CALLWAVE INC
Form S-1/A
August 24, 2004
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As filed with the Securities and Exchange Commission on August 24, 2004

Registration No. 333-115438

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 2

TO

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

CALLWAVE, INC.

(Exact name of Registrant as specified in its charter)

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

136 West Canon Perdido Street, Suite A

Santa Barbara, CA 93101

(805) 690-4000

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

David F. Hofstatter

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Santa Barbara, CA 93101

(805) 690-4000

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

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

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

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

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

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

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

Calculation of Registration Fee

Title of Each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price(1)(2)	Amount of Registration Fee(3)
Common Stock, $0.0001 per share par value	$69,000,000	$8,743

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

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

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Subject to Completion, Dated August 24, 2004

CallWave, Inc.

Shares

Common Stock

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

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

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

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

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

Deutsche Bank Securities

Piper Jaffray

First Albany Capital

WR Hambrecht + Co

The date of this prospectus is , 2004.

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

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PROSPECTUS SUMMARY

This summary highlights selected information contained in greater detail elsewhere in this prospectus. You should read the entire prospectus carefully before making an investment decision, including Risk Factors and the consolidated financial statements and the related notes.

Our Business

We provide application services on a subscription basis that add features and functionality to the telecommunications services used by mainstream consumers and small and home offices. Our software-based services are delivered to consumers and small and home offices through our proprietary Enhanced Services Platform, which allows subscribers to manage calls across their existing landline, mobile and Internet networks. We refer to this process as call-bridging. Our affordable call-bridging services enable subscribers to receive calls on any communications device that is available to them at the time without requiring them to purchase or install additional hardware. For example, our platform allows subscribers who can not answer a call on their home telephone (because either they are not home or the line is busy), to screen and accept the call on a mobile phone or on a personal computer connected to the Internet using voice-over-IP technology. Unlike traditional call-forwarding services, our software allows our subscribers to screen a voicemail in real-time before deciding whether to take the call on their existing landline, mobile or Internet networks, enabling our mass-market subscribers to more effectively manage their personal telecommunications.

By bridging incoming calls across subscribers existing landline, mobile and Internet networks, our subscribers realize greater value from their existing telecommunications services. Our services extend the functionality of our subscribers existing lines by adding easy to use, enhancements such as real-time voicemail with call screening, and virtual phone and fax numbers. As of June 30, 2004, we had approximately 797,000 paying subscribers for these application services. Because our services improve the utilization of existing telecommunications networks, we believe that our application services complement the efforts of landline, mobile and Internet service providers to reduce their subscriber churn. This has allowed us to establish cooperative relationships with network service providers.

We began offering our current services on a paid, subscription basis in April 2001. We continued to sustain net losses through the quarter ended December 31, 2001, experienced our first quarter of profitability in the quarter ended March 31, 2002, and have been profitable in each quarter since. We had an accumulated deficit of $16,933,000 as of June 30, 2004.

The emergence of mobile telephones and the Internet has reshaped the communications market. A decade ago, households and small and home offices typically used a landline telephone as their primary means of communication. Today, both mobile telephones and the Internet are commonly used in addition to traditional landline telephones. Mobile telephones and the Internet, which penetrated early adopter markets in the 1990s, have now reached mass-market acceptance with cost-conscious consumers and small and home offices the mainstream market by delivering to users compelling value at affordable prices. International Data Corporation, or IDC, an independent industry research firm, estimates that there were over 106 million households and over 19 million small and home offices in the United States at the end of 2003. Mainstream users increasingly subscribe to a combination of landline phone,

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mobile phone and Internet services, but do not have an effective means of managing communications across these networks. We provide mainstream users with software-based services that allow them to bridge inbound communications across their existing devices and otherwise manage their incoming calls.

Our objective is to be the leading provider of application services that help mainstream consumers and small and home offices utilize their existing telecommunications services more efficiently and cost-effectively. The key elements of our strategy are to:

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

Corporate Information

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

Our wholly owned subsidiary, Liberty Telecom, is a Nevada-based Competitive Local Exchange Carrier, or CLEC, that provides us access to telecommunications services.

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

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

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THE OFFERING

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

The common stock outstanding after the offering is based on the number of shares outstanding as of June 30, 2004, and excludes:

3,958,018 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.26 per share;

1,400,925 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.62 per share, which do not expire upon the consummation of this offering;

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

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

Unless otherwise indicated, all information in this prospectus assumes:

the conversion of all outstanding shares of our convertible preferred stock into shares of our common stock, on a one-for-one basis, immediately prior to the closing of this offering; and

no exercise by the underwriters of their option to purchase additional shares of common stock in this offering.

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SUMMARY CONSOLIDATED FINANCIAL DATA

(in thousands, except per share data)

The following tables provide summary consolidated financial data for the periods presented. This summary consolidated financial data should be read together with the sections titled Selected Consolidated Financial Data, and Management s Discussion and Analysis of Financial Condition and Results of Operations, and our consolidated financial statements and the related notes appearing elsewhere in this prospectus. The pro forma balance sheet data gives effect upon the closing of this offering to the automatic conversion of all outstanding shares of convertible preferred stock into common stock as if it had occurred on June 30, 2004. The pro forma as adjusted balance sheet data gives further effect to the application of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commissions and estimated offering expenses. See the sections titled Use of Proceeds and Capitalization for additional information.

	Fiscal Year Ended June 30,				
	2000	2001	2002	2003	2004
Statement of Operations Data:					
Revenues	$ 487	$ 2,883	$ 16,383	$ 22,488	$ 38,886
Operating income (loss)	(9,624)	(14,498)	(3,010)	1,601	10,917
Net income (loss)	(9,642)	(16,054)	(3,050)	1,636	11,515
Net income (loss) per share:					
Basic	$ (1.07)	$ (1.77)	$ (0.33)	$ 0.18	$ 1.17
Diluted	(1.07)	(1.77)	(0.33)	0.06	0.44
Pro forma				0.07	0.48
Shares used in net income (loss) per share:					
Basic	9,009	9,060	9,167	9,270	9,811
Diluted	9,009	9,060	9,167	25,484	26,123
Pro forma				23,501	24,042

	As of June 30, 2004		
	Actual	Pro Forma	Pro Forma As Adjusted
Balance Sheet Data:			
Cash and cash equivalents	$ 6,187	$ 6,187	$
Marketable securities	7,003	7,003	
Restricted cash	335	335	
Working capital	11,263	11,263	
Total assets	21,628	21,628	
Convertible preferred stock	28,761		
Accumulated deficit	(16,933)	(16,933)	
Total stockholders equity	15,523	15,523	

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RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors, as well as the other information in this prospectus, before deciding whether to invest in shares of our common stock.

Risks Related To Our Business

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

We were formed in August 1998; some of our free services became commercially available in October 1999 and we began charging for certain of our services in April 2001. Because of our limited operating history, there is limited operating and financial data about us upon which to base an evaluation of our potential future performance and an investment in our common stock. You should consider our business and prospects in light of the risks and difficulties we may encounter, including those frequently encountered by new companies competing in rapidly evolving markets, such as increased competition from well-established companies, declining growth rates as evolving markets mature, fluctuating operating results and managing our system of internal controls in a rapidly changing environment. If we are unable to execute our plans and grow our business, either as a result of the risks identified in this section or for any other reason, our results of operations may suffer.

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

A large portion of our current subscriber base generally obtains access to the Internet through dial-up connection network service providers. The market for communications services is competitive, and many service providers attempt to attract and retain subscribers by offering a collection of services. While service providers that provide Internet call waiting and call-bridging services generally impose a separate charge, those service providers may in the future bundle such services with their other service offerings, thereby effectively offering these services for no incremental fee. If we lose subscribers to those network service providers that bundle services that are competitive with ours and we are unable to find replacement subscribers willing to pay for our services, our business, revenues and profitability would be adversely affected.

