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ATSI COMMUNICATIONS INC/DE  
Form 10QSB  
March 15, 2005

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
=====

FORM 10-QSB

(MARK ONE)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended January 31, 2005
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from \_\_\_\_\_ to\_\_\_\_\_

Commission File Number 1-15687

ATSI COMMUNICATIONS, INC.  
(Exact Name of Small Business Issuer as Specified in Its Charter)

NEVADA  
(State or Other Jurisdiction of  
Incorporation or Organization)

74-2849995  
(IRS Employer  
Identification No.)

8600 WURZBACH, SUITE 700W  
SAN ANTONIO, TEXAS 78240  
(Address of Principal Executive Offices)

(210) 614-7240  
(Issuer's Telephone Number, Including Area Code)

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

CLASS	OUTSTANDING AS OF MARCH 15, 2005
Common Stock, \$.001 par	8,960,311

Transitional Small Business Disclosure Format: Yes  No

ATSI COMMUNICATIONS, INC.  
AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-QSB  
FOR THE QUARTER ENDED JANUARY 31, 2005

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ATSI COMMUNICATIONS, INC.  
 AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (in thousands, except share information)  
 (unaudited)

	January 2005
	-----
ASSETS	
-----	
CURRENT ASSETS:	
Cash and cash equivalents	\$
Accounts receivable	
Prepaid & other current assets	
	-----
Total current assets	-----
	-----
PROPERTY AND EQUIPMENT	
Less - Accumulated depreciation	
	-----
Net property and equipment	-----
	-----
OTHER ASSETS, net	

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Intangible Assets, net of accumulated amortization of \$16

Total assets		\$	
-----			
LIABILITIES AND STOCKHOLDERS' DEFICIT			
-----			
CURRENT LIABILITIES:			
Pre-petition liabilities of bankrupt subsidiaries, net of assets		\$	1
Accounts payable			
Accrued liabilities			
Current portion of obligation under capital leases			
Notes payable			
Convertible debentures			
Series D Cumulative Preferred Stock, 3,000 shares authorized, 742 shares issued and outstanding.			
Series E Cumulative Preferred Stock, 10,000 shares authorized, 1,170 shares issued and outstanding			
Liabilities from discontinued operations, net of assets			
Total current liabilities			1
-----			
LONG-TERM LIABILITIES:			
Notes payable			
Obligation under capital leases, less current portion			
Other			
Total long-term liabilities			
-----			
STOCKHOLDERS' DEFICIT:			
Preferred stock, \$0.001 par value, 10,000,000 shares authorized,			
Series A Cumulative Convertible Preferred Stock, 50,000 shares authorized, 3,750 issued and outstanding			
Series H Convertible Preferred Stock, 16,000,000 shares authorized, 14,001,030 issued and outstanding			
Additional paid in capital			7
Accumulated deficit			(8)
Other comprehensive Income			
Total stockholders' deficit			(1)
-----			
Total liabilities and stockholders' deficit		\$	
=====			

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ATSI COMMUNICATIONS, INC.  
AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands, except per share amounts)  
(unaudited)

	Three months ended January 31,	Six-
	-----	-----
	2005	2004
	-----	-----
	20	20

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OPERATING REVENUES:

Services

Carrier services	\$	1,446	\$	209	\$
Network services		74		42	
		-----		-----	
Total operating revenues		1,520		251	

OPERATING EXPENSES:

Cost of services (exclusive of depreciation and amortization, shown below)		1,422		218	
Selling, general and administrative		82		128	
Legal and professional fees		40		88	
Non-cash warrant expense, for services		591		15	
Non-cash stock-based compensation, employees		474		-	
Bad debt expense		4		-	
Depreciation and amortization		24		-	
		-----		-----	
Total operating expenses		2,637		449	

OPERATING LOSS (1,117) (198)

OTHER INCOME (EXPENSE):

Other expense		4		-	
Debt forgiveness income		-		-	
Loss on an unconsolidated affiliate		-		(53)	
Interest expense		(35)		(25)	
		-----		-----	
Total other income (expense)		(31)		(78)	

NET LOSS (1,148) (276)

LESS: PREFERRED DIVIDENDS (38) (93)

NET LOSS TO COMMON STOCKHOLDERS (\$1,186) (\$369)

BASIC AND DILUTED LOSS PER SHARE (\$0.19) (\$0.36)

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING 6,346,695 1,036,550 5

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	2005	2004	2005
	-----	-----	-----
Net loss to common stockholders	(\$1,186)	(\$369)	(\$
Foreign currency translation adjustment	-	-	
	-----	-----	-----
Comprehensive loss to common stockholders	(\$1,186)	(\$369)	(\$
	=====	=====	=====

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ATSI COMMUNICATIONS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(In thousands)  
(unaudited)

	Six-months ended Janu 2005
	-----
CASH FLOWS FROM OPERATING ACTIVITIES:	
NET LOSS	(\$1,161)
Adjustments to net loss:	
Debt forgiveness income	(460)
Adjustments to reconcile net loss to cash used in operating activities:	
Depreciation and amortization	47
Loss on an unconsolidated affiliate	-
Non-cash issuance of stock grants and options, employees	474
Non-cash issuance of common stock and warrants for services	662
Provision for losses on accounts receivable	4
Changes in operating assets and liabilities:	
Increase in	
Accounts receivable	(150)
Prepaid expenses and other	(42)
Increase in	
Accounts payable	130
Accrued liabilities	39
	-----
Net cash used in operating activities	(457)
	-----
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of property & equipment	(8)
Cash proceeds from sale of ATSI COM	-
Investment in joint venture in ATSI COM	-
Acquisition of business	(8)
	-----
Net cash (used in) provided by investing activities	(16)
	-----
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from notes payable	370
Payments on notes payable	(774)
Proceeds from the exercise of warrants	788
Principal payments on capital lease obligation	(1)

