

CALLWAVE INC  
Form 10-K  
September 12, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

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(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended June 30, 2007

OR

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

Commission File Number: 000-50958

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**CALLWAVE, INC.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

136 West Canon Perdido Street, Suite C

Santa Barbara, California

77-0490995  
(I.R.S. Employer

Identification Number)

93101

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(Address of principal executive offices)

(805) 690-4100

(Zip code)

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, no par value	The NASDAQ Stock Market, LLC

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

[In determining who are affiliates of the Company for purposes of this computation, it is assumed that directors, officers, and any persons who held on December 29, 2006, more than 5% of the issued and outstanding common stock of the Company are affiliates of the Company. The characterization of such directors, officers, and other persons as affiliates is for purposes of this computation only and should not be construed as a determination or admission for any other purpose that any of such persons are, in fact, affiliates of the Company.]

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

The aggregate market value of common stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of December 29, 2006 was \$22,619,414.

At August 6, 2007, the number of shares outstanding of the registrant's common stock, no par value, was 20,880,064.

Portions of the Proxy Statement to be filed with the Securities and Exchange Commission and to be used in connection with the Annual Meeting of Stockholders are incorporated by reference into Part III of this annual report on Form 10-K to the extent stated therein.

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**PART I**

**Item 1. Business**

**BUSINESS**

**Industry Background**

A decade ago, the primary means of communication was the landline telephone. The emergence of the wireless mobile market and the internet is increasingly supplementing and/or replacing the use of the traditional landline telephone. Mobile telephones and the Internet, which penetrated the early adopter markets in the 1990s have now reached mass market acceptance with over 182 million wireless subscribers in the United States alone, according to the Cellular Telecommunications and Internet Association (CTIA). However, mainstream users of mobile telephones still retain their existing landlines for a variety of reasons, including the desire to retain their published telephone number, the familiar experience of a traditional telephone, the varying quality of mobile reception in some areas, and access to the Internet.

Fueled by the business imperative to create new revenue sources, deliver IP applications and protect their large voice calling communities from emerging competitors, telecommunications service providers are beginning to offer services that combine the benefits of landline telephones with the flexibility of mobile phones. This trend is called fixed-mobile convergence. As service providers begin to develop strategies to offer these new services, they are evaluating traditional solutions, such as installing new telecommunications infrastructure or shipping new mobile handsets, as well as non-traditional solutions including software-based private label on-demand solutions. Traditional solutions typically require large capital investments and longer deployment cycles. The private label on-demand model typically requires less capital and operating allocation, greater flexibility, and faster time-to-market because services are provided by a host. This hosted solution platform eliminates the need for the customer to make capital investments in infrastructure in order to utilize the service.

**Company Overview**

CallWave is leading a new category of convergence services focused on Phone Companion Services. Our business strategy encompasses both our traditional direct to consumer web channel and an indirect carrier channel designed to market our services under the brands of telecommunications service providers and web portals.

We provide services on a free trial or subscription basis that add features and functionality to the telecommunications services used by mainstream consumers and small and home offices. Our Phone Companion Software (PCS)-based services are delivered on our proprietary Enhanced Services Platform, which allows subscribers to manage calls across their existing landline, mobile and Internet networks. Our services enable subscribers to receive, respond, and manage calls on most communications devices without requiring them to purchase or install additional hardware, purchase additional telecommunications services, change their phone number, or switch their service provider. Calls can be accessed on a subscriber's handset, in email, or on the Internet.

Our Enhanced Services Platform intercepts inbound phone and fax calls to our subscribers and is able to redirect these calls to the devices or access points selected by the subscribers using their existing telecommunications lines. In addition, the Enhanced Services Platform enables us to provide virtual phone and fax numbers to our subscribers who then can publish multiple phone or fax numbers for use with a single phone line. As of June 30, 2007, we had approximately 631,000 paying subscribers for our services.

Historically, our subscriber base consisted primarily of dial-up subscribers who, before subscribing to our service, had been missing calls while on the Internet via their dial up connection. The CallWave Enhanced Service Platform allowed customers to screen, transfer or intercept incoming calls while their dial-up service

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connection was in use. As customers have migrated away from traditional dial up Internet connections towards faster and more reliable broadband offerings, we have enhanced our service platform in the web and carrier channels. These enhancements include Web 2.0 widgets, voice to text recognition applications, wireless mobile voicemail, and desktop texting applications.

Our services and offerings improve the utilization of existing telecommunications services by our subscribers. We believe our services and offerings complement the efforts of telecommunications service providers to improve average revenue per user ( ARPU ), reduce churn, create new revenue sources, and protect their calling communities from emerging competitors. We do this by providing IP-enabled applications that are interoperable with current generation landline, mobile and IP networks and devices that can seamlessly migrate to an IMS-enabled environment. This has allowed us to establish cooperative relationships with service providers and web portals that market our private label services under their brand.