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

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

such referrals. If we are unable to attract new subscribers on a cost-effective basis, our business will not grow and our results of operations may be adversely affected.

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

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

The majority of our subscribers currently access the Internet through a dial-up connection. Those subscribers are often attracted to our enhanced services because our services allow those subscribers to monitor their incoming telephone calls while their main telephone line is busy accessing the Internet. We believe that over time many dial-up subscribers will switch to broadband that allows subscribers to use the Internet while simultaneously receiving telephone calls on their primary telephone lines. Although we have not generated substantial revenues from broadband access subscribers, we expect the growth of our business to depend upon our ability to expand and market our services successfully to broadband access subscribers. Because broadband access subscribers can receive telephone calls on their main line while they are accessing the Internet without our services, we may have difficulty attracting broadband subscribers if we are not able to successfully market to them the other features of our services. We may be required to develop additional technologies or make improvements to our existing technologies in order to market our services effectively to users that have broadband Internet access. If we are unable to expand our services and market our services effectively to broadband access subscribers, then the trend toward broadband Internet access would cause us to lose subscribers and likely adversely affect our business, results of operations and financial condition.

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

Competition in the communications and information services industries is intense. We face competition for our offerings from Internet service providers, such as AOL, landline and wireless telephone companies, such as AT&T, cable companies and other communications hardware, software and services vendors. These companies are better capitalized, have greater name recognition and significantly larger existing subscriber bases than we do. We may also face competition in the future from communications hardware and software companies that are currently focused on other markets, including 8X8, Net2Phone and Vonage. If these or other companies provide services similar to ours, we may not be able to compete effectively, which would harm our results of operations and financial condition.

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

Telecommunications services were historically provided by companies that made substantial capital investments in their networks. The size of those investments and the time required to deploy those networks served as significant barriers to entry into such markets. In

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contrast, we provide software-based enhanced services that do not require substantial capital expenditures to deploy and maintain. As a result, other companies with strong technical staffs and a knowledge of the communications and information services industries could compete with us without facing significant capital expenditures or other barriers to entry. For example, some companies are creating networks that will provide access to the Internet through local telephone calls that may enable us and others to avoid the need to integrate long-distance services to provide our enhanced offerings. That development may allow other companies to compete with us without having to purchase, install or maintain the relatively more complicated hardware currently necessary to utilize the underlying public switched telephone network. As a result, we may face increasing competition from companies with significantly greater resources than we have, which may force us to reduce our prices and increase our operating expenses to remain competitive. If we are not able to compete successfully with these companies, we may lose customers or fail to grow our business as we anticipate, either of which could harm our financial condition, results of operations and prospects.

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

In providing services to our subscribers, we incur a number of telecommunications costs which are beyond our control. In order to deliver our services to our subscribers, our services re-route certain telephone calls from our subscribers telephone lines to toll-free numbers that we have leased, from that toll-free number to our software-based switching facility, and then from that facility to the number that the subscribers designate. The re-routing of calls from our subscribers lines relies, in part, upon the toll-free network, as well as upon long-distance and local services that we purchase from network service providers. The cost of these services, which we integrate into our service offerings, is beyond our control and may increase for a number of reasons, including:

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

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

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

We currently have contracts with four service providers for long-distance services, and our wholly owned subsidiary, Liberty Telecom, LLC also has interconnection agreements with other telecommunications companies, which together provide us with

services that we integrate into

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our enhanced offerings. Each of those contracts may be terminated without cause by the service provider upon advance written notice. The required notice period, in each instance, is less than the amount of time that we would likely need to negotiate a contract with a successor provider and modify our system to re-route our subscribers inbound calls to that successor s network. In addition, there are only a limited number of service providers with which we can contract to provide these services. As a result, if one or more of the service providers from which we currently procure long-distance or interconnection services were to terminate our existing contractual relationships, we may not be able to locate a substitute provider on a timely basis and upon reasonable terms, if at all, in order to avoid a disruption or loss of service to our subscribers. If we are not able to purchase access to sufficient long-distance and interconnection services at reasonable prices, we may not be able to profitably provide our services to our subscribers and our operating results and financial condition would be harmed.

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

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

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

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

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

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

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

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

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

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

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

Our subscriber acquisition costs are dependent largely upon our ability to purchase multiple types of advertising at a reasonable cost. Our advertising costs vary over time, depending upon a number of factors, some of which are beyond our control, such as seasonality, the particular mix of advertising we use and the rate at which we convert potential subscribers into paying subscribers. Historically, we have used Internet advertising as the primary means of marketing our services. In the future, we expect to expand to other more expensive forms of advertising, such as television, radio and direct mail, which would increase our subscriber acquisition costs. Our sales and marketing and other costs of acquiring new subscribers are substantial relative to the monthly fees derived from subscriptions. Based on historical trends, we expect those costs to continue to rise. If we are not able to reduce our other operating costs, increase our subscriber base or increase revenue per subscriber to offset these anticipated increased subscriber acquisition costs, our results of operations and financial condition would be adversely affected.

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

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

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

Other companies or individuals may claim that we infringe or misappropriate their intellectual property rights. From time to time, third parties have contacted us, asserting that we may infringe their intellectual property rights. For example, in December 2003 and April 2004, a major communications infrastructure company delivered to one of our distributors two letters, in which we were not named, offering to negotiate with our distributor a nonexclusive license to certain patents that the infrastructure company believed to be relevant to our service and implying that our service may infringe those patents. We are in the process of evaluating those letters, which have been provided to us by that distributor. As part of this process, we have received a legal opinion from our intellectual property counsel that our services do not infringe the patents of this infrastructure company, although there is no assurance that a court would agree with that opinion. In addition, in July 2004, the licensing agent for a competitive communications software company sent to us a letter suggesting that an aspect of our services may employ inventions covered by a patent that the software company recently acquired, and offering a nonexclusive license for that patent. We have investigated this matter, and we believe that our services do not use inventions covered by the patent. However, we may not be able to resolve this matter on acceptable terms, if it is pursued by the claimant. 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 would be expensive and time-consuming, would divert management resources and may not ultimately be successful.

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

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

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

We historically have acquired some of our subscribers through third-party affiliate networks, and there is no guarantee that these networks will continue to function as a cost-effective or reliable method of acquiring subscribers.

We historically have compensated third-party affiliate networks for generating a portion of our subscribers. When members of a network generate a new subscriber for us, we pay a referral fee to the coordinator of that affiliate network, such as BeFree, Inc., or Commission Junction, and the coordinator then shares a portion of that fee with the particular member of the affiliate network who generated our subscriber. The performance of these affiliate networks as a cost-effective subscriber acquisition method depends upon a number of factors that are beyond our control, including seasonality and the particular mix of advertising our affiliate members use. If the effectiveness of these affiliate networks diminishes, then our ability to generate paid subscribers may be adversely affected. These networks occasionally are victimized by individuals who attempt to generate referral fees by submitting fabricated registration data. We have policies and procedures to confirm the legitimacy of attempted registrations, and in the past we have identified fabricated registrations on two occasions. Despite such policies and procedures, we may not be able to effectively detect and address such attempts in the future. While we do not pay any referral fees for such illegitimate attempted registrations that we detect, any delay in detecting such attempts may adversely affect the accuracy of our forecasts of future revenues and earnings.