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Net cash provided by financing activities	383	
DECREASE IN CASH	(90)	
CASH AND CASH EQUIVALENTS, beginning of period	94	
CASH AND CASH EQUIVALENTS, end of period	\$ 4	\$
NON-CASH TRANSACTIONS		
Issuance of common stock for conversion of debts	\$ 733	
Issuance of common stock for purchase of Intangible assets	24	

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ATSI COMMUNICATIONS, INC.  
AND SUBSIDIARIES

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

(In thousands, except per share amounts)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited interim financial statements of ATSI Communications, Inc. have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the Securities and Exchange Commission ("SEC"), and should be read in conjunction with the audited financial statements and notes thereto of ATSI Communications Inc. filed with the SEC on Form 10-K for the year ended July 31, 2004. In the opinion of management, these interim financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year. Notes to the financial statements, which would substantially duplicate the disclosure contained in the audited financial statements for the most recent fiscal year ended July 31, 2004, as reported in the Form 10-K, have been omitted.

NOTE 2 - STOCK BASED COMPENSATION

ATSI accounts for its employee stock-based compensation plans under Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees. ATSI granted 2,104,001 options to purchase common stock to employees in the six months ending January 31, 2005. Sixty percent of these options vest immediately and the remaining balances vest over three years. ATSI recorded compensation expense of \$42 under the intrinsic value method during the six months ended January 31, 2005.

The following table illustrates the effect on net loss and net loss per share if ATSI had applied the fair value provisions of FASB Statement No.123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

Three Months Ended		Six Months Ended	
January 31,		January 31,	
2005	2004	2005	2004
-----	-----	-----	-----

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Net loss as reported	\$	(1,186)	\$	(369)	\$	(1,237)	\$	(670)
Add: stock based compensation determined under intrinsic value-based method		42		-		42		-
Less: stock based compensation determined under fair value-based method		(1,000)		-		(1,000)		-
Pro forma net loss	\$	(2,144)	\$	(369)	\$	(2,195)	\$	(670)

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Basic and diluted net loss per common share:								
As reported	\$	(.19)	\$	(.36)	\$	(.25)	\$	(.65)
Pro forma		(.34)		(.36)		(.44)		(.65)

Additionally, during the six months ended January 31, 2005, ATSI issued 955,946 shares and 58,245 shares to its employees and consultants with a market value of \$463 and \$40, respectively.

NOTE 3 - PRE-PETITION LIABILITIES (NET OF ASSETS) OF THE BANKRUPT SUBSIDIARIES

ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan) filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries were ATSI's primary operating companies and they have ceased operations. These bankruptcies did not include ATSI Communications, Inc., the reporting entity. On July 2, 2003, the U.S. Bankruptcy Court handling the Chapter 7 cases for ATSI Texas and TeleSpan approved the sale of two of their subsidiaries, ATSI de Mexico S.A de C.V. (ATSI Mexico) and Servicios de Infraestructura S.A de C.V. (SINFRA), to Latingroup Ventures, L.L.C. (LGV), a non-related party. Under the purchase agreement LGV acquired all the communication center assets and assumed all related liabilities. Additionally, under the agreement, LGV acquired the "Comercializadora" License owned by ATSI Mexico and the Teleport and Satellite Network License and the 20-year Packet Switching Network license owned by SINFRA. The Chapter 7 Bankruptcy Trustee received \$17,500, which represents all the proceeds from the sale of these entities. The Chapter 7 Bankruptcy Trustee will manage the designation of these funds for the benefit of the creditors of ATSI Texas and TeleSpan. Upon liquidation of all the assets owned by ATSI Texas and TeleSpan, the Chapter 7 Trustee will negotiate all claims with creditors. ATSI has not received any creditor objections to these court proceedings.

The following represents the pre-petition liabilities of the bankrupt subsidiaries, net of assets (in thousands):

CURRENT LIABILITIES:	January 31, 2005
-----	-----

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Accounts payable	\$	7,496
Accrued liabilities		2,015
Notes payable		386
Capital leases		2,207
		-----
TOTAL CURRENT LIABILITIES:	\$	12,104
		=====

NOTE 4 - NOTES PAYABLE

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During the first six months of fiscal 2005, ATSI borrowed a total of \$370 from Recap Marketing & Consulting, LLP and entered into a series of unsecured convertible promissory notes bearing interest at the rate of 12% per annum, with the following maturity dates:

ORIGINATION DATE	AMOUNT	MATURITY DATE
-----	-----	-----
August 23, 2004	\$ 25	August 23, 2005
August 30, 2004	25	August 30, 2005
September 15, 2004	25	September 15, 2005
September 20, 2004	150	September 20, 2005
October 8, 2004	25	October 8, 2005
October 12, 2004	25	October 12, 2005
October 15, 2004	10	October 15, 2005
October 25, 2004	15	October 25, 2004
November 5, 2004	25	November 5, 2005
November 15, 2004	15	November 15, 2005
December 1, 2004	10	December 1, 2005
December 21, 2004	10	December 1, 2005
January 4, 2005	10	January 4, 2006
	-----	
TOTAL	\$ 370	
	-----	

