$ 3.31                         |   |                                   |
| Granted  | 875,254   | 2.29                            |   |                                   |
| Exercised  |           |                                 |   |                                   |
| Forfeited or expired                             | (322,857) | 2.92                            |   |                                   |
| Outstanding at September 30, 2008                | 3,585,745 | \$ 3.10                         | 3.46  | \$ 99                             |
| Vested or expected to vest at September 30, 2008 | 2,911,660 | \$ 3.22                         | 3.21  | \$ 99                             |
| Exercisable at September 30, 2008                | 1,518,374 | \$ 3.69                         | 2.23  | \$ 99                             |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company's closing stock price on the last trading day of the quarter ended September 30, 2008 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. This amount will change based on the fair market value of the Company's common stock. The total intrinsic value of options exercised during the three months ended September 30, 2008 and 2007, was \$0 and \$51,000, respectively.

As of September 30, 2008, there was \$2.4 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the Option Plans. That cost is expected to be recognized over a weighted-average period of 3.10 years. Total share-based compensation expense recognized for the three months ended September 30, 2008 and 2007 was \$200,000 and \$625,000, respectively.

**6. Commitments and Contingencies***Leases*

The Company leases office space and certain office equipment under non-cancelable operating leases. Before restructuring charges, rental expense under operating lease agreements was \$199,000 and \$184,000 for the three months ended September 30, 2008 and 2007, respectively.

Future minimum commitments remaining under these agreements as of September 30, 2008, are as follows:

| Twelve Months Ending September 30: | Minimum Commitment (in thousands) |
|------------------------------------|-----------------------------------|
| 2009                               | \$ 803                            |
| 2010                               | 676                               |
| 2011                               | 286                               |

|                     |     |
|---------------------|-----|
| 2012                | 152 |
| 2013 and thereafter | 147 |

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**CALLWAVE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*Other Commitments and Contingencies*

The Company has long-distance service agreements with certain carriers. As of September 30, 2008, minimum obligations under these agreements due within one year total \$216,000. However, the Company expects to maintain some form of long-distance service agreements indefinitely, and will likely assume similar obligations following the expiration of these agreements. As of September 30, 2008, minimum obligations due within one year under agreements with providers of billing and collection services and outsourced customer support total \$62,000.

**7. Restructuring Charges**

During the quarter ended September 30, 2008, the Company announced a reorganization and reduction in workforce. As a result of the reorganization, the Company incurred a charge of approximately \$800,000 associated primarily with severance, health insurance, facilities consolidation and accelerated stock option compensation expense. The entire charge was recognized in the quarter ended September 30, 2008.

During the quarter ended September 30, 2007, the Company announced a reorganization and reduction in workforce and the termination of the Chief Executive Officer. As a result of the reorganization, the Company incurred a restructuring charge of approximately \$1.1 million associated primarily with severance, health insurance, and accelerated stock option compensation expense. The entire charge was recognized in the quarter ended September 30, 2007.

**8. Income Taxes**

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which temporary differences and net operating losses become deductible and tax credits become usable. Due to the uncertainty surrounding the timing of realizing the benefits of its favorable tax attributes in future tax returns, the Company has placed a valuation allowance against its otherwise recognizable deferred tax assets. The net increase in the valuation allowance for the three months ended September 30, 2008, was approximately \$936,000 due to management's determination that it is more likely than not that the deferred tax asset will not be realized.

As of September 30, 2008, the Company has cumulative net operating loss carryforwards for federal and California income tax purposes of approximately \$19.5 million and \$28.1 million respectively. The losses begin to expire in fiscal year 2010. In addition, the Company has available tax credit carryforwards of approximately \$2.5 million and \$1.4 million for federal and California tax purposes, respectively. The federal tax credits begin to expire in 2009. California tax credits can be carried over indefinitely. expire in

**9. Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157). This standard clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing an asset or liability. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157* which permits a one-year deferral for the implementation of SFAS 157 with regard to non-financial assets and liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* which clarifies the application of SFAS 157 in a market that is not active. SFAS No. 157 was adopted on July 1, 2008 and did not have a material impact on the Company's financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of SFAS No. 115*. The new statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. SFAS No. 159 is effective for fiscal

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years beginning after November 15, 2007. SFAS No. 159 was adopted on July 1, 2008 and did not have a material impact on the Company's financial condition or results of operations.

**Table of Contents****CALLWAVE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS No. 141R ). The purpose of issuing the statement is to revise current guidance in SFAS No. 141 to better represent the economic value of business combination transactions. The revisions include, but are not limited to: (1) acquisition costs will be recognized separately from the acquisition; (2) known contractual contingencies at the time of the acquisition will be considered part of the liabilities acquired and will be measured at their fair value; all other contingencies will be measured at their fair value only if it is more likely than not that they meet the definition of a liability; (3) contingent consideration based on the outcome of future events will be recognized and measured at the time of the acquisition; (4) business combinations achieved in stages (step acquisitions) will need to recognize the identifiable assets and liabilities, as well as noncontrolling interests in the acquiree, at the full amounts of their fair values; and (5) a bargain purchase (defined as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree) will require that excess to be recognized as a gain attributable to the acquirer. Management does not anticipate that the adoption of SFAS No. 141R will have a material impact on the Company's financial condition or results of operations. SFAS No. 141R will be effective for any business combinations that occur after December 15, 2008.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*. SFAS No. 160 was issued to improve the relevance, comparability, and transparency of financial information provided to investors by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way, that is, as equity in the consolidated financial statements. Moreover, SFAS No. 160 eliminates the diversity that currently exists in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. SFAS No. 160 will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Management does not anticipate that the adoption of SFAS No. 160 will have a material impact on the Company's financial condition or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*. This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS 161 applies to all derivative instruments within the scope of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. SFAS 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. Management does not anticipate that the adoption of SFAS No. 161 will have a material impact on the Company's financial condition or results of operations.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Management does not expect the adoption of SFAS 162 to have a material effect on our consolidated results of operations and financial condition.