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

Our future success will depend in part upon our ability to procure sufficient quantities of telephone numbers in area codes where our subscribers are located at costs we can afford. The ability of telecommunications carriers to provide us with telephone numbers to be used in conjunction with our services depends on applicable regulations, the practices of telecommunications carriers that provide telephone numbers, and the level of demand for new telephone numbers. In addition, the Federal Communications Commission, or FCC, has

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regulations concerning numbering resource utilization. If Liberty Telecom does not sufficiently utilize the numbers assigned to it, it may have to relinquish control of those unused numbers. Furthermore, the FCC and state public utility commissions periodically review numbering utilization, and may in the future propose additional changes to regulations governing number assignment and availability. Failure to have access to telephone numbers in a timely and cost-effective manner, or the loss of use of numbers we have accessed or may access, could prevent us from entering some markets or slow our growth in the markets in which we currently sell our services.

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

Our hardware and software systems are complex and are critical to our business. If our systems fail, our subscribers might experience reduced levels of service or service interruptions. In the past year, we have experienced occasional unplanned outages, including one system- wide outage that lasted for approximately two hours. Software-based services, such as ours, may contain undetected errors or failures when introduced or when new versions are released. Errors may be found in our software before or after commercial release, and, as a result, we may experience development delays or a disruption of our services. Failures in our system or interruptions to our service could cause us to lose paying subscribers and harm our business, prospects, financial condition and results of operations.

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

We currently collect the majority of our revenues through billing arrangements in which our subscribers   regional telephone companies collect our service fees from our subscribers and forward those fees to us. As of June 30, 2004, approximately 68% of our paying subscribers were billed through their local telephone company. We collect the remainder of our revenues through our subscribers   credit cards and checks. If the telephone companies terminated those billing arrangements, or if the cost of those arrangements increased significantly, we may be unable to continue to collect a significant portion of our revenues in this manner, and instead would have to collect those revenues through use of subscribers   credit cards, by having subscribers mail checks to us, or by other means. Because many subscribers prefer to pay for our services through their telephone bills, any need to rely upon alternative means to collect a significant portion of our revenues may lead to a loss of a substantial portion of the subscribers who currently pay for our services as part of their monthly bill from their telephone company, a decline in the rate at which we increase the number of our paying subscribers, or significant delinquencies in payments by our subscribers. If we are not able to successfully manage and maintain these billing relationships, our bad debt reserves may increase and we may lose subscribers that prefer paying for our services on their local telephone bill.

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

Historically, calls to our subscribers were routed on long-distance circuits through the public switched telephone network to our software switching facilities in Nevada. That structure requires that we often pay for long-distance telephone service. We expect to link calls to our subscribers to and from our centralized platform increasingly through the public Internet or third-party managed Internet protocol networks, which would not change how we provision services to our subscribers, but would allow us to reduce our cost of sales by using more of the less expensive Internet and local telephone network minutes and fewer of the more expensive

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long-distance telephone network minutes. We recently entered into a contract with a provider of these Internet and managed Internet protocol network services, which is a privately managed Internet where access is controlled to ensure quality of service. If we are unable to establish and effectively manage such relationships on a cost-effective basis, or if the costs associated with Internet and local telephone network minutes increase, then our ability to manage our costs may be adversely affected and our results of operations may suffer.

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

We have recently installed a new financial accounting system, and we may encounter technical and operating difficulties during the transition to that new system. We may experience problems in implementing the new system as our financial employees learn the new system, transfer data from our existing system to the new system and operate with the new system. The transition may not be completed promptly or at all. Any difficulties that we encounter in implementing the new system may disrupt our ability to deal effectively with our employees, subscribers, vendors and other companies with which we have commercial relationships and also may prevent us from effectively closing a quarterly period and reporting our financial results in a timely manner.

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

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

Our business and operations are experiencing rapid growth. If we fail to manage our growth, our business and operating results will be harmed.

We have experienced, and continue to experience, rapid growth in our business and operations, which has placed, and will continue to place, significant demands on our management, operational and financial infrastructure. As the number of our subscribers and the volume of their calls increases, we will need to be able to continue to expand and adapt our network systems. If we do not effectively manage our growth, the quality of our products and services could suffer, which could negatively affect our brand and operating results. Our ability to manage future growth, if it occurs, would depend upon our ability to scale the capacity, reliability and security of our network systems and our ability to improve our operational, financial and management controls and our reporting systems and procedures. These systems enhancements and improvements will require significant capital expenditures and allocation of valuable management resources. If the improvements are not implemented successfully, our ability to manage our growth would be impaired and we may have to make significant additional expenditures to address these issues, which could harm our financial position. The required improvements include:

enhancing our information and communication systems to ensure that our offices are coordinated and that we can effectively communicate with our base of subscribers;

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- enhancing systems of internal controls to ensure timely and accurate reporting of our operations;
- documenting our information technology systems and our business processes for our systems; and
- improving our information technology infrastructure to maintain the effectiveness of our search systems.

We may need to raise additional capital to support the growth of our operations, but such additional funds may not be available.

Our future capital needs are difficult to predict. We may require additional capital in order to take advantage of opportunities, including strategic alliances and potential acquisitions, or to respond to changing business conditions and unanticipated competitive pressures. Additionally, funds generated from our operations may be less than anticipated. As of June 30, 2004, we had total working capital of $11.3 million and $6.2 million of cash and cash equivalents. For the 12 months ending June 30, 2005, we anticipate making capital expenditures of approximately $900,000. While we believe that our current capital resources along with the proceeds from this offering will be sufficient to fund our operations for the next 12 months, we may need to raise additional funds either by borrowing money or issuing additional equity in order to handle unforeseen contingencies or take advantage of new opportunities. We may not be able to raise such funds on favorable terms, if at all. If we are unable to obtain additional funds, then we may be unable to take advantage of new opportunities or take other actions that otherwise might be important to our business or prospects.

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

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

Risks Related To Our Industry

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

The communications and information services industries are undergoing rapid and significant technological change. We cannot predict the effect of technological changes on our business. We expect that new services and technologies will emerge in the markets in which we compete. Those new services and technologies may be superior to the services and technologies that we provide or those new services may render our services and technologies

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obsolete. In addition, those services and technologies may not be compatible with ours. If we are not able to effectively respond to technological changes, the services we provide may no longer be attractive to our current and potential subscribers and our business, prospects, financial condition and results of operations may be harmed.

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

The Communications Assistance to Law Enforcement Act, or CALEA, requires telecommunications carriers to have the capability to perform wiretaps and to record other call identifying information. There is substantial uncertainty within the industry as to how to implement these requirements with respect to packet-switched networks, such as that operated by Liberty Telecom. As Liberty Telecom expands its service offerings, further modifications to its local switching equipment may be necessary to comply with applicable laws and regulations. On March 12, 2004, the FCC issued a public notice seeking public comment with respect to a Petition for Rulemaking (Docket RM-10865) filed by the Department of Justice, Federal Bureau of Investigation and U.S. Drug Enforcement Agency, seeking to resolve various outstanding issues associated with the implementation of CALEA. That proceeding could result in additional regulatory burdens for us and for Liberty Telecom. Complying with CALEA and rules implementing CALEA may require us to incur substantial costs, which could negatively impact our results of operations.

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

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

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

At present there are few laws, regulations or rulings that specifically address access to or commerce on the Internet, including the provision of Internet protocol-based telephony and

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

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

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

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

On May 21, 2004, the New York Public Service Commission ruled that Vonage must become certified as a telephone corporation and file a tariff for the provision of an IP-based communications application service that Vonage had previously held out as an information service. The Commission concluded that Vonage, by owning and managing equipment used to connect its customers to other customers, via the public telephone networks, as necessary, was operating a telephone line used to facilitate telecommunications to its customers and, under state law, was a telephone corporation. On June 30, 2004, the federal district court in the Southern District of New York issued a temporary injunction to prohibit the effectiveness of the New York Public Service Commission decision. A hearing has been scheduled for January 2005 to determine whether the ruling should become permanent. Vonage, after a similar adverse decision before the Minnesota Public Utilities Commission, had sought both review by a federal court and a preemptive ruling by the FCC. The petition before the FCC is pending, although the federal district in Minnesota ruled that the Public Utilities Commission had both ruled incorrectly and that it was outside the state s jurisdiction to regulate Vonage s service. The Minnesota PUC has appealed.