**The CallWave Solution**

We provide Phone Companion Services that facilitate the convergence of fixed and mobile telephone services on a free trial or subscription basis to mainstream consumers and small and home offices. Our solution is delivered over the Internet and through our Phone Companion Software (PCS), which is simple to adopt and use, running on a user's desktop that is a companion to the user's communication device. Our proprietary Enhanced Services Platform allows subscribers to bridge calls across existing landline, mobile and Internet networks. This software-based call-bridging service enables 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, get a new telephone number, or change service providers. Additionally, we add value to traditional telecommunications devices by offering information services that provide call management and are easy to use features.

For example, our platform allows subscribers who cannot answer a call on their home telephone or mobile phone (because either the subscriber is unavailable or the line is busy), to screen and accept the call on another device, such as a landline, mobile phone or 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 communications. By screening incoming calls across existing landline, mobile and Internet networks, our subscribers realize greater value from their existing telecommunications services. Our platform also allows mobile phone subscribers to get their voicemail in their email or on the Internet. Unlike traditional mobile voicemail where there is limited opportunity to easily manage the message experience, our software allows our subscribers to get a copy of their mobile voicemail in their email or on the Internet to more easily see and prioritize who has called and then listen, respond, and manage the message accordingly.

Customers have the flexibility to pay us for their subscriptions using credit cards, mail-in checks or through their telephone bills. Subscribers register for our service either on our website or on our partners' websites and download our client software onto their personal computers to utilize our applications. Our Web 2.0 widgets and wireless mobile voicemail applications do not require a download of our client software.

Our private label carrier business delivers IP-enabled applications to service providers marketed under their brand that are interoperable with current network infrastructures. These applications enable service providers to deliver converged voice services ahead of converged networks that are rapidly deployed at a minimal cost.

Certain key aspects of our solutions are common, including:

*Affordable application services.* Our application-based services are customized to meet the requirements of cost-conscious mainstream subscribers, without requiring them to purchase additional hardware or telephone lines or change service providers. We offer flexible service levels, enabling our subscribers to pay for only those applications they need to manage their existing telecommunications services.

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*Ease of installation and use.* We designed our application-based services to be easy to install on a personal computer and easy to use with minimal behavioral changes. During registration and installation, our software is automatically configured, based on subscribers' existing communications services. The registration and installation process typically takes only a few minutes. In most cases, we automatically provision our services without subscribers having to call their existing network service providers. Our call-bridging services are delivered over subscribers' existing communication networks and require no additional hardware and no new telephone number. Our wireless mobile voicemail services do not require a software download.

*Optimized use of existing telecommunications networks and devices.* Our software-based service enables real-time connectivity among subscribers' existing telecommunications services and devices by allowing them to choose where a call is delivered. Our application-based services also provide users with detailed caller identification information, giving subscribers the choice to take the call or direct it to their preferred and most convenient answering device. Our wireless mobile voicemail service offers many of the same benefits without having to download software.

*Scalable, reliable and flexible software platform.* Our software platform has been designed to scale to support millions of users, to deliver carrier-class reliability and to be sufficiently flexible to address the changing market needs. Our software-based infrastructure and open architecture enable us to efficiently and economically identify and develop new information services for our subscribers as they adopt new technologies and desire enhanced functionality from their communication services as well as support IMS and next generation network requirements of service providers.

*Complementary to telecommunications service providers.* Our software platform integrates with and enhances the existing offerings of the providers of telecommunications services and is interoperable with current generation landline, mobile and IP networks and devices that can seamlessly migrate and scale to an IMS enabled environment.

## **Products and Services**

### **CallWave Internet Answering Machine**

Our CallWave Internet Answering Machine services have historically generated most of our revenues. These services extend the functionality of our subscribers' existing telecommunications services by adding easy-to-use enhancements such as real-time voicemail, which allows subscribers to screen a message being left on their landline number from their mobile phone or their Internet-connected personal computer. Our landline services also include virtual telephone numbers that enable our subscribers to receive the benefits of a personalized or dedicated phone number routed to their existing telephone lines, without requiring additional physical phone lines to be installed. As a result, multiple virtual numbers can be set up to deliver calls to the same physical landline telephone that might otherwise be shared by multiple people in a household or small business. These services extend the functionality of networks and devices that our subscribers already use by connecting their landline phones to their mobile phones and Internet networks without requiring new equipment at their premises. During the year, CallWave upgraded this service to support an auto-populating address book with integration to the customer's mobile phone and giving some customers the ability to use our enhanced features to initiate text or voice communications to persons in their address book.