In May 2008, the FASB issued SFAS No. 163, *Accounting for Financial Guarantee Insurance Contracts – An interpretation of FASB Statement No. 60* ( SFAS 163 ). SFAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default when there is evidence that credit deterioration has occurred in an insured financial obligation. It also clarifies how FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities, and requires expanded disclosures about financial guarantee insurance contracts. SFAS 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, except for some disclosures about the insurance enterprise's risk management activities. SFAS 163 requires that disclosures about the risk management activities of the insurance enterprise be effective for the first period beginning after issuance. Except for those disclosures, earlier application is not permitted. Management does not anticipate that the adoption of SFAS No. 163 will have a material impact on the Company's financial condition or results of operations.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS**

This quarterly report 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, potential, continue, expects, anticipates, future, intends, plans, believes, estimates, and as well as statements in future 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 Overview.

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 law. 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.

**Overview**

**Industry Background**

Historically, CallWave has been an Internet telephony company bridging the gap between the mobile telephone, desktop computer and traditional fax line. The primary revenue sources were from dial-up subscribers who used our services to screen, transfer and store messages on their landline and mobile phones and virtual fax users who were looking for a cheaper alternative to premise based fax machines. However, as these subscribers have migrated to broadband and VOIP services over the last few years we have seen a consistent decline in our revenue. Over the last twelve months we have been using the capital from our legacy business to invest in the growing unified communications space.

The term unified communications represents the power of software to deliver complete communication solutions by integrating voice, messaging and video across applications and devices that people use every day. These include landline and mobile telephone services such as



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voice mail, phone calls, messaging and conferencing, and computer-based services such as document creation, email, instant messaging (IM) and collaboration.

The convergence of available international bandwidth and Internet technology along with software solutions that bridge the gap between telephony and computing have created an opportunity for unified communications. Disintermediation of wireless and landline carrier operators via Internet technology, software applications and available bandwidth is breaking down the regional barriers that historically defined traditional telecommunications. Many pioneers of the telecommunications and software industries believe that software will ultimately control telephony. Industry experts believe the transition from traditional telecommunications to software-based telecommunications represents a global unified communications annual market revenue opportunity of \$40 to \$50 billion.

CallWave is addressing the global collaboration and conferencing segment of the unified communications market. Based on historical data and growth trends, research firms Gartner Inc. and IDC estimate the collaboration and conferencing market will reach \$4.8 billion globally in annual revenue and \$3.4 billion in the U.S. in 2009, with global growth to \$5.8 billion annually by 2012.

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A number of macro-economic forces are driving growth in the online collaboration and conferencing market. Work groups and corporate organizational structures are being redesigned and formed around telecommuting. The new work style is characterized by the need to share ideas and work together instantly and easily from anywhere, anytime. Companies are supporting this new work style in addressing these forces:

Globalization requires competitive companies and their employees to speak and collaborate with partners and customers anywhere around the globe as effectively as they do with parties that are physically located in the building down the street.

The stagnant global economic conditions have necessitated corporate expense reductions, including reductions in travel and telecommunication expenses. Mobile professionals and enterprises are moving away from airplanes as a means of attending routine meetings, and are increasing investments in collaboration and conferencing technologies to meet corporate communication objectives more efficiently and cost effectively.

Environmentalism is on the rise and, increasingly, the public considers corporate responsibility as fundamental to enterprise success there by placing emphasis on alternative communication solutions to eliminate travel and commuting time.

Young knowledge workers who are predisposed to evolving technologies are entering the workforce. This cohort of workers is typically equipped with mobile-centric backgrounds and is accustomed to using real-time messaging and communication solutions such as IM in lieu of email.

Expanding mobile workforces require the expansion of non-traditional work environments. Collaboration solutions make it easier to work effectively and collaborate from any location, reducing the need to be in the office.

State legislative initiatives are being introduced to reduce congested freeways and dependency on energy there by placing emphasis on alternative communication solutions to eliminate travel and commuting time.

## **Company Overview**

Historically we have offered several on-demand web telephony services and virtual fax services. Starting in the first quarter of our fiscal year ending June 30, 2009, we offered a new web collaboration service as well as mobile federated IM and presence services which we acquired in August 2008 when we purchased certain assets of WebMessenger.

Our legacy services add features and functionality to the telecommunications services used by mainstream consumers and small and home offices and are provided on a free trial or subscription basis. Our Phone Companion Software (PCS)-based services are delivered on our proprietary Enhanced Services Platform, which allows subscribers to manage calls across their existing landline, mobile and Internet networks. Our services enable subscribers to receive, respond and manage calls or faxes on most communications devices without requiring them to purchase or install additional hardware, purchase additional telecommunications services, change their phone number, or switch their service provider. Calls can be accessed on a subscriber's handset, in email, or on the Internet. Our Enhanced Services Platform intercepts inbound phone and fax calls to our subscribers and is able to redirect these calls to the devices or access points selected by the subscribers using their existing telecommunications lines. In addition, the Enhanced Services Platform enables us to provide virtual phone and fax numbers to our subscribers who then can publish multiple phone or fax numbers for use with a single phone line. As of September 30, 2008, we had approximately 457,000 paying subscribers for our services. We currently view these services as strategic only to the extent they provide capital resources to fund our new web collaboration software. Our intent is to maximize cash flow from the legacy business and only invest in systems maintenance to keep these services running.