On November 1, 2004, ATSI entered into a note payable with Franklin Cardwell and Jones, PC, for \$103 associated with legal and professional services previously rendered. The promissory note payable has a maturity date of December 1, 2005 and has an annual interest rate of 6%. The note is secured by ATSI equipment and accounts receivable. If ATSI pays the total outstanding balance on or before April 30, 2005, all accrued interest is waived and ATSI receives a 10% discount on the total outstanding balance. Beginning November 1, 2005, the holder of the note may convert all or any part of the outstanding balance and accrued and unpaid interest to shares of ATSI's common stock equal to the amount converted divided by the product of (a) .90 times (b) the five-day average of the last sales of the common stock prior to the conversion day.

NOTE 5 - WARRANTS

On October 13, 2003, ATSI entered into consulting agreements for twelve months with certain individual affiliates of Recap Marketing & Consulting, LLP that provided for the issuance of compensation warrants to purchase a total of 3,900,000 shares of ATSI's common stock at prices as indicated in the following table. These warrants expire on November 30, 2005. At issuance ATSI recognized



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\$7,053 of non-cash compensation expense associated with the issuance of these warrants.

COMMON SHARES	EXERCISE PRICE
-----	-----
2,000,000	\$ 0.01/share
800,000	\$ 0.25/share
850,000	\$ 0.50/share
250,000	\$ 0.75/share

During the 2nd quarter of fiscal 2005, individual affiliates of Recap Marketing & Consulting LLP elected to exercise 3,380,644 warrants and Recap Marketing & Consulting LLP forgave notes in the amount of \$774 as the conversion price. The following reflect the various exercise of warrants.

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EXERCISE DATE	EXERCISE PRICE	COMMON SHARES
-----	-----	-----
September 21, 2004	\$ 0.01/share	762,000
October 14, 2004	\$ 0.01/share	436,000
October 15, 2004	\$ 0.01/share	150,000
November 2, 2004	\$ 0.01/share	50,000
November 11, 2004	\$ 0.01/share	36,100
November 11, 2004	\$ 0.25/share	495,072
December 10, 2004	\$ 0.25/share	300,000
December 15, 2004	\$ 0.25/share	4,928
December 15, 2004	\$ 0.50/share	95,072
December 17, 2004	\$ 0.50/share	130,000
January 14, 2005	\$ 0.50/share	834,472
January 31, 2005	\$ 0.50/share	87,000
		-----
		3,380,644
		-----

On November 1, 2004, ATSI extended the consulting agreements for an additional six months with certain individual affiliates of Recap Marketing & Consulting, LLP that provided for the issuance of compensation warrants to purchase a total of 1,000,000 shares of ATSI's common stock at price of \$0.50 per share. These warrants expire on October 31, 2005. At signing of the extension to the consulting agreements ATSI recognized \$591 of non-cash compensation expense associated with the issuance of these warrants.

### NOTE 6 - SETTLEMENT AND RESTRUCTURING OF DEBT

On October 1, 2004, ATSI entered into a Settlement Agreement and Mutual release with Alfonso Torres Roqueni, the former owner of the concession license purchased by ATSI in July 2000. Under the settlement agreement amounts owed of \$1,360 were restructured and settled in exchange for the issuance by ATSI of 687,600 common shares for the payment of \$860 of the related obligation. The

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common shares were considered issued at \$1.25 per share. However, if on the measurement date of April 1, 2005, the average closing price of the ATSI common stock for the ten (10) trading days immediately preceding the measurement date is below \$1.15, ATSI will be required to issue an additional 59,791 common shares. If, however, the average closing price of the ATSI common stock for the ten (10) trading days immediately preceding the measurement date is at or above \$1.15, no other consideration will be given and the 687,600 shares issued will be considered as the final consideration. Additionally as part of the settlement, ATSI issued a promissory note for the remaining balance of \$500. The note accrues interest at the rate of 6% per annum and has a maturity date of October 1, 2007, with no monthly payments. ATSI recognized a gain of \$235 on the settlement of this debt.

On October 26, 2004, ATSI entered into a Settlement Agreement and Mutual release with Infraestructura Espacial, S.A de C.V. and Tomas Revesz, a former ATSI director. Under the settlement agreement, ATSI issued 30,000 shares of its common stock for the settlement of all principal and interest owed under a note payable in the amount of \$250. This note was originally entered into on March 22, 2001 and subsequently restructured on September 12, 2002. ATSI recognized a gain of \$225 on the settlement of this debt.

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### NOTE 7 - ACQUISITION OF A LOCAL EXCHANGE CARRIER COMPANY

On August 1, 2004, ATSI entered into an Asset Purchase Agreement with Hinotel, Inc., a Hispanic owned Competitive Local Exchange Carrier ("CLEC") based in South Texas. The assets purchased under the agreement included Hinotel's customer base, a customer management and billing system, and supplier contracts. Additionally, the transaction included the assignment and transfer of the CLEC license in the State of Texas. The purchase price of the assets was \$32, paid in 40,000 shares of ATSI common stock and \$8 in cash.