We offer three principal levels of CallWave service:

*CallWave Alert (\$1.50 per month or \$17.95 per year).* CallWave Alert is our lowest-priced subscription level. Our CallWave Alert service delivers notifications of calls placed to any of our subscribers' telephone numbers, even when those lines are not answered or are in use by sending a message to a device of our subscribers' choosing.

*CallWave Messenger (\$5.95 per month).* CallWave Messenger is our mid-level subscription, providing all of the features of CallWave Alert, as well as caller identification and delivery of voice messages, even when subscribers' lines are in use or are not answered.

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*CallWave Connect (\$7.95 per month)*. CallWave Connect is our most feature-rich and high-end service level currently offered. CallWave Connect service enables customers to screen, transfer or receive calls in real-time, and if they choose, interrupt the message to take the call. In addition, subscribers to CallWave Connect receive the benefits of a system that automatically creates a contact book based on the calls received and allows them to use our enhanced features to reply or call back to persons listed in their contact book and to initiate text or voice communications to other persons as well.

#### **CallWave Fax**

CallWave Fax utilizes the same Enhanced Services Platform to offer customers personalized fax numbers that deliver faxes to the user's e-mail account. This provides greater flexibility to customers by allowing them to receive and print faxes from any location where they are connected to a personal computer and allows customers to keep a digital history of all faxes. It also provides financial stability for customers by charging a flat fee of \$7.95 for unlimited faxes every month.

#### **CallWave Mobile**

CallWave Mobile is the company's first visual voicemail product. This service sends a copy of the mobile phone's voicemail to the user's email, enabling the user to sort, prioritize, listen and respond (via text reply or call back) to messages all from their email in-box. The service does not require the user to download software, switch service providers, purchase a new handset or change their mobile phone number. When users are not at their PCs, they are notified of mobile voicemail messages via an SMS text message sent to the handset. Users can also access messages the traditional way by dialing into their mobile phone's voicemail system. This service is currently free during the beta testing period.

#### **CallWave Web 2.0 Widgets**

Widgets are mini web applications that are very simple to download and highly cost-effective channels for delivering software and services to consumers whom we may not reach through other marketing channels. During the year, CallWave introduced SMS text messaging widgets in addition to the wireless industry's first visual voicemail widget. The visual voicemail widget enables users to view their list of wireless mobile voice messages on their desktop and then prioritize and listen to these messages. The SMS text widget allows desktop sending of text messages throughout the world. All widgets have access to a PhonePage described below. We distribute our widgets on popular galleries including Google, Apple, Yahoo!, Microsoft, and social networks. The widgets are currently free during the beta testing period. At June 30, 2007, we had approximately one million widget subscribers.

#### **CallWave Vtxt and PhonePage**

Our Vtxt service transforms mobile voicemail into readable, searchable and storable content. Incorporating our proprietary speech recognition and Web 2.0 visual voicemail technology, the Vtxt service allows subscribers to read the GIST of their voicemail on their handset. Users will also be able to manage and reply to voice and text messages from a personal web page and search for a permanent archive of voice and text messages. The Phone Page also gives the user the ability to reply to callers via text or voice right from the Web and automatically creates a contact book based on the calls received. The Vtxt service is built upon state of the art voicemail-optimized speech recognition technology and a managed services architecture that will offer unlimited storage. This enables the Vtxt service to function without requiring live operator transcription and expands the market to include privacy conscious consumers and public corporation users who are subject to non-disclosure laws. The Vtxt service is currently free during the beta testing period.

#### **Our Strategy**

Our objective is to establish ourselves as the leader in the convergence service category of Phone Companion Services. This includes services that require our Phone Companion Software (PCS) on the desktop,

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which is simple to adopt and use, and is a voice portal running on the user's PC. Unlike traditional VoIP services, CallWave's PCS serves as a companion to the user's existing mobile or landline phone, providing a more seamless integrated communications experience. Through CallWave's Enhanced Services Platform, the PCS desktop is fully synchronized and interoperable with the end user's existing phone number, service provider, contacts, call log and voice messages. The CallWave Enhanced Services Platform is fully scalable to manage other next generation rich media sources. Our strategy also includes Web 2.0 and wireless mobile voicemail applications that do not require a software download and enable users to manage their communications on the handset, in email, and over the Internet. We plan to achieve this objective through a combination of offering services direct to consumers in our web channel and through private label of these services to indirect carrier partners.

*Invest personnel and marketing resources in the wireless mobile services market.* We believe that the market for mobile telephony services will continue to grow at a faster rate than the market for landline telephony services. We intend to focus our marketing efforts on acquiring new wireless mobile subscribers and retaining existing landline customers.