Our new web collaboration and messaging platform, which was launched on September 17, 2008, is called FUZE. FUZE is a browser-based solution that leverages our telephony foundation and enables enterprise-class, cross-platform collaboration, presence, real-time messaging and conferencing with unique features including high-resolution visuals, high-definition audio and synchronized video and imagery between browsers anywhere in the world. FUZE works with desktops, laptops and most smart phones. The target customers for FUZE are enterprises, small- and medium-enterprises (SMEs) as well as mobile professionals.

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We believe that mobility is the key to collaboration. According to Gartner, Inc., today there are more than 4 billion mobile subscribers worldwide. About 25% of these are business professionals and about 10% of the worldwide mobile workforce uses their mobile device to dial-in to conferences every day. According to a recent survey published by Gartner, Inc., the virtualization of the U.S. workforce has grown by more than 800% in the last five years. While mobile endpoint devices have become the default device in the enterprise, enterprise investments in mobile communications have been minimal creating a gulf between office and mobile devices. Our product development strategy is aimed at bridging this chasm.

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WebMessenger's technology offers a presence engine for all of CallWave's products and the ability to extend FUZE to endpoint devices such as mobile phones. At the same time WebMessenger integrates those endpoint devices into Microsoft's Office Communications Server (OCS). WebMessenger includes RSA-encrypted, enterprise-class, real-time messaging that integrates the corporate environment with the mobile user and extends desktop collaboration across all networks and platforms BlackBerry, Windows Mobile, Symbian, Palm, smartphones and iPhones. Interoperability among platforms with a mobile extension represents one of the major development hurdles in creating collaboration and conferencing solutions. WebMessenger is sold as an independent product line and has also been integrated into our FUZE web collaboration platform.

CallWave plans to offer several pricing packages and tiers that are designed to drive recurring, predictable and scalable economics via subscription-based pricing and traditional software licensing and maintenance agreements. Subscription-based pricing is an accepted form of pricing for Software-as-a-Service (SaaS) solutions for small, medium and enterprise business, as well as the small office and home office (SoHo) markets. With larger enterprise customers, CallWave plans to offer both subscription-based pricing and software licensing to further align its product offerings with traditional software-based buying disciplines and budgets.

CallWave's products will be distributed through direct corporate sales via the Company's sales force; online, web marketing sales; and third party distribution partnerships including resellers. FUZE is designed to be a multi-year lifecycle product. As CallWave grows its user-base, the Company plans to continue to develop enhanced versions and features of this product and cross-sell other future complementary products that it adds to its portfolio.

## **Services and Technology Architecture**

We have designed and developed our technology architecture for our new unified communications software to satisfy the interactive communications requirements of a broad range of customers. We provide a number of on-demand web-collaboration services that don't require the users to download any software. Our web-collaboration services are delivered through a hosted model built on top of Amazon's EC2 cloud computing technology that will allow us infinite scalability without the need to invest in or build out data centers. By leveraging Amazon's EC2 architecture we can scale our capacity up or down depending on our customer demand, leverage their investment in secure architecture and focus on enhancing our core web collaboration and mobile software products.

Many of the features, including federated IM, conferencing and some video content, are available on the majority of today's smart phones. The mobile extensibility architecture consists of two components: the WebMessenger Mobile Server and the WebMessenger Mobile Client that can be loaded on the mobile handset over the air (OTA). The Mobile Server sits in the data center and provides a communication interface between Microsoft Office Communications Server (OCS) and mobile handsets as illustrated below.

For organizations supporting RIM Blackberry devices, the Web Messenger Mobile Server also interfaces with the Blackberry Enterprise Server (BES). Each mobile device must run the WebMessenger Mobile Client. The client communicates with the WebMessenger Mobile Server using a proprietary WebMessenger protocol (i.e. not SIP based). Information passed between the client and the server contains the IM and presence information available within OCS.

Our Legacy technology is delivered by our desktop based Phone Companion Software (PCS) through our proprietary Enhanced Services Platform. Our wholly owned subsidiary Liberty Telecom, a competitive local exchange carrier (CLEC), provides us with proprietary call routing and switching technology. 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. Our Enhanced Services Platform intercepts inbound calls from traditional landline, wireless and IP-based networks, manages and filters calls and delivers calls to our subscribers on landline telephones, mobile phones and personal computers. 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. For example, our software allows subscribers who are using their landline telephones for Internet access to screen and accept telephone calls on other devices such as a mobile or landline telephone.

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### **CallWave FUZE**

We launched our new enterprise-class collaboration, presence and real time communications product called FUZE on September 17, 2008 in New York at the Web 2.0 Expo New York and Interop New York 2008 tradeshows. FUZE allows customers to meet online and bridges the gulf between the office and mobile devices. With FUZE, customers are now able to collaborate with clients and their teams instantly from anywhere and on any device. Meetings can be conducted from your desktop or mobile phone with High Definition (HD) quality and leverages proprietary synching technology that ensures that content is always in-sync across multiple connections and countries. Our new FUZE platform incorporates high fidelity conferencing and enterprise-class security and reliability. FUZE also integrates federated IM across all popular IM platforms, is presence enabled and syncs with Microsoft Outlook so meetings are easy to schedule and coordinate.