### NOTE 8 - SUBSEQUENT EVENTS

Subsequent to January 31, 2005, ATSI amended the extension to the consulting agreement entered into with certain individual affiliates of Recap Marketing & Consulting, LLP on November 1, 2004. The amended consulting agreement provides for the issuance of compensation warrants to purchase a total of 1,250,000 shares of ATSI's common stock at prices as indicated in the following table. These warrants expire on February 28, 2006.

COMMON SHARES	EXERCISE PRICE
-----	-----
300,000	\$ 0.40/share
300,000	\$ 0.30/share
650,000	\$ 0.35/share

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

SPECIAL NOTE: This Quarterly Report on Form 10-QSB contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities and Exchange Act of 1934, as amended. "Forward looking statements" are those statements that describe management's beliefs and expectations about the future. We have identified forward-looking statements by using words such as "anticipate," "believe," "could," "estimate,"

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"may," "expect," and "intend." Although we believe these expectations are reasonable, our operations involve a number of risks and uncertainties, including those described in the Additional Risk Factors section of the Annual Report Form 10-K and other documents filed with the Securities and Exchange Commission. Therefore, these types of statements may prove to be incorrect.

The following is a discussion of the consolidated financial condition and results of operations of ATSI for the three and six months ended January 31, 2005 and 2004. It should be read in conjunction with our Consolidated Financial Statements, the Notes thereto and the other financial information included in the annual report on Form 10-K filed with the SEC on November 8, 2004. As used in this section, the term "fiscal 2005" means the year ending July 31, 2005 and "fiscal 2004" means the year ended July 31, 2004.

### GENERAL

We are an international telecommunications carrier that utilizes the Internet to provide economical international telecommunications services. Our current operations consist of providing digital voice communications over data networks and the Internet using Voice-over-Internet-Protocol ("VoIP"). We provide high quality voice and enhanced telecommunication services to carriers, telephony resellers and others through various agreements with local service providers in the United States, Mexico, Asia, the Middle East and Latin America utilizing VoIP telephony services. Our services are as follows:

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**Carrier Services:** We provide VoIP termination services to United States and Latin American telecommunications companies who lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically these telecommunications companies offer their services to the public for domestic and international long distance services.

**Network Services:** We offer private communication links for multi-national and Latin American corporations or enterprise customers who use a high volume of telecommunications services to communicate with their U.S. offices or businesses and need greater dependability than is available through public networks. These services include data, voice and fax transmission as well as Internet services between the customers multiple international offices and branches

On August 1, 2004, we acquired a Local Exchange Carrier ("CLEC") based in South Texas. This acquisition will serve as a gateway to reach out to the Hispanic communities residing along the US and Mexico border. Our strategy is to provide reliable and affordable local and long distance services to the underserved Hispanic community through Texas. Our entry to the retail services arena will allow us to leverage our existing international VoIP network with additional services that have the potential to deliver higher margins than our wholesale international VoIP services. We have deployed various postpaid and prepaid retail services and generated approximately \$43,000 in retail services revenue during the six months ended January 31, 2005.

We have incurred operating losses and deficiencies in operating cash flows in each year since our inception in 1994 and expect our losses to continue through July 31, 2005. Our operating losses were \$8,485,000, for the year ending July 31, 2004. We had an operating loss of \$1,559,000, for the six months ended January 31, 2005 and a working capital deficit of \$17,010,000 at January 31, 2005. Due to such recurring losses, as well as the negative cash flows generated from our operations and our substantial working capital deficit, the auditor's opinion on our financial statements as of July 31, 2004 calls

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attention to substantial doubts about our ability to continue as a going concern. This means that there is substantial doubt that we will be able to continue in business through July 31, 2005.

We have experienced difficulty in paying our vendors and lenders on time in the past. As a result, during the six months ended January 31, 2005 management continued to pursue different avenues for funding and we entered into various short-term convertible promissory notes in the aggregate amount of \$370,000. These funds have allowed the Company to pay those operating and corporate expenses that were not covered by our current cash inflows from operations. We will continue to require additional funding until the cash inflows from operations are sufficient to cover the monthly operating expenses. There is no assurance that we will be successful in securing additionally funding over the next twelve months.

### RESULTS OF OPERATIONS

The following table sets forth certain items included in the Company's results of operations in dollar mounts and as a percentage of total revenues for the three and six-month period ended January 31, 2005 and 2004.

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	Three months ended January 31,				Si
	2005		2004		2
	\$	%	\$	%	\$
	(Unaudited)				
Operating revenues					
-----					
Services					
Carrier services	\$ 1,446	95%	\$ 209	83%	\$ 2,215
Network services	74	5%	42	17%	147
	1,520	100%	251	100%	2,362
Total operating revenues					
Cost of services (Exclusive of depreciation and amortization, shown below)	1,422	94%	218	87%	2,194
	98	6%	33	13%	168
Gross Margin					
Selling, general and administrative expense	82	5%	128	51%	306
Legal and professional fees	40	3%	88	35%	305
Non-cash warrant expense, for services	591	39%	15	6%	591
Non-cash stock-based compensation, employees	474	31%	-	0%	474
Bad debt expense	4	0%	-	0%	4
Depreciation and amortization	24	2%	-	0%	47

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Operating loss	(1,117)	-73%	(198)	-79%	(1,559)
Debt forgiveness income	0	0%	-	0%	460
Other expense	(31)	-2%	(78)	-31%	(62)
Net loss	(1,148)	-76%	(276)	-110%	(1,161)
Less: preferred stock dividends	(38)	-3%	(93)	-37%	(76)
Net loss to applicable to common shareholders	(\$1,186)	-78%	(\$369)	-147%	(\$1,237)

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THREE MONTHS ENDED JANUARY 31, 2005 COMPARED TO THREE MONTHS ENDED JANUARY 31, 2004

Operating Revenues. Consolidated operating revenues increased by 506% between periods from \$251,000 for the quarter ended January 31, 2004 to \$1,520,000 for the quarter ended January 31, 2005.