*Extend our reach through indirect carrier and web portal partnerships.* Today, most of our sales come from direct acquisition of customers through our web channel. We also have commercial relationships with Internet and telecommunications service providers through which we provide various call-bridging services to their subscribers. In addition, we also maintain online distribution relationships with a number of smaller companies. We intend to develop similar relationships with other carriers to help us reach a wider range of subscribers, particularly as broadband and voice-over-IP technology are adopted by the mainstream.

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

*Continue to follow a subscriber-driven approach to development of new products and offerings.* We believe that our large subscriber base helps us gain a comprehensive and accurate understanding of the needs, desires and priorities of our subscribers, which is critical to the ongoing success of our business. We also conduct subscriber studies and focus groups to further increase our understanding of our subscribers' needs, desires and priorities. The information captured through this ongoing research and analysis enables us to better identify subscriber requirements and behavioral patterns and continue to develop new and enhanced communications services that current and potential subscribers in the mainstream market value. This information is also helpful in our efforts to attract new strategic partners. We intend to continue to follow a subscriber-driven approach to product development and marketing.

*Provide enhanced communications services for mainstream and wireless mobile users.* Our software-based platform bridges calls effectively across all mainstream forms of Internet access and across all landline, mobile and Internet service providers. This enables us to provide affordable, value-added communications services to mainstream users without the additional cost of changing service providers or purchasing new hardware or the inconvenience of changing phone numbers. We intend to continue to serve the cost-conscious and mobile market across all telecommunications services and devices.

*Extend and enhance component applications and service levels.* Our centralized software platform gives us the flexibility to design, deploy, test and enhance features and applications quickly and easily. We are able to bundle these component applications rapidly into new service levels. We intend to offer additional applications and service levels to meet the diverse and evolving needs of our existing and targeted subscribers and we intend to enhance existing applications and service levels to remain competitive.



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#### **Technology**

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

We designed our Enhanced Services Platform to be:

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

*Scalable and reliable.* Our platform currently processes over 17 million calls per month, and is designed to handle significantly higher call volume under the current architecture. Our software platform has been designed to be fully redundant, with no single points of failure in our software switching facility. We use fully-redundant fault-tolerant components, redundant network connections and redundant copies of data. We also maintain spare parts on site for critical components.

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

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

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

Our Enhanced Services Platform intercepts inbound calls from traditional landline, wireless and IP-based networks, manages and filters calls and delivers calls to our subscribers on landline telephones, mobile phones and personal computers. Our platform contains a number of component applications, or communications applets, which we bundle into customized services to address the unique needs of our different target markets. For example, our software allows subscribers who are using their landline telephones for Internet access to screen and accept telephone calls on other devices such as a mobile phone or other landline telephone.

*Intercept calls.* Our software switch intercepts inbound phone and fax calls to our subscribers and is able to redirect these calls to the devices selected by the subscribers. This software switch is a carrier-class switch that resides within the communications network. In most cases, our subscribers use traditional call-forwarding services provided by their telecommunications service providers to redirect inbound calls to our software switch for delivery to the subscriber. To simplify the initial configuration process, we can automatically provision these call-forwarding services for most of our subscribers without time-consuming manual intervention.

*Filter and manage calls.* Our subscribers are able to screen calls in real-time before deciding whether or not to take the call. The real-time screening experience is similar to listening to a voice message as it is being left on an answering machine. While screening a call, a subscriber is able to accept the call on a mobile or landline phone by pressing a specified button on the phone or by clicking the "take the call" button on our client software that appears on the subscriber's personal computer. We also provide our subscribers with detailed caller identification information and enable them to block telemarketer calls. Our client software has a user interface that allows our subscribers simply to type in the phone numbers of the devices to which calls can be delivered.

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*Deliver calls.* Calls intercepted by our software platform can be delivered to any available telecommunications device. Once users decide to accept a call, either after reviewing the caller identification information or while screening a message, we deliver the call to the appropriate telecommunications service provider through our software switch. In order to deliver the call, our software switch initiates a new call to the subscriber and then connects, or bridges, the initial call and the new call together, rather than simply re-routing the initial call. This feature enables subscribers to receive calls in real-time after first screening the call.

### **Customer Support**

Support is provided to customers at all stages of their experience with us through our client software, email and telephone. Email inquiries and help requests are generally responded to within 24 hours, while telephone inquiries are handled through a toll-free number during normal business hours. Our customer support representatives have direct access to customers' account information and can change service configurations for customers in real time.

Our customer care staff services the customer email and telephone support load. The customer care workforce is augmented with additional agents from third-party call center operations trained for, and dedicated to, our support.

### **Sales and Marketing**

We sell our services directly to consumers through our web channel and private label our services through our carrier channel. The majority of our sales to date have been through our web channel.