On June 11, 2004, the Washington State Utilities and Transportation Commission ruled that LocalDial, a company offering phone-to-phone voice over Internet protocol, or VoIP, service, is a telecommunications company that should be regulated in the same manner and to the same extent as interexchange carriers that provide functionally identical services. LocalDial customers use ordinary touch-tone telephones to make voice calls that are transmitted using a local carrier s wires. The Washington Commission noted that LocalDial advertised its services as unlimited long distance calling for a low flat rate and supplemental phone service for domestic long distance calling.

The specific services at issue in the New York and Washington state public utility commission decisions cited above were offered to the public as substitutes for, or as

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substantially equivalent to, existing telecommunications services. In contrast, the services that we currently offer are not offered to the public as substitutes for, or as substantially equivalent to, existing telecommunications services. Our services allow our customers to manage calls which are initiated by third parties to our customers and completed over the local service facilities of our customers existing telecommunications service providers. As such, our customers could not use our service unless they are also receiving telecommunications services from their own service provider. The New York and Washington cases suggest an increased interest by some state commissions in regulating services that may be perceived as the functional equivalent of local phone service. If state regulators attempt to regulate the enhanced services that we provide or determine that the enhanced services that we provide are currently subject to their regulatory provisions, then we may be faced with substantially increased regulatory burdens and costs.

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

Risks Related To This Offering And Our Common Stock

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

Our executive officers, directors and 5% stockholders together beneficially own approximately 82.1% of our common stock immediately prior to the closing of this offering, including shares subject to options and warrants that confer beneficial ownership of the underlying shares and will own approximately % of our common stock after the sale of the shares in this offering, assuming no exercise of the underwriters over-allotment option. Accordingly, these stockholders, for the foreseeable future will continue to have significant influence over our affairs including the election of directors and significant corporate transactions, such as a merger or other sale of our company or its assets. This concentrated control will limit your ability to influence corporate matters and, as a result, we may take actions that our stockholders do not view as beneficial. For example, this concentration of ownership could have the effect of delaying or preventing a change in control or otherwise discouraging a potential acquirer from attempting to obtain control of us, which in turn could cause the market price of our common stock to decline or prevent our stockholders from realizing a premium over the market price for their shares of our common stock.

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Existing stockholders will hold a significant number of shares that will be eligible for future sale. The sale of substantial amounts of these shares, or the prospect of such sales, could cause the price of our common stock to decline.

Sales of substantial amounts of shares of our common stock in the public market, or the prospect of such sales, could adversely affect the market price of our common stock. Upon completion of this offering, we will have outstanding shares of common stock. Of the shares outstanding prior to this offering, all shares of common stock held by current stockholders are subject to lock-up agreements under which the holders of such shares have agreed not to sell or otherwise dispose of any of their shares for a period of 180 days after the date of this prospectus without the prior written consent of Deutsche Bank Securities Inc. and us. After the 180-day period, 16,152,203 shares held by current stockholders will be eligible for sale under Rule 144, Rule 144(k) or Rule 701. The remaining 8,689,602 shares held by existing stockholders will become eligible for sale from time to time in the future under Rule 144, Rule 144(k) or Rule 701. Certain existing stockholders holding approximately 14,391,641 shares of common stock are also entitled to certain registration rights with respect to their shares of common stock. See the sections titled Shares Eligible for Future Sale and Description of Capital Stock Registration Rights for additional information.

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

There has not been a public market for our common stock. Even though we anticipate that our shares will be quoted on the Nasdaq Stock Market, an active trading market for our common stock may not develop following this offering. You may not be able to sell your shares quickly or at the current market price if trading in our stock is not active. The initial public offering price for the shares will be determined by negotiations between us and the representatives of the underwriters and may not be indicative of prices that will prevail in the trading market. See the section titled Underwriting for more information regarding our arrangement with the underwriters and the factors considered in setting the initial public offering price.

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

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

- variations in our results of operations;
- announcements of technological innovations, new services or service enhancements, strategic alliances or significant agreements by us or by our competitors;
- recruitment or departure of key personnel;
- litigation, legislation, regulation or technological developments that adversely affect our business;

changes in the estimates of our results of operations, changes in recommendations and the research and reports that may be published by any securities analyst that elects to follow our company or industry; and

market conditions in our industry, the industries of our subscribers and the economy as a whole.

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

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

- we are subject to Section 203 of the Delaware General Corporation Law, which would make it difficult for another party to acquire us without the approval of our board of directors;
- our certificate of incorporation authorizes our board of directors to issue preferred stock without requiring stockholder approval, and preferred stock could be issued as a defensive measure in response to a takeover proposal; and
- our certificate of incorporation or bylaws:
  - creates a classified board of directors;
  - prohibits cumulative voting in the election of directors;
  - limits the persons who may call special meetings of our stockholders; and
  - imposes advance notice requirements for nominations for election to our board of directors and for proposing matters to be acted upon by our stockholders.

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

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

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

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

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

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

Our initial public offering price will be substantially higher than the $0.62 in net tangible book value per share of our common stock as of June 30, 2004. Therefore, if you purchase our shares in this offering you will incur immediate and substantial net tangible book value dilution of $ per share from the price you paid, based on the initial public offering price of $ per share. Additional dilution will result if holders of stock options, whether currently outstanding or subsequently granted, exercise their options or if warrant holders exercise their warrants to purchase common stock. For a further description of the dilution that you could experience immediately after this offering, please see the section titled Dilution.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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

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USE OF PROCEEDS

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

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

DIVIDEND POLICY

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

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CAPITALIZATION

The following table sets forth our capitalization as of June 30, 2004:

- on an actual basis;
- on a pro forma basis to give effect to the automatic conversion of all outstanding shares of convertible preferred stock into common stock upon the closing of this offering, as if it had occurred on June 30, 2004; and
- on a pro forma as adjusted basis to give further effect to the application of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, after deducting the estimated underwriting discounts and commissions and estimated offering expenses.

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

	As of June 30, 2004		
	Actual	Pro Forma	Pro Forma as Adjusted
	(in thousands, except share data)		
Cash and cash equivalents	$ 6,187	$ 6,187	$
Marketable securities	7,003	7,003	
Restricted cash	335	335	
Stockholders equity:			
Preferred Stock, $0.0001 par value; 17,391,641 shares authorized, 14,230,941 shares issued and outstanding, actual; 10,000,000 shares authorized, 0 shares issued and outstanding, pro forma; 10,000,000 shares authorized, 0 shares issued and outstanding, pro forma as adjusted	28,761		
Common stock, $0.0001 par value; 50,000,000 shares authorized, 10,610,864 shares issued and outstanding, actual; 100,000,000 shares authorized, 24,841,805 shares issued and outstanding, pro forma; 100,000,000 shares authorized, shares issued and outstanding, pro forma as adjusted	3,998	32,759	
Deferred stock-based expense	(303)	(303)	(303)
Accumulated deficit	(16,933)	(16,933)	(16,933)
Total stockholders equity	$ 15,523	$ 15,523	$

In the table above, the number of shares outstanding on a pro forma and pro forma as adjusted basis as of June 30, 2004, does not include:

3,958,018 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.26 per share;

1,400,925 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.62 per share, which do not expire upon the consummation of this offering;

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

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

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DILUTION

If you invest in our common stock, your interest will be diluted immediately to the extent of the difference between the public offering price per share of our common stock and the pro forma net tangible book value per share of our common stock after this offering. As of June 30, 2004, our pro forma net tangible book value was approximately $15,523,000, or $0.62 per share of common stock. Pro forma net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of common stock outstanding after giving effect to the automatic conversion of all outstanding shares of convertible preferred stock into common stock.