Carrier services revenues increased approximately \$1,237,000, or 592% from the quarter ended January 2004 to the quarter ended January 2005. Our carrier traffic increased from approximately 4.9 million minutes in the quarter ended January 31, 2004 to approximately 41.9 million minutes during the quarter ended January 31, 2005. The increase in revenue and carrier traffic can mainly be attributed to the growth in VoIP carrier services since the implementation of the NexTone VoIP soft-switch during the last quarter of fiscal 2004.

Network services revenues increased approximately 76% or \$32,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The increase in network services revenue is primarily due to the purchase and assignment of a network services contract from American TeleSource International de Mexico S.A de C.V. (ASTIMEX). Under the assignment and purchase agreement with ATSIMEX, we acquired the remaining term of the network services contract, which extended from February 2004 through June 2004 and generated monthly revenues of approximately \$22,000. The agreement has expired and we are providing service to this customer on a month-to-month basis at the same revenue rate.

Cost of Services (Exclusive of depreciation and amortization). The consolidated cost of services increased by approximately \$1,204,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The increase in cost of services is a direct result of the increase in carrier services revenue and network services revenue. As mentioned above, our carrier traffic increased from approximately 4.9 million minutes during the quarter ended January 31, 2004 to approximately 41.9 million minutes in the quarter ended January 31, 2005, thus increasing our cost of services between quarters.

Selling, General and Administrative (SG&A) Expenses. SG&A expenses decreased by approximately \$46,000, or 36% from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The decrease is attributable to an adjustment in salaries and wages and a reversal of an over-accrual for services previously recognized.

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Legal and professional Fees. Legal and professional fees decreased by approximately \$48,000, or 55% from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. During the quarter ended January 31, 2004, the company incurred approximately \$50,000 various legal and professional services associated to the proxy preparation and annual shareholder meeting. These legal and professional expenses were not incurred during the quarter ended January 31, 2005.

Non-cash warrant expense, for services. Non-cash warrant expense for services increased by \$576,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. This increase is primarily due to recognition of approximately \$591,000 in non-cash compensation expense associated with the consulting agreements entered into with certain individual affiliates of Recap Marketing & Consulting, LLP. The consulting agreement provided for the issuance of compensation warrants to purchase a total of 1,000,000 shares of ATSI's common stock at price of \$0.50 per share.

Non-cash stock-based compensation, employees. Non-cash compensation expense to employees increased by \$474,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. This increase is attributed to the recognition of approximately \$474,000 in non-cash compensation expense associated with the grant of stock options and stock grants to our employees and board of directors.

Bad debt expense. Bad debt expense increased by \$4,000 from the quarter ended January 31, 2004 to the

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quarter ending January 31, 2005. During the quarter ending January 31, 2005 we recognized \$4,000 in bad debt expense associated with the write-off of a carriers services customer that ceased operations.

Depreciation and Amortization. Depreciation and amortization increased by 100% or \$24,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The increase is attributed to the recognition of depreciation expense and amortization on the NexTone VoIP soft-switch that was acquired during the last quarter of fiscal 2004.

Operating Loss. The Company's operating loss increased by approximately \$919,000 or 464% from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The increase in operating loss is attributed to the recognition of \$591,000 in non-cash warrant expense and \$474,000 in non-cash stock based compensation expense associated with the stock options and stock grants awarded to the company employees and board of directors. The increase in non-cash warrant and compensation expense was offset slightly by the increase in gross margin of approximately \$65,000.

Other expense. Other expense decreased approximately \$47,000 or 60% from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The decrease in other expense is attributed to the decrease in loss in investment in ATSI.COM of approximately \$53,000 recognized during the quarter ended January 31, 2004 associated with our portion of the losses on our investment in ATSI.COM. During the quarter ended January 31, 2005 the Company did not have a loss in ATSI.COM.

Preferred Stock Dividends. Preferred Stock Dividends expense decreased by approximately \$55,000 between periods, from \$93,000 for the quarter ended January 31, 2004 to \$38,000 during the quarter ended January 31, 2005. During fiscal 2004 we converted all Redeemable Preferred Series F and Series G shares

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to common. As a result of these conversions, no dividends were incurred during the quarter ended January 2005 related to these securities.

**Net loss to Common Stockholders.** The net loss for the quarter ended January 31, 2005 increased to \$1,186,000 from \$369,000 for the quarter ended January 31, 2004. The increase in net loss to common stockholders is mainly attributed to the recognition of \$591,000 in non-cash warrant expense and \$474,000 in non-cash stock based compensation expense associated with the stock options and grants awarded to the company employees. Also, there was an increase in depreciation and amortization of approximately \$24,000 from the quarter ended January 31, 2004 to the quarter ended January 31, 2005. The increase in non-cash warrant and compensation expense and depreciation expense was offset slightly by the increase in gross margin of approximately \$65,000.