Historically, we have offered potential subscribers a free 30-day trial to our CallWave Connect service, the highest level of service we currently offer. At the end of the trial period, the user may choose to subscribe to our lower-priced CallWave Messenger or CallWave Alert services, remain on our CallWave Connect service or cancel the service entirely. In the past, we offered a free service to consumers and small and home offices and attempted to convert them to paying subscribers over time. Services that are in beta are typically offered free during the beta testing period.

We reach our customers through a variety of sales and marketing channels. We continuously analyze and re-evaluate our sales and marketing strategies to ensure we are effectively reaching out to our target markets. Our primary sales and marketing channels include:

*Internet advertising.* We use a number of different Internet advertising relationships and channels to reach our potential and existing subscribers. We typically pay fees to our Internet advertising vendors, based principally on the number of website visitors.

*Channel relationships.* We have a commercial relationship with Hawaiian Tel, Century Tel, and EarthLink under which they resell our services to their customers on a co-branded basis. We also maintain channel relationships with several smaller service providers.

*Unpaid channels.* We acquire a portion of our subscribers through unpaid channels such as widget galleries and word-of-mouth referrals. For example, many of our subscribers sign up for our service after calling another subscriber, interacting with our platform and learning about the benefits of our service.

### **Customers and Channel Relationships**

#### *Customers*

From April 2001, when we first introduced our paid services, through June 30, 2005, our subscriber base increased dramatically. Over the last two years we have experienced the expected churn in our traditional business as subscribers move away from dial-up services as an access medium for the internet to faster more



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reliable broadband services. For the year ended June 30, 2006 we had 706,000 paying subscribers. During fiscal year 2007, as expected, our paid subscriber base decreased 11% to 631,000. Our paying subscribers primarily elect one of our three current service offerings: CallWave Alert, CallWave Messenger and CallWave Connect. As of June 30, 2007, approximately 30% of paying subscribers use our CallWave Messenger service, with CallWave Alert and CallWave Connect comprising approximately 44% and 22% of the paying subscriber base, respectively. CallWave Connect is our newest service and was introduced in April 2003. The remaining approximately 4% of our subscribers are on our legacy CallWave Pro service, which is no longer actively marketed to subscribers.

**Infrastructure and Operations**

*Infrastructure*

We have developed a sophisticated subscription billing system that supports free trials, monthly and prepaid annual plans, installment payments and configurable packages and price points. We bill our subscribers directly, in which case they pay either by check or credit card, or indirectly through regional and national service providers.

All subscriber data is stored in SQL Server databases. We store and analyze aggregate subscriber data to understand trends and subscriber behavior. This data is not currently shared with any other party, except for the express purposes of service provisioning, billing and legal compliance, and is not sold to any other party.

*Operations*

Our operations group manages our system and service deployments and upgrades, facility build-outs, network architecture, physical and network security, data redundancy and availability, system health monitoring, data logging, capacity planning, disaster planning, interaction with telecommunications technical staff and general troubleshooting.

Our wholly-owned subsidiary, Liberty Telecom, operates telecommunications switching equipment and other facilities in Reno, Nevada. Our Reno, Nevada facility is built using a highly-redundant architecture to enhance the reliability and availability of our services. We completed building a backup site in a Las Vegas, Nevada co-location facility to achieve geographic redundancy. At this time all services are redundantly hosted in the new facility. The architecture of our services simplifies our ability to build this redundant facility in a way where the use of backup services is, in most cases, automatic and unnoticed by the customer.

We monitor the performance of our service and our infrastructure. We utilize monitoring tools that we have developed in-house or licensed from third parties, as well as open source monitoring tools. System status is reported to centralized consoles. System status reports are open for viewing by any employee and alarms are delivered proactively to operations personnel and engineering experts. We make extensive use of data logging and graphing for monitoring subscriber trends and capacity issues, and for detecting and notifying our operations staff of uncharacteristic changes in traffic. This data collection is used extensively throughout the organization for various decision support and troubleshooting purposes. The monitoring infrastructure is continually updated to improve our ability to detect problems before they are noticed by subscribers.

**Liberty Telecom**

Liberty Telecom, LLC, a Delaware limited liability company, is our wholly-owned subsidiary. Liberty Telecom is a local exchange carrier and is subject to the jurisdiction of both the Nevada State Public Utilities Commission, or Nevada PUC, and the FCC. Liberty Telecom has received approval from the Nevada PUC to operate as a Local Exchange Carrier, or LEC. This LEC approval enables Liberty to provide local exchange and intrastate exchange access telecommunication services to end user customers and long distance carriers and other

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consumers of exchange access service. Under federal law, Liberty Telecom provides interstate exchange access services under blanket authority granted by the FCC in its rules. As a local exchange carrier, Liberty Telecom maintains a tariff for interstate access charges on file at the FCC, has obligations to make periodic payments to the federal and state universal service funds, file periodic reports on its utilization of numbers, and is subject to the general laws and regulations of both Nevada and the United States applicable to telecommunications carriers, including the obligation to provide services that are just, reasonable, and non-discriminatory.