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

After giving effect to the receipt of the net proceeds from our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share and after deducting estimated underwriting discounts and commissions and the estimated offering expenses, our pro forma net tangible book value as of June 30, 2004, would have been approximately $ million, or $ per share of common stock. This represents an immediate increase in pro forma net tangible book value of $ per share to existing stockholders and an immediate dilution of $ per share to new investors purchasing shares at the initial public offering price. The following table illustrates the per share dilution:

Assumed initial public offering price per share		$
Pro forma net tangible book value per share as of June 30, 2004	0.62	
Increase in pro forma net tangible book value per share attributable to new investors		
Pro forma net tangible book value per share after this offering		
Dilution per share to new investors		$

The following table summarizes, as of June 30, 2004, on the pro forma basis described above, the number of shares of common stock purchased from us, the total consideration paid to us and the average price per share paid by existing stockholders and by new investors purchasing shares of common stock in this offering, before deducting estimated underwriting discounts and commissions and estimated offering expenses (in thousands, except per share data):

	Shares Purchased		Total Consideration		Average Price Per Share
	Number	Percent	Amount	Percent	
Existing stockholders	24,842	%	$ 29,408	%	$ 1.18
New investors					

Total		100%	$	100%

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

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

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In the discussion and table above, the number of shares outstanding as of June 30, 2004, does not include:

- 3,958,018 shares issuable upon the exercise of outstanding stock options at a weighted-average exercise price of $1.26 per share;

- 1,400,925 shares issuable upon the exercise of outstanding warrants at a weighted-average exercise price of $1.62 per share, which do not expire upon the consummation of this offering;

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

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

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

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SELECTED CONSOLIDATED FINANCIAL DATA

(in thousands, except per share data)

The following selected consolidated financial data should be read in conjunction with, and are qualified by reference to, our consolidated financial statements and related notes and the section titled Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this prospectus. The statement of operations data for the years ended June 30, 2001, 2002, 2003 and 2004 and the balance sheet data as of June 30, 2002, 2003 and 2004 are derived from, and are qualified by reference to, our consolidated financial statements, which are included elsewhere in this prospectus. The statement of operations data for the years ended June 30, 1999 and 2000 and the balance sheet data at June 30, 1999, 2000 and 2001 are derived from our consolidated financial statements, which are not included elsewhere in this prospectus.

	Fiscal Year Ended June 30,				
	2000	**2001**	**2002**	**2003**	**2004**
Statements of Operations Data:					
Revenues	$ 487	$ 2,883	$ 16,383	$ 22,488	$ 38,886
Cost of sales	1,565	5,222	6,568	8,467	11,673
Gross profit	(1,078)	(2,339)	9,815	14,021	27,213
Operating expenses:					
Sales and marketing	5,004	6,215	4,180	3,959	5,987
Research and development	2,090	3,965	4,382	4,894	5,294
General and administrative	1,452	1,979	4,263	3,376	4,985
Impairment of long-lived assets				191	30
Total operating expenses	8,546	12,159	12,825	12,420	16,296
Operating income (loss)	(9,624)	(14,498)	(3,010)	1,601	10,917
Interest income (expenses), net	(17)	(1,555)	(39)	36	93
Income before income taxes	(9,641)	(16,053)	(3,049)	1,637	11,010
Income tax expense (benefit)	1	1	1	1	(505)
Net income (loss)	$ (9,642)	$ (16,054)	$ (3,050)	$ 1,636	$ 11,515
Net income (loss) per share:					
Basic	$ (1.07)	$ (1.77)	$ (0.33)	$ 0.18	$ 1.17
Diluted	(1.07)	(1.77)	(0.33)	0.06	0.44
Pro forma				0.07	0.48
Shares used in net income (loss) per share:					
Basic	9,009	9,060	9,167	9,270	9,811
Diluted	9,009	9,060	9,167	25,484	26,123
Pro forma				23,501	24,042

As of June 30,

	2000	2001	2002	2003	2004
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 222	$ 198	$ 1,446	$ 2,380	$ 6,187
Marketable securities					7,003
Restricted cash					335
Working capital (deficit)	(5,239)	(3,039)	(1,601)	685	11,263
Total assets	2,784	3,761	4,882	7,439	21,628
Convertible preferred stock	7,323	25,706	28,761	28,761	28,761
Accumulated deficit	(10,980)	(27,034)	(30,084)	(28,448)	(16,933)
Total stockholders equity (deficit)	(3,066)	(463)	977	2,725	15,523

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MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

Overview

We provide application services on a subscription basis that add features and enhanced functionality to the telecommunications services used by mainstream consumers and small and home offices. Our software-based services are delivered on our proprietary Enhanced Services Platform, which allows subscribers to manage calls across existing landline, mobile and Internet networks. As of June 30, 2004, we had approximately 797,000 paying subscribers for these application services. Because our services improve the utilization of existing telecommunications services by our subscribers, we believe that our application services complement the efforts of landline, mobile and Internet service providers to reduce their subscriber churn. This has allowed us to establish cooperative relationships with network service providers.

We first marketed our services in February 1999. We initially offered our services for free, partially supported by advertising revenues. From inception through March 2001, we staffed our operations, built our infrastructure, created, marketed and delivered our services and obtained a sizable base of free subscribers. Our advertising revenues, however, were insufficient to support operations and we sustained net losses throughout this period. We supported operations with financing obtained from issuing five series of preferred stock, generating total paid-in capital of approximately $29,000,000.

In April 2001, we began offering our current services on a paid, subscription basis and started to transition our business from an advertising-based model to a paid subscription-services model. We continued to sustain net losses through the quarter ended December 31, 2001. During the quarter ended March 31, 2002 we had grown our paying subscriber base substantially, and we had our first quarter of profitability. We have continued to grow our paying subscriber base, and we have been profitable every quarter since. However, because our near-term focus is to grow our subscriber base and market share, we expect to increase our customer acquisition expenses significantly and, as a result, may sacrifice operating margins and profitability in order to develop our long-term growth prospects.

As of June 30, 2004, our accumulated deficit was $16,933,000, resulting from net losses sustained from inception through the quarter ended December 31, 2001, partially offset by net income earned since the quarter ended March 31, 2002.

We currently derive substantially all of our revenues from subscription fees at rates generally ranging from $1.50 per month for CallWave Alert to $7.95 per month for CallWave Connect, our most feature-rich level of service. We also provide an enhanced version of CallWave Connect at $9.95 per month to a limited number of subscribers. For the year ended June 30, 2004, our

average subscription fee per subscriber was approximately $4.50. Currently, we offer new subscribers a 30-day free trial of our CallWave Connect service, with charges starting for the service level selected by the subscriber at the end of that 30-day period. As of

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March 31, 2004, we had approximately 88,000 new users on a free 30-day free trial period. For the users who initiated their free 30-day trial period in the month ended March 31, 2004, approximately 38% of those users became paying subscribers within 90 days of their registration date. We market our software and services directly to consumers through our website and online advertising, and indirectly through our channel relationships with EarthLink and several smaller service providers.

We have a limited history of revenue growth and profitability, and we cannot be certain that our revenues will continue to grow or that we will maintain profitability in the future. We cannot accurately predict our future growth rate, if any, or the ultimate size of our market. Our ability to increase revenues and maintain profitability depends on a number of factors outside of our control, including the extent to which:

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

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

Fiscal Year

Our fiscal year ends on June 30. References to fiscal 2004, for example, refer to the fiscal year ended June 30, 2004.