### **CallWave WebMessenger**

CallWave acquired certain assets of WebMessenger in August 2008 for \$9.0 million. WebMessenger's presence engine and federated IM technology has been integrated into our FUZE web collaboration product line which was launched on September 17, 2008. The Web Messenger product line allows the FUZE platform to extend collaboration to the mobile phone. We believe that it will be critical for web meeting and content providers to have an enterprise class collaboration solution that can be extended to the mobile endpoint devices. WebMessenger will also be sold as a stand alone product line to small and medium sized companies as well as enterprise customers. We plan to offer the following WebMessenger product lines:

*WebMessenger Message Alerts.* WebMessenger Message Alerts allows end users and group administrators to define custom filters and alert rules that are automatically applied to all incoming email, SMS messages, and phone calls. Message Alerts manages and controls communications on mobile business devices. The WebMessenger Message Alerts product will be sold in a standard, enterprise and compliance package, at various pricing tiers depending upon the number of users and architecture requirements.

*WebMessenger Mobile Voice.* WebMessenger Mobile Voice works in conjunction with WebMessenger Mobile Enterprise Collaboration solutions to unify mobile (instant messaging) IM and (internet protocol) IP telephony within the enterprise environment, significantly enhancing real-time collaboration for mobile professionals, while dramatically reducing mobile phone costs. WebMessenger Mobile Voice simplifies IT deployment of mobile collaboration and IP telephony solutions. Mobile professionals can communicate from their mobile device in the same way they do from their desk. By combining mobile IM and voice in a single solution, an enterprise can extend its investment in real-time collaboration platforms from Microsoft, IBM and others, as well as investments in VoIP and IP PBX solutions. WebMessenger Mobile Voice will be sold as a premise, hosted and stand-alone package with various pricing tiers depending upon the number of users and architecture requirements.

*WebMessenger Mobile.* WebMessenger Mobile extends presence and secure enterprise class IM to the mobile phone. The solution is federated across all enterprise collaboration platforms and public IM networks including Microsoft OCS/LCS, IBM Lotus Sametime, Jabber/XMPP, Reuters Messaging, MSN Messenger, AOL IM, Yahoo IM, Google Talk, Skype and ICQ. The platform is optimized for all major mobile platforms including BlackBerry, Windows Mobile, Apple iPhone, Symbian and Palm. WebMessenger Mobile will be sold as both consumer and fully integrated enterprise solutions with various pricing packages depending on the number of users and the architecture requirements.

### **CallWave Internet Answering Machine**

Our CallWave Internet Answering Machine services have historically generated most of our revenues. These services extend the functionality of our subscribers' existing telecommunications services by adding easy-to-use enhancements such as real-time voicemail, which allows subscribers to screen a message being left on their landline number from their mobile phone or their Internet-connected personal computer. Our landline services also include virtual telephone numbers that enable our subscribers to receive the benefits of a personalized or dedicated phone number routed to their existing telephone lines, without requiring additional physical phone lines to be installed. We do not plan to invest additional resources in this business. However, we view this business as a core asset that allows the Company to test new products and feature sets and importantly provides significant free cash flow that can be invested in our unified communications products.

We offer three principal levels of CallWave service:

*CallWave Alert (\$1.50 per month or \$17.95 per year).* 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 not answered or are in use by sending a message to a device of our subscribers' choosing.

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*CallWave Messenger (\$5.95 per month)*. CallWave Messenger is our mid-level subscription, 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 Connect (\$7.95 per month)*. 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, and if they choose, interrupt the message to take the call. In addition, subscribers to CallWave Connect receive the benefits of a system that automatically creates a contact book based on the calls received and allows them to use our enhanced features to reply or call back to persons listed in their address book and to initiate text or voice communications to other persons as well.

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### **CallWave Internet Fax**

CallWave Fax utilizes the same Enhanced Services Platform to offer customers personalized fax numbers that send and receive faxes to the user's e-mail account. This provides greater flexibility to customers by allowing them to receive and print faxes from any location where they are connected to a personal computer and allows customers to keep an unlimited digital history of all faxes. We provide various pricing packages ranging from \$7.95-\$12.95 per month.

### **Callwave HD Audio Conferencing**

Callwave HD Audio Conferencing service provides audio conferencing and allows participants to call in any way they want—mobile, Skype or a landline from anywhere in the world—all at competitive prices. HD Audio Conferencing allows users to visually manage conferences from a computer or smartphone with no software required. We provide various pricing packages ranging from \$9.95-\$19.95 per month.

### **CallWave Voicemail-To-Text**

CallWave Voicemail-To-Text, launched January 2007, enables users to manage calls from multiple sources (i.e. PCs, and mobile and home phones), making available unlimited, searchable, easily archived digital voicemail. Voicemail-to-Text sends a copy of mobile phone voicemail messages to users' email, enabling them to sort and prioritize, listen and respond to messages all from their email inbox. When not at the computer, users are notified of mobile voicemail messages via detailed text message, with the ability to sort messages, listen, pause, replay, save, delete or reply to the caller (via text or callback), all from their desktop. In January 2008, CallWave also launched Voicemail-to-Text for Apple products that have the look and feel of Apple operating systems. We provide various pricing packages ranging from \$14.95-\$49.95 per month.