SIX MONTHS ENDED JANUARY 31, 2005 COMPARED TO SIX MONTHS ENDED JANUARY 31, 2004

**Operating Revenues.** Consolidated operating revenues increased by 625% between periods from \$326,000 for the six months ended January 31, 2004 to \$2.4 million for the six months ended January 31, 2005.

Carrier services revenues increased approximately \$2 million, or 815% from the six months ended January 2004 to the six months ended January 2005. Our VoIP carrier traffic increased from approximately 5.7 million minutes during the six months ended January 31, 2004 to approximately 65.4 million minutes during the six months ended January 31, 2005. The increase in revenue and carrier traffic can mainly be attributed to an increase in capacity during the last quarter of fiscal 2004.

Network services revenues increased approximately 75% or \$63,000 from the six-month period ended January 31, 2004 to the six-month period ended January 31, 2005. The increase in network services revenue is primarily due to the purchase and assignment of a network services contract from American TeleSource International de Mexico S.A de C.V. (ASTIMEX). Under the assignment and purchase agreement with ATSIMEX, we acquired the remaining term of

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the contract, which extended from February 2004 through June 2004 and generated monthly revenues of approximately \$22,000. The agreement has expired and we are providing service to this customer on a month-to-month basis at the same revenue rate.

**Cost of Services (Exclusive of depreciation and amortization).** The consolidated cost of services increased by approximately \$1.9 million, or 722% from the six months ended January 31, 2004 to the six months ended January 31, 2005. The increase in cost of services is a direct result of the increase in carrier services revenue and network services revenue. As mentioned above, our carrier traffic increased from approximately 5.7 million minutes during the six months ended January 31, 2004 to approximately 65.4 million minutes in the six months ended January 31, 2005, thus increasing our cost of services between periods.

**Selling, General and Administrative (SG&A) Expenses.** SG&A expenses increased by approximately \$57,000, or 23% from the six-month period ended January 31, 2004 to the six-month period ended January 31, 2005. The increase is attributed to the recognition of approximately \$61,000 in wages and contract labor associated with the operations of the retail services acquired during fiscal 2005.

**Legal and professional Fees.** Legal and professional fees increased by approximately \$156,000, or 105% from the six-month period ended January 31, 2004

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to the six-month period ended January 31, 2005. The increase is attributable to the recognition of approximately \$150,000 in professional fees associated with a marketing campaign that commenced during the first quarter of fiscal 2005. Additionally, during the six-month period we recognized approximately \$90,000 in legal fees associated to the lawsuit for stock fraud and manipulation by various institutions.

Non-cash warrant expense, for services. Non-cash warrant expense for services increased by \$561,000 from the six months ended January 31, 2004 to the six months ended January 31, 2005. This increase is primarily due to recognition of approximately \$591,000 in non-cash compensation expense associated with the consulting agreements entered into with certain individual affiliates of Recap Marketing & Consulting, LLP. The consulting agreement provided for the issuance of compensation warrants to purchase a total of 1,000,000 shares of ATSI's common stock at price of \$0.50 per share.

Non-cash stock-based compensation, employees. Non-cash compensation expense to employees increased by \$474,000 from the six months ended January 31, 2004 to the six months ended January 31, 2005. This increase is attributed to recognition of approximately \$474,000 in non-cash compensation expense associated with the grant of stock options and stock grants to our employees and board of directors.

Bad debt expense. Bad debt expense remained consistent at \$4,000 over the six months ended January 31, 2004 and the six months ended January 31, 2005. During the six months ended January 31, 2005 we recognized \$4,000 in bad debt expense associated with the write-off of a carriers services customer that ceased operations.

Depreciation and Amortization. Depreciation and amortization increased by 100% or \$47,000 from the six months ended January 31, 2004 to the six months ended January 31, 2005. The increase is attributed to the recognition of depreciation expense and amortization on the NexTone VoIP soft-switch that was acquired during the last quarter of fiscal 2004.

Operating Loss. The Company's operating loss increased by approximately \$1,186,000 or 318% from the six months ended January 31, 2004 to the six months ended January 31, 2005. The increase in operating loss is attributed to the recognition of \$591,000 in non-cash warrant expense and \$474,000 in non-cash stock based compensation expense associated with the stock options and stock grants awarded to the company employees and board of directors. The increase in non-cash warrant and compensation expense was offset slightly by the increase in gross margin of approximately \$109,000.

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Debt forgiveness income. Our debt forgiveness income increased approximately \$460,000 from the six months ended January 31, 2004 to the six months ended January 31, 2005. During the six-month period ended January 31, 2005, we negotiated and exchanged various liabilities for equity. These settlements were related to the settlement of the \$859,500 liability with Alfonso Torres Roqueni, the former owner of the concession license acquired in July 2000, and the settlement of a \$250,000 note payable with Infraestructura Espacial, S.A de C.V. and Tomas Revez, a former ATSI director. The debt forgiveness income was based on the difference between the market price of ATSI equity at the time of issuance and the market price calculated at the time of the settlement of the debt.

Other expense. Other expense decreased approximately \$49,000 or 44% from the six months ended January 31, 2004 to the six months ended January 31, 2005. The decrease in other expense is attributed to the decrease in loss in



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investment in ATSI COM of approximately \$53,000 recognized during the six months ended January 31, 2004 associated with our portion of the losses on our investment in ATSI COM. During the six months ended January 31, 2005 the Company did not have any loss in ATSI COM.