Sources of Revenue

We earn revenues primarily from subscription services, and to a much lesser extent, fees earned from local exchange carrier call termination access charges. We also historically earned limited revenues from advertisements placed by third parties within our service. Subscription revenues accounted for 99% of total revenues in fiscal 2004, 94% of our total revenues in fiscal 2003, 86% of our total revenues in fiscal 2002 and 2% of our total revenues in fiscal 2001. Subscription revenues are driven primarily by the number of paying subscribers for our service and the average subscription price, which in turn is driven by the composition and pricing of our service levels. We define paying subscribers as those subscribers who have made a payment to us within the past 45 days for subscribers who pay by credit card or through their local telephone company or within the past 60 days for subscribers who pay us by check, or who have a balance due of less than the payment increment on their selected subscription plan. We also include subscribers acquired through our relationship with EarthLink as paying subscribers if they have completed their 30-day free trial period and their service has not been cancelled. None of our customers accounted for more than 10% of our revenues in any fiscal year.

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As of June 30, 2004 we had deferred revenue of $2,401,000. We defer revenue when subscribers pre-pay us for annual subscriptions or pay monthly subscriptions when the balance of the services have not yet been provided for that month. This deferred revenue is recognized as revenue as services are delivered. For those customers who have elected to be billed monthly for their subscriptions, this revenue will be earned within 30 days after the end of the period. For those customers who have elected an annual billing plan, this revenue will be earned within 12 months after the end of the period. As of June 30, 2004, approximately 78% of our customers have elected to be billed monthly while the remaining 22% are billed annually. The ending deferred revenue balance at any given date will depend on the ratio of those customers electing monthly or annual billing. We expect to maintain a positive deferred revenue balance for the foreseeable future.

We increased our subscription revenues significantly in recent quarters as we executed on our plan to convert our free subscribers to paying subscribers. In addition, we began to market our services to new subscribers effective May 14, 2004 using a 30-day trial period with charges imposed as of the beginning of that 30-day period if the subscriber elects to retain a paid version of our service following that trial period. This change accounted for an increase of approximately $80,000 in our revenues for the quarter ended June 30, 2004. However, we expect that our subscription revenues will not increase at these historical rates because we already have converted to paying status most of the free subscribers that we expect we will be able to convert. We expect the trend of increasing subscription revenues to continue as we remain focused on increasing the number of our paying subscribers. We have not had any advertising revenues since June 2003. While we do not anticipate any advertising revenue in the near term, we may consider it as an additional source of revenue in the future as Internet advertising rates recover. This might include paid search results as well as display advertising. We expect termination access fee revenue to decline due to an expected decrease in tariffs allowed by the FCC.

Cost of Sales and Operating Expenses

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

Our primary method of billing our customers, which we implemented in November 2002, allows our customers to be billed for our services through their local telephone company. Alternatively, our subscribers may elect to be billed by us directly, in which case they can pay us either by check or through a credit card. Billing customers through their local telephone company is more expensive than the 900 toll number billing system we relied on previously due to increased per-transaction charges from local telephone companies and fees charged by a third party that manages the billing relationships for us. However, we believe the increased expense is offset by our improved ability to retain subscribers and collect revenues. As of June 30, 2004, approximately 68% of our paying subscribers were billed through their local telephone company. We expect our billing costs per subscriber to remain relatively stable.

We expect our billing and collection costs to increase on an absolute basis as we increase the number of our paying subscribers. However, we do not anticipate that our billing and collection costs will increase as a percentage of recognized revenue. We expect our overall network service provider costs to increase on an absolute basis as we increase the number of

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our paying subscribers. However, we expect our network service provider costs to remain relatively constant or potentially even decline on a per-user basis, as we attempt to optimize our telecommunications network usage and also negotiate more advantageous pricing agreements with our network service providers.

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

Sales and marketing. Sales and marketing expenses consist primarily of payroll and related expenses for marketing personnel and consultants, promotional fees and media costs related to customer acquisition. We expect our sales and marketing costs to increase as we will need to identify and market to potential subscribers who are willing to begin paying for our services following a free trial. We intend to continue marketing our services to potential subscribers through Internet-based advertising and referrals by our affiliates. These channels will likely be more expensive and we expect it will be more difficult to measure the exact costs of acquiring customers through those channels. In the future, we expect sales and marketing expenses to increase as a percentage of revenue. We may also use non-Internet channels to acquire customers in the future. We also expect to direct marketing and selling efforts toward our base of active users of our free facsimile service. As of March 31, 2004, we had in excess of 100,000 users that had utilized our free fax service at least once in the past 90 days.

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

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

Our bad debt expense increased during fiscal 2003 as we started billing the majority of our subscribers through their local telephone companies. We record revenue and a related receivable from these subscribers as we successfully send their billing information to the local telephone companies. We also record an allowance for doubtful accounts and corresponding bad debt expense for that portion of those billings which we estimate will ultimately be written-off by the local telephone companies and uncollected by us. We expect our bad debt expense to increase on an absolute basis as our revenue increases. However, we do not anticipate that our bad debt expense will increase as a percentage of revenue.

Stock-based Compensation

We have granted to our employees options to purchase our common stock at exercise prices equal to the fair market value of the underlying stock, as determined by our board of

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

We currently expect to record stock-based compensation expenses, assuming no forfeiture of awards, of $115,000 in fiscal 2005, $79,000 in fiscal 2006, $58,000 in fiscal 2007 and $39,000 in fiscal 2008. These amounts do not include stock-based compensation-related to options or warrants that we may grant or issue subsequent to June 30, 2004.

Critical Accounting Policies and the Use of Estimates

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

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

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

Our subscription revenues consist of monthly recurring subscription fees, which are paid in advance in one of three ways: a charge placed on the customer s telephone bill, credit card or paper invoice. In accordance with accounting principles generally accepted in the United States and with the Securities and Exchange Commission Staff Accounting Bulletin 104, *Revenue Recognition*, which clarifies certain existing accounting principles for the timing of revenue recognition and classification of revenues in the financial statements, we recognize revenue when there is persuasive evidence of an arrangement, our software has been successfully downloaded, the fees are fixed and determinable and collection is reasonably assured. We defer the portion of subscription fees collected in advance and recognize that portion over the subscription period, beginning at the time the fee becomes due and collection is reasonably assured.

We determine when collection is reasonably assured for our subscription services based on payment type. For subscribers billed through their local telephone company, collection is deemed to be reasonably assured when we receive confirmation from the third

party that

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

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

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

Allowances for Doubtful Accounts

We record an allowance for doubtful accounts based on our historical experience with bad debts and negotiated 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 $402,000 as of June 30, 2004 and $272,000 as of June 30, 2003. Our allowance for doubtful accounts is correlated with our aggregate billings through the local telephone companies.

Billing and Collection Costs

Our management team s judgment is required to assess the amounts of our billing and collection costs. Because the local telephone companies do not report their fees to us for a given period until after we have closed that period of our financial statements, we must make estimates as to what our billing and collection costs are for such period.

We analyze the actual billing and collection costs for the most recent month available, including the trend from preceding months. We calculate the billing and collection costs per billing transaction for those periods. We then estimate the billing and collection costs per billing transaction for the current month. We apply this estimated cost per billing transaction to the known number of billing transactions in the current month to derive our estimate of billing and collection costs for the current month.

Accounting for 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 86, or SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Under SFAS 86, we expense the costs of research, including predevelopment efforts prior to establishing technological feasibility and costs incurred for training and maintenance. Software development costs are capitalized when technological feasibility has been established and anticipated future revenues assure recovery of the capitalized amounts. Because of the relatively short time period between technological feasibility and product release, and the insignificant amount of cost incurred during such period, no amount of software development costs has been capitalized to date. If in

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the future, we determine that technological feasibility has been established and anticipated future revenues assure recovery of expenses related to developed software, we may capitalize such costs, which will reduce our research and development costs in the period in which we capitalize such costs and increase our expenses when such capitalized costs are amortized. If we do capitalize these costs, we will amortize such capitalized costs over the estimated useful life of the asset.