### **CallWave Web 2.0 Widgets**

Widgets are mini web applications that are very simple to download and highly cost-effective channels for delivering software and services to consumers whom we may not reach through other marketing channels. During the year, CallWave introduced SMS text messaging widgets in addition to the wireless industry's first visual voicemail widget. The visual voicemail widget enables users to view their list of wireless mobile voice messages on their desktop and then prioritize and listen to these messages. The SMS text widget allows desktop sending of text messages domestically within the United States. All widgets have access to a PhonePage described below. We distribute our widgets on popular galleries including Google, Apple, Yahoo!, Microsoft, and social networks. The widgets are currently free and will be used as a lead generation channel for our FUZE and WebMessenger products.

### **Our Strategy**

CallWave's business objective is to become a leading provider of software solutions to enterprises, SMEs and mobile professionals with differentiated technologies and products that address the high-growth collaboration and conferencing segment of the unified communications market. We plan to achieve this objective through the following strategies:

*Leverage CallWave's first mover advantage with its unique WebMessenger and FUZE collaboration and conferencing platforms.* The Company's product lines offer differentiated features and address major development hurdles in the collaboration and conferencing market including providing platform agnostic mobile collaboration capabilities across devices, high-def audio, video and document sharing. With this first mover advantage, CallWave believes it is well positioned to become a leader in the collaboration and conferencing market.

*Extend FUZE to mobile devices—smartphones and business users.* Integrating WebMessenger's presence-based technology with FUZE allows CallWave to offer FUZE to Mobile endpoint devices. With this unique capability, FUZE collaboration applications can be extended globally, securely and across platforms to mobile devices without downloading any software. FUZE is designed to work through any mobile endpoint device or personal computer (PC) screen and an IP connection, which means FUZE will be able to operate on most end-point devices including set-top boxes, gaming consoles and other platforms that are being developed and will be brought to market. CallWave plans to leverage FUZE's unique mobile extensibility, technology independence and platform agnostic abilities.

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*Establish global footprint through FUZE and WebMessenger rollout.* CallWave's FUZE and WebMessenger product lines address growing global trends in collaboration and conferencing. With collaboration and conferencing solutions that extend RSA-encrypted, enterprise class applications to the mobile phone regardless of the platform, CallWave's products are designed to meet global demand.

*Make strategic acquisitions that accelerate, enhance and/or defend CallWave's leadership position.* CallWave's acquisition strategy is opportunistic and based on three criteria. The Company evaluates acquisition opportunities that it believes will generate additional subscribers or customers, provide unique technologies or capabilities, and/or help accelerate the Company's revenues and earnings growth.



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*Invest in future growth and current trends while controlling operating expense.* In conjunction with its new product launches and to remain at the forefront of evolving technology, the Company expects to continue to invest in sales, marketing, and research and development in fiscal 2009. CallWave operates software teams in Silicon Valley, California and Sofia, Bulgaria.

*Scale technology using cloud computing and virtualization.* CallWave plans to use cloud computing to scale its business without incurring traditional costs that are associated with growth of operations. Cloud computing and virtualization provide computer networking and storage services for business customers. It can also eliminate a company's need for its own data center and allows business to pay for bandwidth on an on-demand basis.

Our historical business has been a traditional direct-to-consumer dial-up business with an Internet voicemail application that ensures subscribers won't miss calls while on line with their dial-up connection. Our legacy business includes approximately 457,000 subscribers as of September 30, 2008.

The customer base for our legacy products has been declining. At this time we do not plan to invest additional resources in our legacy business. However, we do expect to maintain the legacy infrastructure and limited advertising to drive profitable new subscribers to our legacy businesses. We view the legacy business as a core asset that allows us to test new products and feature sets and provide significant free cash flow that can be invested in our new line of unified communications products. We expect that over time sales of our new products will mitigate the impact of declining revenue from our legacy business.

### **Critical Accounting Policies and the Use of Estimates**

Our discussion and analysis of our financial condition and results of operations is based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, allowances for doubtful accounts, accounting for income taxes, loss contingencies, marketable securities, stock-based compensation, and valuation of acquired intangible assets. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our Condensed Consolidated Financial Statements. Management has discussed the development and selection of the following critical accounting policies, estimates and assumptions with the Audit Committee of our Board of Directors and the Audit Committee has reviewed these disclosures.

#### *Revenue recognition.*

We earn revenues primarily from paid subscriber services and, to a lesser extent, from local exchange carrier call termination access charges and the offering of third-party products and services to our subscribers.

We recognize revenue in accordance with accounting principles generally accepted in the United States and with Securities and Exchange Commission Staff Accounting Bulletin 104 (SAB 104), *Revenue Recognition*, which clarifies certain existing accounting principles for the timing of revenue recognition and classification of revenues in the financial statements. We recognize revenue beginning when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the fees are fixed and determinable and collection is reasonably assured. Our subscriber revenues consist mainly of monthly recurring subscription fees. We recognize revenue ratably over the subscription period when the SAB 104 criteria are met. Revenues and associated expenses are deferred and recognized over the associated service period. Associated expenses are deferred only to the extent of such deferred revenue.

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

#### *Allowances for Doubtful Accounts*

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We record an allowance for doubtful accounts based on our historical experience with bad debts. We periodically review and evaluate bad debt reserves held by the local telephone companies and the third party that manages our billing relationship with the telephone companies. Judgment is required when we assess the realization of receivables, including assessing the probability of collection. Our allowance for doubtful accounts totaled \$247,000 as of September 30, 2008 and \$285,000 as of June 30, 2008. Our allowance for doubtful accounts is correlated with our aggregate billings through the local telephone companies.