**Preferred Stock Dividends.** Preferred Stock Dividends expense decreased by approximately \$110,000 between periods, from \$186,000 for the six months ended January 31, 2004 to \$76,000 during the six months ended January 31, 2005. During fiscal 2004 we converted all Redeemable Preferred Series F and Series G shares to common. As a result of these conversions, no dividends were incurred during the six months ended January 2005 related to these securities.

**Net loss to Common Stockholders.** The net loss for the six months ended January 31, 2005 increased to \$1,237,000 from \$670,000 for the six months ended January 31, 2004. The increase in net loss to common stockholders is mainly attributed to the recognition of \$591,000 in non-cash warrant expense and \$474,000 in non-cash stock based compensation expense associated with the stock options and stock grants awarded to the company employees and board of directors. Also, there was an increase in depreciation and amortization of approximately \$47,000 from the six months ended January 31, 2004 to the six months ended January 31, 2005. The increase in non-cash warrant and compensation expense and depreciation expense was offset slightly by the increase in gross margin of approximately \$109,000.

### LIQUIDITY AND CAPITAL RESOURCES

**Cash used in operating activities:** During the six months ended January 31, 2005, operations consumed approximately \$457,000 in cash. This cash consumed by operations is primarily due to net losses of approximately \$1.2 million incurred during the six months ending January 31, 2005 plus non-cash income of \$460,000 arising from the forgiveness of debts. During the six months ended January 31, 2005 we recognized \$474,000 in non-cash compensation expense associated with the stock grants and stock options awarded to the employees and board of directors. Additionally, we recognized \$662,000 in non-cash warrant expense associated with the consulting services agreement entered into during the second quarter of fiscal 2005. We also recognized an increase in accounts payable of approximately \$130,000 and an increase in accrued liabilities of approximately \$39,000. The increase in accrued liabilities and accounts payable is primarily due to the company recognizing approximately \$66,000 in interest expense associated with various notes, the accrual of preferred stock dividends of \$76,000 and the accrual of professional fees of approximately \$20,000 associated with the quarterly reviews and legal consulting work rendered during the six months. Also, we recognized an increase in accounts receivables of \$150,000 associated with the billing to our customers during the quarter ending January 31, 2005. We also recognized an increase in prepaid expenses for \$30,000 related to the prepayments/retainers to our attorneys for legal services.

**Cash provided used in investing activities:** During the six months ended January 31, 2005, the Company made various payments for \$8,000 related to the acquisition of some telecommunications equipment acquired during fiscal 2005. Additionally, during the quarter ended October 31, 2004, ATSI entered into an Asset Purchase Agreement with

Hinotel, Inc., a Hispanic owned Competitive Local Exchange Carrier ("CLEC") based in South Texas. The assets purchase under the agreement included Hinotel's customer base, a customer management and billing system, and supplier contracts. The transaction also included the assignment and transfer of the CLEC license in the State of Texas. The purchase price of the assets was \$31,500, paid in 40,000 shares of ATSI common stock and \$7,500 in cash.

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Cash provided by financing activities: During the quarter ended October 31, 2004 we made principal payments on our capital lease obligation for approximately \$1,000 and we received \$788,000 from the exercise of warrants and \$370,000 from proceeds from various notes payables. In addition, a result of the exercise of warrants we also recognized payments of \$774,000 on our notes payable.

Overall, our net operating, investing and financing activities during the six months ended January 31, 2005 provided a decrease of approximately \$90,000 in cash balances. We intend to cover our monthly operating expenses with our remaining available cash. Additionally, we will continue to pursue additional equity offerings to cover our deficiencies in cash reserves. However, there is no assurance that we will be able to secure the equity offerings required to supplement our deficiencies in cash reserves.

Our working capital deficit at January 31, 2005 was approximately \$17,010,000. This represents a decrease of approximately \$1,938,000 from our working capital deficit at July 31, 2004. The decrease can primarily be attributed to the settlement of various liabilities through the issuance of common stock. These settlement were related to the settlement of \$859,500 liability with Alfonso Torres Roqueni, the former owner of the concession license acquired in July 2000 and the settlement of a \$250,000 note payable with Infraestructura Espacial, S.A de C.V. and Tomas Revesz, a former ATSI director.

Our working capital deficit at January 31, 2005 included approximately \$12,104,000 related to the pre-petition liabilities (net of assets), associated with ATSI-Texas and TeleSpan, the two subsidiaries currently under Chapter 7 Bankruptcy. The pre-petition liability balance is composed primarily of the following:

- \$3 million in debt owed to IBM Corporation associated to a capital lease;
- \$1.3 million in debt to Northern Telecom, a subsidiary of Nortel Networks, associated with some telecommunications equipment acquired during fiscal year 2001;
- \$5.1 million in debt to various international and domestic telecommunications carriers for services provided during fiscal year 2002 and 2003;
- \$250,000 in property taxes to various taxing entities,
- \$550,000 to Universal Service Fund for telecommunication taxes; and
- \$2.4 million associated with rent expense, salaries and wages and professional services to various entities.

Our working capital deficit after exclusion of the pre-petition liabilities is approximately \$5,612,000.

Our current obligations include \$103,000 owed to Attorneys for legal services rendered during fiscal 2004.