Accounting for Stock-Based Awards

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

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

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

Accounting for Income Taxes

We account for income taxes using the asset and liability method in accordance with SFAS 109, *Accounting for Income Taxes*, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and tax bases of the assets and liabilities. At June 30, 2004, we had net deferred tax assets of $11,642,000. Due to the uncertainty of realizing a portion of these net deferred tax assets, we have maintained a valuation allowance of $9,978,000 for net deferred tax assets. Such uncertainty primarily relates to the potential for future taxable income as well as loss carryforwards and tax credits expiring in 2006 and 2019, respectively. In addition, pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of our net operating loss carryforwards may be limited in the event of a cumulative change in ownership of more than 50% within a three-year period. No valuation allowance has been recorded to offset the remaining $1,664,000 of net deferred tax assets as we have determined that it is more likely than not that these assets will be realized within the 2005 and 2006 fiscal years. We will continue to assess the likelihood of realization of such assets; however, if future events occur which do not make the realization of such assets more likely than not, we will record a valuation allowance against all or a portion of the remaining net deferred tax assets. An example of an event that might occur which would make the realization of such assets not likely is a lack of taxable income resulting from poor operating results.

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Results of Operations

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

	Fiscal Year Ended June 30,		
	2002	2003	2004
	(in thousands)		
Statement of Operations Data:			
Revenues	$ 16,383	$ 22,488	$ 38,886
Cost of sales	6,568	8,467	11,673
Gross profit	9,815	14,021	27,213
Operating expenses:			
Sales and marketing	4,180	3,959	5,987
Research and development	4,382	4,894	5,294
General and administrative	4,263	3,376	4,985
Impairment of long-lived assets		191	30
Total operating expenses	12,825	12,420	16,296
Operating income (loss)	(3,010)	1,601	10,917
Interest income (expense), net	(39)	36	93
Income (loss) before income taxes	(3,049)	1,637	11,010
Income tax expense (benefit)	1	1	(505)
Net income (loss)	$ (3,050)	$ 1,636	$ 11,515

	Fiscal Year Ended June 30,		
	2002	2003	2004
Percent of Revenues:			
Revenues	100%	100%	100%
Cost of sales	40	38	30
Gross profit	60	62	70
Operating expenses:			
Sales and marketing	26	18	15
Research and development	27	22	14
General and administrative	26	15	13
Impairment of long-lived assets		1	
Total operating expenses	78	55	42

Operating income (loss)	(18)	7	28
Interest income (expense), net	0	0	0
Income (loss) before income taxes	(19)	7	28
Income tax expense (benefit)	0	0	(1)
Net income (loss)	(19)%	7%	30%

	Fiscal Year Ended June 30,		
	2002	**2003**	**2004**
		(in thousands)	
Supplemental Revenue Data:			
Subscription	$ 14,137	$ 21,190	$ 38,568
Advertising	2,024	965	
Termination access fees	222	333	318
Total revenue	$ 16,383	$ 22,488	$ 38,886

	As of June 30,		
	2002	**2003**	**2004**
		(unaudited, in thousands)	
Subscriber Data:			
Paying subscribers	389	673	797

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Fiscal Years Ended June 30, 2004 and June 30, 2003

Revenues. Revenues were $38,886,000 in fiscal 2004, compared to $22,488,000 in fiscal 2003, an increase of $16,398,000, or 73%. Subscription revenues were $38,568,000 in fiscal 2004, representing 99% of revenues, compared to $21,190,000 in fiscal 2003, representing 94% of revenues, an increase of $17,378,000, or 82%. The increase in our revenues in fiscal 2004 was attributable primarily to an increase in the number of paying subscribers from approximately 673,000 at June 30, 2003 to approximately 797,000 at June 30, 2004, partially offset by the elimination of advertising revenues as we phased this revenue stream out of our business model.

Cost of sales. Cost of sales was $11,673,000 in fiscal 2004, compared to $8,467,000 in fiscal 2003, an increase of $3,206,000, or 38%. The increase in our cost of sales in fiscal 2004 was primarily attributable to the increase in our paying subscriber base, as well as our transition to billing our customers through their local telephone bills. The increase in our customer billing costs was partially offset by a decrease in our communications costs due to a reduction in the number of free subscribers using our services and the related communications charges. As a result, our gross margins increased from 62% in fiscal 2003, to 70% in fiscal 2004.

Sales and marketing. Sales and marketing expenses were $5,987,000, or 15% of revenues, in fiscal 2004, compared to $3,959,000, or 18% of revenues, in fiscal 2003, an increase of $2,028,000, or 51%. The increase in sales and marketing expenses was primarily due to a $1,518,000 increase in spending on media channels for fiscal 2004, partially offset by a reduction in staffing costs, consultants fees and promotional fees. The decrease as a percentage of revenues was primarily attributable to increased efficiencies in our subscriber acquisition process.

Research and development. Research and development expenses were $5,294,000, or 14% of revenues, in fiscal 2004, compared to $4,894,000, or 22% of revenues, in fiscal 2003, an increase of $400,000, or 8%. The increase in research and development expenses was due to increased staffing costs. Although research and development expenses increased on an absolute basis, these expenses decreased as a percentage of revenues due to an increase in the number of paying subscribers.

General and administrative. General and administrative expenses were $4,985,000, or 13% of revenues in fiscal 2004, compared to $3,376,000, or 15% of revenues, in fiscal 2003, an increase of $1,609,000, or 48%. The increase in general and administrative expenses was due primarily to an increase in bad debt expense related to our increased revenues and an increase in legal, accounting, staffing and insurance costs. Bad debt expense was $1,146,000, or 3% of revenues in fiscal 2004, compared to $498,000, or 2% of revenues in fiscal 2003, an increase of $648,000, or 130%. Bad debt expense is directly related to revenue, and increases as revenue increases.

Income tax provision. We recognized an income tax benefit for fiscal 2004 of $505,000 as we determined it was more likely than not that we would be able to realize a portion of our net deferred tax assets in fiscal 2005. These net deferred tax assets were fully reserved prior to March 31, 2004. We will continue to assess the likelihood of realization of our net deferred tax assets. If future events occur that do not make the realization of such assets more likely than not, a valuation allowance will be established against all or a portion of the net deferred tax assets.

Net income. Net income was $11,515,000 in fiscal 2004, compared to $1,636,000 in fiscal 2003, an increase of $9,879,000 or 604%. This increase in net income was the result of a

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corresponding increase in revenue during this period, but without a corresponding increase in costs of sales and operating expenses. During fiscal 2004, our revenues increased by $16,398,000, while our cost of sales increased by $3,206,000 and operating expenses increased by $3,876,000. During fiscal 2004, we increased the number of our paying subscribers and our revenue without proportionate increases in our cost of sales and operating expenses, primarily because we were successful during this period in converting many of our subscribers from a free level of service to a paying level of service. In addition, beginning in the fourth quarter of fiscal 2003, we began to market our services to new subscribers using a free 30-day trial period with charges starting for the service level selected by the subscriber at the end of that 30-day period, which helped us increase the number of our paying subscribers. We do not expect our net income to increase at the same rate in future quarters because we no longer have as sizeable a base of subscribers to a free level of service whom we can convert to a paying level of service and because we expect our subscriber acquisition costs to increase.