Our service is designed to allow customers, when they are connected to the Internet on a dial-up connection, to receive a notice that someone is calling them, as well as to give them the opportunity to take that call. In order to provide this capability, we need to have local circuits terminating at our center in Reno, Nevada that carry the calls, which have been redirected and forwarded to our center over toll-free lines. Liberty Telecom provides us with those local connections for receiving the call-forwarded traffic. In addition, if, after screening a call, a subscriber wishes to take the call, we need a carrier to carry the local portion of the traffic to the device on which the customer will receive the call. Liberty provides us with the telecommunications services that support that need.

In addition to using its own facilities to provide telecommunications services, Liberty Telecom also has Interconnection Agreements with SBC/Nevada Bell and Sprint in Nevada under which Liberty Telecom can exchange traffic with these carriers, obtain services, lease facilities, and collocate its own facilities, as necessary, in order to provide its own telecommunications services.

Our ownership of Liberty Telecom provides us with several benefits, including the following:

Liberty Telecom saves us money because it is able to connect calls directly with other telecommunications carriers as a peer, often at little or no charge from the other carriers. Because the wholesale rate given to a peer carrier is lower than the lowest rate given to a non-peer customer for certain types of purchased telecommunication services, our ownership of Liberty Telecom allows us to reduce substantially the access facilities charges we otherwise would pay.

Liberty Telecom provides us a reliable source of telephone numbers, which we need in order to provide services to our subscribers. Unrelated telecommunications service providers would not be as reliable a source of telephone numbers, as they have a limited supply of telephone numbers and may allocate their available numbers to other companies rather than to us.

Liberty Telecom increases the reliability of our services to our customers by providing us with interconnections to the carriers that host the inbound and outbound telecommunications services used by our subscribers. This allows us to identify and resolve service problems far more quickly and effectively than we would be able to achieve if we were to obtain these interconnections from unrelated service providers, and reduces the number and extent of service disruptions that our customers encounter.

### **Research and Development**

We believe it is essential to have a strong research and development team in order to respond rapidly to market needs with a high degree of quality, reliability and scalability. Our research and development team follows a formal development process that has been refined to meet our objectives and minimize post-deployment maintenance. We operate a single version of our centralized software-based platform and are able to automatically upgrade our client software, allowing us to minimize the cost of maintaining and supporting legacy versions of technology.

Our research and development expenditures were \$7,178,000, \$6,805,000 and \$6,868,000 for the fiscal years ended June 30, 2007, 2006 and 2005, respectively.

### **Competition**

The market for our products and services is increasingly competitive, evolving rapidly and is subject to shifting customer needs and introductions of new products and services. Our current and potential competitors approach the market from different areas of expertise and vary in size and scope with respect to the products and services that they offer or may offer in the future.



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We face competition from providers of enhanced services and products, such as answering machines, voicemail, Internet call waiting, and virtual telephone numbers for fax or voice communications. The companies that compete in these areas include Avaya, AOL, Protus IP Solutions, Ring Central, and j2 Global Communications, or j2. For example, Avaya enables telecommunications service providers to offer voice messaging enhanced services to their customers. j2 offers fax services that provide users local fax and voicemail numbers, and the ability to send faxes from the user's computer desktop as well as to receive faxes as email attachments, optical character recognition of incoming faxes, and the ability to listen to voicemail. Those services compete with our enhanced services and fax service offerings. Protus IP Solutions enables online fax by email, using existing email accounts and the Internet to send and receive faxes without a fax machine. Some of those services compete with our fax service offerings.

We face competition from Internet service providers such as AOL, Google, MSN, AT&T WorldNet, and United Online, which are increasingly integrating enhanced functionalities with their basic services. AOL offers an enhanced communication application that includes such services as caller ID, caller name and location, incoming call management technology, telemarketer blocking, ability to listen to messages while online, call log of missed calls while online, ability to answer calls while user is online and voicemail for unanswered incoming phone calls. AOL markets its service offerings primarily to customers that already subscribe to AOL's Internet access services, though its service offerings also are available to non-AOL users.

We face competition from telephone service providers such as the regional Bell operating companies and cable access providers. These competitors are increasingly integrating enhanced functionalities with their basic services. For example, BellSouth offers an Internet call waiting service that competes with our service offerings. The product includes caller ID, caller name, incoming call management technology and voicemail for unanswered incoming phone calls. BellSouth markets its product primarily to its residential telephone user base, though its service is not presently available in all BellSouth service areas.