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### *Accounting for Income Taxes*

We account for income taxes using the asset and liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and tax bases of the assets and liabilities. At September 30, 2008 and June 30, 2008 we had net deferred tax assets of \$11.8 million and \$10.9 million, respectively. Due to the uncertainty of realizing these net deferred tax assets, we have recorded a valuation allowance for the entire balance of the deferred tax assets. Such uncertainty primarily relates to the potential for net operating loss carryforwards and tax credits which begin to expire in 2010 and 2009, respectively, to be realized against future taxable income. We will continue to assess the likelihood of realization of these assets.

### *Loss Contingencies*

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. We consider the likelihood of loss or impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. We regularly evaluate current information available to us to determine whether such accruals should be adjusted and whether new accruals are required.

### *Marketable securities*

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

### *Stock-Based Compensation*

We account for stock-based compensation in accordance with the provisions of SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R). Under the fair value recognition provision of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the award. We estimate the fair value of stock options granted using the Black-Scholes-Merton option pricing model and a single option award approach. The fair value is amortized on a straight-line basis over the requisite service period of the awards, which is generally the vesting period.

Determining the appropriate fair value of stock-based awards at the grant date requires judgment, including estimating stock price volatility, forfeiture rates and expected term. We compute expected volatility based on a combination of both historical volatility and market-based implied volatility, as we believe that the combination provides a more accurate estimate of future volatility. The expected term represents the period of time that our stock-based awards are expected to be outstanding and is determined based on historical experience of similar awards. Due to the inherent uncertainty in valuing awards for publicly-traded stock as of the grant date, given that such awards will be exercised, purchased or sold at indeterminate future dates, the actual value realized by the recipients, if any, may vary significantly from the value of the awards estimated by us at the grant date.

### *Valuation of acquired intangible assets*

We have acquired intangible assets primarily via the acquisition of license agreements. These license agreements give us the right to practice and use certain technologies in the fax, voice and internet telephony space. These assets are accounted for under Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires us to record these assets at their fair value. Historically, we have used the cash purchase price at the time of acquisition as the best indicator of fair value. SFAS No. 142 also requires us to periodically evaluate the carrying value of intangible assets to determine if an impairment loss should be recorded under Statement of Financial Accounting Standards (SFAS) No. 144. In accordance with Statement 144, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value.

SFAS No. 144 outlines the factors which individually or in combination could trigger an impairment review as follows:

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A significant decrease in the market price of a long-lived asset (asset group)

A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

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A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

If we determine that the carrying value of intangible assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we would measure any impairment based on a projected discounted cash flow method using a discount rate commensurate with the risk inherent in our business.

*Recent Accounting Pronouncements*

A discussion of recent accounting pronouncements is included in Note 9 of the Notes to the Unaudited Condensed Consolidated Financial Statements.

**Results of Operations**

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

|                                      | <b>Three Months Ended<br/>September 30,</b> |             |
|--------------------------------------|---|-------------|
|                                      | <b>2008</b>                                 | <b>2007</b> |
| <b>Statement of Operations Data:</b> |   |             |
| Revenues                             | \$ 4,342                                    | \$ 5,352    |
| Cost of sales                        | 1,778                                       | 1,932       |
| Gross profit                         | 2,564                                       | 3,420       |
| <b>Operating expenses:</b>           |   |             |
| Sales and marketing                  | 1,236                                       | 1,581       |
| Research and development             | 1,636                                       | 1,609       |
| General and administrative           | 1,661                                       | 2,162       |
| Restructuring charges                | 787   | 1,095       |
| Total operating expenses             | 5,320                                       | 6,447       |
| Operating loss                       | (2,756)                                     | (3,027)     |
| Interest income                      | 280   | 700         |
| Loss before income taxes             | (2,476)                                     | (2,327)     |
| Income tax expense                   |   |             |
| Net loss                             | \$ (2,476)                                  | \$ (2,327)  |

*Three Months Ended September 30, 2008 and September 30, 2007*

**Revenues.** Revenues were \$4,342,000 for the three months ended September 30, 2008, compared to \$5,352,000 for the three months ended September 30, 2007, a decrease of \$1,010,000, or 19%. Subscription revenues were \$4,322,000 for the three months ended September 30, 2008, representing 99% of revenues, compared to \$5,324,000 for the three months ended September 30, 2007, representing 99% of revenues, a decrease of \$1,002,000, or 19%. The decrease in our revenues was attributable primarily to a decrease in the number of paying subscribers from approximately 572,000 at September 30, 2007 to approximately 457,000 at September 30, 2008. The decrease in subscribers is driven by the migration of dial up users to broad band which is a trend we expect to continue. Revenues from our indirect channel distributors for the three months ended September 30, 2008, were \$468,000 or 11% of revenues compared to \$620,000 or 12% of revenues for the same period last year. A beta version of our new web collaboration and messaging platform, called FUZE, was launched on September 17, 2008 in New York. Our new suite of applications did not contribute significant revenue in the current quarter. We expect our new application to come out of beta at the end of our fiscal second quarter. Accordingly, we do not expect significant revenue contribution until the second half of our fiscal year ending June 30, 2009.