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

Revenues. Revenues were $22,488,000 in fiscal 2003, compared to $16,383,000 in fiscal 2002, an increase of $6,105,000, or 37%. Subscription revenues were $21,190,000 in fiscal 2003, representing 94% of revenues, compared to $14,137,000 in fiscal 2002, representing 86% of revenues, an increase of $7,053,000, or 50%. The increase in our revenues in fiscal 2003 was primarily attributable to an increase in our paying subscriber base from approximately 389,000 as of June 30, 2002 to approximately 673,000 as of June 30, 2003, a majority of whom were added in the quarter ended June 30, 2003, resulting in $7,053,000 of increased subscription revenue during fiscal 2003 over fiscal 2002. In addition, termination access fee revenue increased by $111,000 from fiscal 2002 to fiscal 2003. Advertising revenue decreased by $1,059,000 from fiscal 2002 to fiscal 2003 as we transitioned our business model from an advertising-based model to a paid subscription-services model. The increase in our paying subscribers in fiscal 2003 was largely driven by our campaign to convert free subscribers to paying subscribers and, to a lesser extent, our transition to local telephone billing, which allowed us to increase the percentage of our subscribers from whom we were able to collect subscription revenues.

Cost of sales. Cost of sales was $8,467,000 in fiscal 2003, compared to $6,568,000 in fiscal 2002, an increase of $1,899,000, or 29%. The increase in our cost of sales in fiscal 2003 was primarily due to a $1,756,000 increase in billing and collection costs resulting from an increase in our paying subscriber base and, to a lesser extent, from our beginning to collect the majority of our revenues from those subscribers through their local telephone bills. In addition, our communications services costs increased by $213,000 in fiscal 2003 and remained relatively constant per user from fiscal 2002 to fiscal 2003, partially offset by a decrease of $256,000 in our expenses related to advertising revenue as we transitioned our business model from an advertising-based model to a paid subscription-services model. Our gross margins increased from 60% in fiscal 2002 to 62% in fiscal 2003.

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

Research and development. Research and development expenses were $4,894,000, or 22% of revenues, in fiscal 2003, compared to $4,382,000, or 27% of revenues, in fiscal 2002, an

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increase of $512,000, or 12%. The increase in research and development expenses was due to increased staffing costs. Although research and development expenses increased on an absolute basis, these expenses decreased as a percentage of revenues due to an increase in the number of paying subscribers.

General and administrative. General and administrative expenses were $3,376,000, or 15% of revenues, in fiscal 2003, compared to $4,263,000, or 26% of revenues, in fiscal 2002, a decrease of $887,000 or 21%. The decrease in general and administrative expenses was due to certain compensation-related charges against earnings in fiscal 2002. In fiscal 2002, our board of directors elected to extend the expiration date of certain warrants, and we recognized a corresponding non-cash charge of $1,228,000 against earnings in accordance with applicable accounting guidance. We had no corresponding charge in fiscal 2003. This decrease was partially offset by an increase in bad debt expense from $93,000 in fiscal 2002 to $498,000 in fiscal 2003, as our revenues increased and an increase in legal, accounting and staffing costs and insurance.

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

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

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Selected Quarterly Operating Results

The following tables set forth the unaudited quarterly statements of operations data, operations data as a percent of revenues and supplemental revenues data for the 12 quarters ended June 30, 2004, as well as the paying subscribers as of the dates indicated. The unaudited quarterly information in the 12 quarters ended June 30, 2004 has been prepared on substantially the same basis as the audited financial statements included elsewhere in this prospectus and, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, except as otherwise indicated, necessary for the fair presentation of the results of operations for such periods. This data should be read in conjunction with the audited financial statements and the related notes included elsewhere in this prospectus. These quarterly operating results are not necessarily indicative of our operating results for any future period.

	Three Months Ended											
	Sep. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	Jun. 30, 2002	Sep. 30, 2002	Dec. 31, 2002	Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003	Mar. 31, 2004	Jun. 30, 2004
	(unaudited, in thousands)											
Statement of Operations Data:												
Revenues	$ 2,044	$ 4,170	$ 4,610	$ 5,559	$ 5,074	$ 5,366	$ 5,649	$ 6,399	$ 8,697	$ 9,557	$ 10,212	$ 10,420
Cost of sales	1,863	1,608	1,488	1,609	1,752	1,855	2,228	2,632	2,724	2,934	2,990	3,025
Gross profit	181	2,562	3,122	3,950	3,322	3,511	3,421	3,767	5,973	6,623	7,222	7,395
Operating expenses:												
Sales and marketing	1,434	1,028	840	878	1,077	1,170	881	831	1,212	1,534	1,503	1,738
Research and development	1,067	999	1,108	1,208	1,126	1,185	1,352	1,231	1,260	1,137	1,316	1,581
General and administrative	903	1,983	601	776	681	784	901	1,010	1,218	1,050	1,452	1,265
Impairment of long-lived assets								191				30
Total operating expenses	3,404	4,010	2,549	2,862	2,884	3,139	3,134	3,263	3,690	3,721	4,271	4,614
Operating income (loss)	(3,223)	(1,448)	573	1,088	438	372	287	504	2,283	2,902	2,951	2,781
Interest income (expense), net	(47)	(1)	5	4	4	14	9	9	12	20	24	37
Income (loss) before income taxes	(3,270)	(1,449)	578	1,092	442	386	296	513	2,295	2,922	2,975	2,818
Income tax expense (benefit)	1				1				1		(887)	381
Net income (loss)	$ (3,271)	$ (1,449)	$ 578	$ 1,092	$ 441	$ 386	$ 296	$ 513	$ 2,294	$ 2,922	$ 3,862	$ 2,437

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	Three Months Ended											
	Sep. 30, 2001	**Dec. 31, 2001**	**Mar. 31, 2002**	**Jun. 30, 2002**	**Sep. 30, 2002**	**Dec. 31, 2002**	**Mar. 31, 2003**	**Jun. 30, 2003**	**Sep. 30, 2003**	**Dec. 31, 2003**	**Mar. 31, 2004**	**Jun. 30, 2004**
	(unaudited)											
Percent of Revenues:												
Revenues	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Cost of sales	91	39	32	29	35	35	39	41	31	31	29	29
Gross profit	9	61	68	71	65	65	61	59	69	69	71	71
Operating expenses:												
Sales and marketing	70	25	18	16	21	22	16	13	14	16	15	17
Research and development	52	24	24	22	22	22	24	19	14	12	13	15
General and administrative	44	48	13	14	13	15	16	16	14	11	14	12
Impairment of long-lived assets								3				
Total operating expenses	167	96	55	51	57	58	55	51	42	39	42	44
Operating income (loss)	(158)	(35)	12	20	9	7	5	8	26	30	29	27
Interest income (expense), net	(2)	(0)	0	0	0	0	0	0	0	0	0	0
Income (loss) before income taxes	(160)	(35)	13	20	9	7	5	8	26	31	29	27
Income tax expense (benefit)	0				0				0		(9)	4
Net income (loss)	(160)%	(35)%	13%	20%	9%	7%	5%	8%	26%	31%	38%	23%

	Three Months Ended											
	Sep. 30, 2001	**Dec. 31, 2001**	**Mar. 31, 2002**	**Jun. 30, 2002**	**Sep. 30, 2002**	**Dec. 31, 2002**	**Mar. 31, 2003**	**Jun. 30, 2003**	**Sep. 30, 2003**	**Dec. 31, 2003**	**Mar. 31, 2004**	**Jun. 30, 2004**
	(unaudited, in thousands)											
Supplemental Revenue Data:												
Subscriptions	$ 1,364	$ 3,584	$ 4,094	$ 5,095	$ 4,676	$ 4,990	$ 5,328	$ 6,196	$ 8,611	$ 9,482	$ 10,137	$ 10,338
Advertising	643	534	456	391	326	294						