Our current liability includes approximately \$1,160,000 associated with the Series D Cumulative preferred stock. Of this balance, \$942,000 is associated with the full redemption of this security and \$218,000 is related to the accrued dividends as of January 31, 2005.

Our current liabilities include approximately \$1,310,000 associated with the Series E Cumulative preferred stock. Of this balance, \$1,058,000 is associated with the full redemption of this security and \$252,000 is related to the accrued dividends as of January 31, 2005. During the fiscal year ended July 31, 2003, the Company was de-listed from AMEX and according to the terms of the Series E Cumulative preferred stock Certificate of Designation, if the

Company fails to maintain a listing on NASDAQ, NYSE or AMEX the Series E preferred stockholder could request a mandatory redemption of the total outstanding preferred stock. As of the date of this filing we have not received such redemption notice.

On October 31, 2002 we filed a lawsuit in the Southern District Court of New York against two financial institutions, Rose Glen Capital and Shaar Fund, the holders of Series D and E Redeemable Preferred Stock, for stock fraud and manipulation. These liabilities combined for a total of approximately \$2,470,000. Accounting rules dictate that these liabilities remain in our books under Current Liabilities until the lawsuit is resolved in the judicial system or otherwise. At this time we cannot predict the outcome or the time frame for this to occur.

We also have approximately \$1,152,000 of current liabilities (net of assets) associated to the discontinued operations of the retail services unit. This balance is composed primarily of approximately \$453,000 owed to the Mexican taxing authorities related to a note assumed through the acquisition of Computel and approximately \$699,000 related to income taxes owed as of January 31, 2005.

#### ONGOING OPERATIONS

We believe that, based on our limited access to capital resources and our current cash balances, financial resources may not be available to support our ongoing operations for the next twelve months or until we are able to generate income from operations. These matters raise substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern is dependent upon the ongoing support of our stockholders and customers, our ability to obtain capital resources to support operations and our ability to successfully market our services.

As outlined in Note 4 to the financial statements, we have incurred amounts of debt to finance our working capital requirements. During the six months ended January 31, 2005, we borrowed a total of \$370,000 and subsequent to the quarter ended January 31, 2005 we borrowed an additional \$24,000 from Recap Marketing & Consulting, LLP; to fund our operating expenses and other corporate expenses. This debt will be applied to the payment of warrants issued to certain individual affiliates of Recap Marketing & Consulting, LLP.

We will continue to pursue cost cutting or expense deferral strategies in order to conserve working capital. These strategies will limit the implementation of our business plan and increase our future liabilities. We are dependent on our operations and the proceeds from future debt or equity investments to fund our operations and fully implement our business plan. If we are unable to raise sufficient capital, we will be required to delay or forego some portion of our business plan, which will have a material adverse effect on our anticipated results from operations and financial condition. Alternatively, we may seek interim financing in the form of private placement of debt or equity securities. Such interim financing may not be available in the amounts or at the time when is required, and will likely not be on the terms favorable to the Company.

#### ITEM 3. CONTROLS AND PROCEDURES

The Company has adopted and implemented disclosure controls and procedures designed to provide reasonable assurance that all reportable information will be recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Under the supervision and with the participation of

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the Company's management, including the Company's President and Chief Executive Officer and the Company's Controller and Principal Financial Officer, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e) as of the end of the fiscal quarter covered by this report. Based on that evaluation, the President and Chief Executive Officer and the Controller and Principal Financial Officer have concluded that these disclosure controls and procedures are effective as of the end of the fiscal quarter

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covered by this report. There were no changes in the Company's internal control over financial reporting during the fiscal quarter covered by this report that have had a material affect or are reasonably likely to have a material affect on internal control over financial reporting

### PART II. OTHER INFORMATION

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

As of January 31, 2005, the Company was in arrears with respect to the declaration of the following dividends payable on outstanding shares of its Preferred Stock:

Series A Cumulative Preferred Stock	\$193,750
Series D Cumulative Preferred Stock	217,930
Series E Cumulative Preferred Stock	251,925
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TOTAL	\$663,605
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#### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K/A

(a) Exhibits: The following documents are filed as exhibits to this report.

EXHIBIT  
NUMBER  
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- 4.1 Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. \*
- 4.2 Convertible Promissory Note issued to Franklin Cardwell and Jones, PC. \*
- 10.1 Extension to consulting agreements with Hunter M. A. Carr and Donald W. Sapaugh. \*
- 31.1 Certification of our President and Chief Executive Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. \*
- 31.2 Certification of our Corporate Controller and Principal Financial Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. \*
- 32.1 Certification of our President and Chief Executive Officer, under

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Section 906 of the Sarbanes-Oxley Act of 2002. \*

32.2 Certification of our Corporate Controller and Principal Financial Officer, under Section 906 of the Sarbanes-Oxley Act of 2002. \*

(b) The following Current Reports on Form 8-K were filed during the second quarter of fiscal 2005.

None

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SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ATSI COMMUNICATIONS, INC.  
(Registrant)

Date: March 15, 2005

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By: /s/ Arthur L. Smith

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Name: Arthur L. Smith

Title: President and  
Chief Executive Officer

Date: March 15, 2005

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By: /s/ Antonio Estrada

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Name: Antonio Estrada

Title: Corporate Controller  
(Principal Accounting and Principal  
Financial Officer)

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