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*Cost of sales.* Cost of sales was \$1,778,000, or 41% of revenues, for the three months ended September 30, 2008, compared to \$1,932,000, or 36% of revenues, for the three months ended September 30, 2007. The significant increase as a percentage of sales is caused by the amortization of intangible assets acquired in August 2008. The amortization expense incurred in the current quarter as a result of the newly acquired intangible assets was \$228,000, or 5% of sales. Without this increase, our gross margin would have been consistent with the prior period. We expect the total amortization of intangible assets to be approximately \$520,000 per quarter, of which, \$360,000 is related to these newly acquired assets. This non-cash amortization expense will negatively impact our gross margin throughout the remainder of our current fiscal year.

*Sales and marketing.* Sales and marketing expenses were \$1,236,000, or 28% of revenues, for the three months ended September 30, 2008, compared to \$1,581,000, or 30% of revenues, for the three months ended September 30, 2007, a decrease of \$345,000, or 22%. We have significantly reduced our advertising expense associated with our legacy services as we focus on bringing our new service offerings to market. In addition, headcount associated with the marketing and sales of our legacy products has been reduced. We expect sales and marketing expenses will increase in future quarters as we build out our sales force and expand our web based advertising associated with our new product lines.

*Research and development.* Research and development expenses were \$1,636,000, or 38% of revenues, for the three months ended September 30, 2008, compared to \$1,609,000, or 30% of revenues, for the three months ended September 30, 2007. The increase was driven by time and effort expended in bringing our new products to market. We believe it is essential to have a strong and efficient research and development team as we develop new products in the unified communications and collaboration market. Because our key differentiator will be mobile collaboration we will be frequently adapting to new mobile device specifications and updating our existing product base. We will continue to invest in new technologies and will be frequently upgrading our mobile collaboration and conferencing technologies in an effort to stay at the forefront of this market.

*General and administrative.* General and administrative expenses were \$1,661,000, or 38% of revenues for the three months ended September 30, 2008, compared to \$2,162,000, or 40% of revenues, for the three months ended September 30, 2007, a decrease of \$501,000, or 23%. General and administrative expenses have declined due to reductions in headcount associated with our legacy lines of business, lower bad debt expense, facilities consolidation costs, and lower management incentive compensation.

*Restructuring charges.* On August 28, 2008, the Company announced a third reorganization and reduction in workforce. As a result of the reorganization the Company incurred a charge of approximately \$800,000 associated primarily with severance, health insurance, facilities consolidation, and accelerated stock option compensation expense. The entire charge was recognized in the quarter ended September 30, 2008. We do not expect further restructuring charges during our fiscal year ending June 30, 2009.

*Income tax provision.* No tax benefit was derived from the net loss recognized during the three months ended September 30, 2008 and 2007 due to the valuation allowance established to offset our deferred tax assets. Total deferred tax assets at September 30, 2008, amount to \$11.8 million and have been fully offset by a valuation allowance reflecting the fact that we have not determined that it is more likely than not that we will be able to use our deferred tax assets to reduce income taxes. We will continue to assess the likelihood of realization of our net deferred tax assets and will adjust the balance accordingly.

*Net loss.* Net loss was \$2,476,000 for the three months ended September 30, 2008, compared to net loss of \$2,327,000 for the three months ended September 30, 2007.

**Liquidity and Capital Resources**

At September 30, 2008, our principal sources of liquidity were cash and cash equivalents of \$19,206,000, marketable securities of \$7,913,000, and accounts receivable net of allowance for doubtful accounts of \$1,605,000. We do not expect cash flow from operations to be positive in the current fiscal year. Although we expect losses from operations as we migrate our business from our legacy dial-up line of business to our current unified communications product suite, we believe our current cash reserves are adequate to cover the anticipated losses over the next twelve months. We reexamine our cash requirements periodically in light of changes in our business.

Cash and cash equivalents and marketable securities declined from \$38.6 million at June 30, 2008 to \$27.1 million at September 30, 2008. This decrease is primarily due to the purchase of technology from WebMessenger for \$9.0 million, cash used in operations of \$1.2 million, and the repayment of short term debt of \$1.0 million.

During the quarter ended December 31, 2007, certain auction rate securities began to fail auction due to sell orders exceeding buy orders. Of the Company's \$12.2 million marketable securities portfolio at September 30, 2008, \$4.3 million is currently associated with failed auctions, all of which have been in a loss position for less than 12 months. The funds associated with failed auctions will not be accessible until a successful auction occurs or a buyer is found outside of the auction process. All of the auction rate securities were AAA rated and were in compliance with

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our investment policy at the time of acquisition. We currently have the ability and intent to hold these investments until a recovery of the auction process or until maturity. Based on third party valuation models and an analysis of other-than-temporary impairment factors, we have determined that these securities are not permanently impaired. We recorded an unrealized loss related to these auction rate securities within Other Comprehensive Loss of approximately \$5.7 million pre-tax at September 30, 2008. Securities that have been subject to the highest risk of decline in value have generally been securities that are not tax exempt (e.g. non-municipal securities). We do not invest in tax exempt securities because of our large net operating loss carry forwards.



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These securities are being analyzed each reporting period for impairment, including other-than-temporary impairment factors. We will continue to closely monitor developments and will record a permanent impairment if circumstances lead us to believe that the value of these securities will not recover. The Company's auction rate securities were held with a bank that declared bankruptcy during the quarter ended September 30, 2008. It is now uncertain whether liquidity will be restored to these securities in the near future. We now believe that the liquidity of these securities is unlikely to be restored in a period less than twelve months from the balance sheet date. Accordingly, our auction rate securities have been classified as non-current assets on our balance sheet. These auction failures are symptomatic of current conditions in the broader debt markets and are not unique to CallWave.