We face competition from providers of voice-to text products. The companies that compete in these areas include Simulscribe, Spinvox and Vonage. Simulscribe and Spinvox use speech recognition technology and live operators to fully transcribe the voicemail message to text. Simulscribe private labels its services to Vonage. Because CallWave's service does not rely on live operator assistance, messages remain private and secure, while the overall service becomes highly scalable.

Further, we face competition from primary line displacement vendors which are competing with telephone service providers. These competitors include Vonage, AT&T CallVantage, 8X8, and Net2Phone, and are offering enhanced services with their basic telephone services. For example, Vonage offers local and long-distance telephone services for consumers and small businesses. Each of these plans includes features such as voice mail, caller ID, caller name, call waiting, call forwarding, and three-way calling. Vonage also offers other options at an additional cost, including a dedicated fax line and additional phone numbers. These services are marketed to users with high-speed Internet access and compete directly with our service offerings to those same users.

We compete with all of the above companies for a share of the monthly telecommunications and information services spending of our target market. We differentiate ourselves by offering services that are independent of the underlying network infrastructure and, hence, enabling subscribers access to enhanced communication services without changing their service providers, phone number, or purchasing new equipment.

The principal factors upon which we compete in our markets include the following:

service features targeted at the needs of the mainstream market;

reasonable and affordable pricing;

low capital expenditure cost structure;

commercial relationships with existing network service providers;

network and device independence;



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reliability and availability of service;

ease of installation and use; and

vendor reputation and brand.

We believe that we compete favorably based on these factors. Many of our current and potential competitors, however, have greater name recognition, longer operating histories, larger subscriber bases and significantly greater financial resources than we have. In particular, many of our competitors are large, established network service providers such as AOL, Google, AT&T, Comcast, Verizon and SBC that are able to market and distribute enhanced communications services within their already large base of subscribers. They may be able to devote greater resources to product development and marketing and sales than we can. As a result, they may be able to respond more quickly to new technologies and changes in customer requirements than we can. Furthermore, these competitors may be able to adopt more aggressive pricing policies and offer customers more attractive terms, including potentially providing a competing solution at little or no cost as part of a bundled product offering. We cannot assure you that our current and future competitors will not offer or develop products or services that are superior to ours or achieve greater market acceptance than ours or that we will be able to compete effectively against them.

**Intellectual Property**

Our success is dependent in part upon our ability to develop and preserve our technology and to operate our business without infringing on the proprietary rights of others. We rely on a combination of patents, trademarks, domain name registrations, trade secret laws and contractual restrictions to enforce our rights in our intellectual property. We seek to limit disclosure of our intellectual property by requiring employees and consultants with access to our proprietary information to execute confidentiality agreements. While the protection of our intellectual property is important to our business, because of the rapid pace of innovation within the telecommunications and information services industries, we believe that factors such as the technological and creative skills of our personnel, our focus upon our subscribers' needs and timely and effective customer support are more important to the success of our business.

We are the owner of United States Patent Number 6,477,246, which was issued in November 2002, and expires in March 2020, which relates to the method and systems for providing Internet call waiting services. We are the owner of United States Patent Number 6,738,461 which was issued in May 2004, and expires in February 2022, which relates to the method and systems for returning a call to a private number over a telephone system. We are the owner of United States Patent Number 6,879,677 which was issued in April 2005, and expires in January 2023, which relates to method and systems for notifying a wireless caller when a called party's line is available to take a call. We are the owner of United States Patent Number 6,898,275 which was issued in May 2005, and expires in September 19, 2020, which relates to method and systems for providing Internet call waiting services. We are the owner of United States Patent Number 6,968,174 which was issued on November 22, 2005, and expires July 3, 2023, which relates to methods and systems for providing consumers with a reliable, secure, and convenient method of utilizing a telecommunications network to pay for goods or services on a one-time or recurring basis. Lastly, we are the owner of United States Patent Number 7,103,167 which was issued on September 5, 2006, and expires November 9, 2023, which relates to methods and systems for screening telephone calls. In addition, we have a collection of patent applications pending in the United States relating to fixed and mobile telephony, fax processing and billing. We cannot assure you that patents will be issued from pending or future applications or that, if patents are issued, they will not be challenged, invalidated or circumvented, or that any rights granted thereunder will provide meaningful protection or other commercial advantage to us. Moreover, we cannot assure you that any patent rights will be upheld in the future or that we will be able to preserve any of our other intellectual property rights.

We hold several registered trademarks in the United States, including a registered mark on the phrase "Internet Answering Machine", the name CallWave, and on a stylized service mark for CW.