*Off-Balance Sheet Arrangements*

We have not entered into any off-balance sheet arrangements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*Foreign currency exchange risk.* We do not currently hedge foreign currency exposures. We believe that a sudden or significant change in foreign exchange rates would not have a material impact on future net income or cash flows.

*Interest rate sensitivity.* We had cash and cash equivalents totaling \$19.2 million and marketable securities totaling \$12.2 million (including auction rate securities) at September 30, 2008, and cash and cash equivalents totaling \$29.8 million and marketable securities totaling \$16.3 million (including auction rate securities) at June 30, 2008. Cash and cash equivalents were held for working capital purposes in depository accounts at FDIC-regulated banking institutions. Marketable securities consist of investment grade securities, including auction-rate securities, which carry interest or dividend rates that reset every seven to 28 days, corporate bonds, and government and agency securities. We do not enter into investments for trading or speculative purposes. Declines in interest rates, however, will reduce our future interest income. If interest rates were to decline by 3.0% as compared to the rates at September 30, 2008, our interest income would decrease by approximately \$225,000 on a quarterly basis based on the outstanding balance of our marketable securities and money market funds at September 30, 2008. A decline in market value of 3.0% would reduce the value of our marketable securities by approximately \$237,000.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures.* Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15(e) or 15d-15(e)) as of the end of the period covered by this quarterly report, have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

*Changes in Internal Control over Financial Reporting.* There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

*Inherent Limitations on Effectiveness of Controls.* Our management, including our Chief Executive Officer and Chief Financial Officer, believes that our disclosure controls and procedures and internal control over financial reporting are effective at the reasonable assurance level. However, our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.



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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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. Any effort to defend ourselves from assertions of infringement or misappropriation of a third party's intellectual property rights, whether or not we are successful, would be expensive and time-consuming and would divert management resources. Any adverse determination that we have infringed the intellectual property rights of a third party, or the costs we incur to defend ourselves against such claims, whether or not we are successful, would have a material adverse impact on our business and results of operations.

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

From time to time, we may be subject to litigation, such as class action lawsuits, that could negatively affect our business operations and financial position. Such disputes could cause us to incur unforeseen expenses, could occupy a significant amount of our management's time and attention, and could negatively affect our business operations and financial condition.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors set forth under the caption "Risk Factors" in Part I, Item 1A, of our Annual Report on Form 10-K, for our fiscal year ended June 30, 2008. The risks discussed in our Annual Report on Form 10-K could materially affect our business, financial condition and future results. The risks described in our Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results. Other than those described below, there have been no material changes to the Risk Factors as previously disclosed in our Form 10-K for the fiscal year ended June 30, 2008.

**We are subject to risks relating to currency rate fluctuations and we do not hedge this risk.**

Although our Bulgarian operation does not generate revenue, approximately 5 percent of our costs are denominated in Leva, the Bulgarian currency. Any movement in the exchange rate for the Leva may adversely affect our cash flows, operating results, and financial position. We do not currently hedge against this risk.

**In some foreign jurisdictions, our rights may not be as strong as the rights we enjoy in the U.S.**

The legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. It may be difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights in these jurisdictions.

**As the number of individuals whom we employ in our Finance Department decreases, there is a risk that we will not have sufficient individuals to enable us to segregate duties among our employees.**

A fundamental objective of effective internal controls is to segregate duties among responsible individuals so that no single person can inflict financial damage by reason of possessing unsupervised control over significant portions of the business' financial or accounting functions. Over the past year, we have implemented several reductions in force, and the number of individuals whom we employ in our finance function has been reduced significantly. We believe that we currently have segregated duties among our employees on an acceptable basis, and that the integrity of our internal controls has not been impaired by the reductions in the number of our finance employees. However, if we realize any additional reductions in the number of our finance employees, then the effectiveness of our internal controls, and the integrity of our financial reporting, may be adversely affected.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**  
*Sales of Unregistered Securities*

None.

*Use of Proceeds*

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

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

None

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

**Exhibit**

| <b>Number</b>      | <b>Description</b>  |
|--------------------|---|
| 3.1 <sup>(1)</sup> | Amended and Restated Certificate of Incorporation of the Registrant.  |
| 3.2 <sup>(2)</sup> | Certificate of Amendment to Amended and Restated Certificate of Incorporation.  |
| 3.3 <sup>(3)</sup> | Certificate of Amendment to Amended and Restated Certificate of Incorporation.  |
| 3.4 <sup>(4)</sup> | Bylaws of the Registrant.   |
| 31.1               | Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2               | Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1               | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                          |
| 32.2               | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                          |

(1) Previously filed in the Registrant's Registration Statement Amendment No. 5 on Form S-1 (File No. 333-115438) filed on September 27, 2004 and incorporated herein by reference.

(2) Previously filed in the Registrant's Quarterly Report on Form 10-Q filed on February 14, 2006 and incorporated herein by reference.

(3) Previously filed in the Registrant's Quarterly Report on Form 10-Q filed on February 13, 2007 and incorporated herein by reference.

(4) Previously filed in the Registrant's Registration Statement on Form S-1 (File No. 333-115438) on May 13, 2004 and incorporated herein by reference.

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**SIGNATURES**

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

**CALLWAVE, INC.,**

Date: November 14, 2008

By: /s/ Jeffrey Cavins  
Jeffrey Cavins,  
President and Chief Executive Officer

Date: November 14, 2008

By: /s/ Mark Stubbs  
Mark Stubbs  
Chief Financial Officer  
(principal financial and accounting officer)