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We license intellectual property from third parties and incorporate such intellectual property into our services. These relationships are generally non-exclusive and have a limited duration. Moreover, we have certain obligations with respect to non-use and non-disclosure of such intellectual property. We cannot assure you that the steps we have taken to prevent infringement or misappropriation of our intellectual property or the intellectual property of third parties will be successful.

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

### **Employees**

As of June 30, 2007, we had 113 full-time employees: 47 are in research and development, 32 are in operations and customer care, 20 are in sales and marketing and 14 are in general and administrative functions. None of our employees are covered by collective bargaining agreements. We believe that our relations with our employees are good.

### **Item 1A. Risk Factors**

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

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

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

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

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we undergo this transition from a business based upon our traditional landline services sold directly to the consumer, to one based primarily upon the delivery of services through indirect distribution relationships, we are likely to realize losses from operations and reduce our accumulated cash reserves.

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

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

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

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

**Our ability to successfully implement indirect carrier distribution arrangements and custom integrate our technology with that of the service providers that distribute our services may cause us to reduce our ability to innovate in our direct web channel.**

In order for our indirect distribution arrangements to be successful, the companies with whom we enter into indirect distribution arrangements require custom features, unique network integrations and branding. That integration process requires development from our engineering team. Given limited engineering resources, our ability to rapidly innovate and deliver competitive new services in the direct web channel may be reduced.

**If telecommunications carriers modernize their voice mail and call management services at a rate that is slower than what we predict, then we may experience delays in realizing growth in revenues and profitability from our services.**

Our services allow carriers to upgrade their existing telephone-based voicemail systems to a visual voice mail system where users can receive their voicemail in their email or web page or in a client application running on the user's personal computer. We believe that there is an opportunity for the marketing and distribution of our visual voicemail and call management services because these services are more convenient to use and have lower underlying costs to the carrier. We therefore have decided to devote substantial resources to indirect marketing

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and distribution of our services. If the pace of that convergence of landline and other telecommunications services unfolds more slowly than we currently foresee it occurring, then the proportion of mass market consumers who are ready to subscribe to our services may be much smaller than is necessary to support substantial growth in our revenues and profitability. If the proportion of consumers who subscribe for our services is correspondingly lower, then our results of operations and financial condition will be adversely affected.

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

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

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

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

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

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

**New Internet-based distribution channels are emerging for the types of services we offer direct to the consumer which may cause an increase in our marketing costs.**

Widgets and Gadgets have introduced a new, low cost distribution channel for direct-to-consumer web services such as voicemail and other call management services. If we fail to establish a position in this new channel it may impact our ability to acquire customers for our services unless we increase our marketing costs.

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

Customer billing is a highly complex process, and our billing system must efficiently interface with third party systems. Our ability to accurately and efficiently bill our subscribers is dependent on the successful operation of the third party systems upon which we rely and our ability to provide these third parties the information required to process transactions. Any failures or error in our current billing systems or procedures or resulting from any upgrades to our billing systems or procedures could materially and adversely affect our business and financial results.

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

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

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

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

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

Telecommunications services were historically provided by companies that made substantial capital investments in their networks. The size of those investments and the time required to deploy those networks served as significant barriers to entry into such markets. In contrast, we provide software-based enhanced services that do not require substantial capital expenditures to deploy and maintain. As a result, other companies with strong technical staffs and knowledge of the communications and information services industries could compete with us without facing significant capital expenditures or other barriers to entry. As a result, we may

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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 future growth prospects.

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

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

a general increase in wholesale long-distance rates or charges for call forwarding services;

an election by service providers to implement a new pricing structure on the services that we currently purchase;

an election by third-party service providers to impose charges for services which are currently toll-free; and

an increase in subscriber usage patterns that increases the cost of the services that we purchase.

Our ability to offer services to our subscribers at competitive rates is partially dependent upon our ability to use that toll-free telephone network and our subsidiary's ability to procure telephone network access and services on a reliable basis and at reasonable prices. If we are unable to effectively manage the cost of our underlying network services, then our pricing structure with a significant number of our subscribers would increase, which could make it difficult to conduct business at attractive margins. Similarly, if the costs of the ancillary services which our subscribers must purchase from their telecommunications providers in order to receive our services were to increase, then our services may become less attractive to our existing and prospective customers, and we may lose subscribers which would adversely affect our revenues, our prospects for growth, our operating results, and our financial condition.

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

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

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**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 paid 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 for our landline services, which generally range from \$1.50 to \$7.95 per month, and are as high as \$9.95 per month in limited circumstances. We expect that recruiting new subscribers may become more expensive on average if we increase our marketing efforts. If we experience significant cost increases or otherwise want to increase our margins, we may be unable to increase our monthly charges by an amount sufficient to allow us to maintain margins or our profitability, and our business and operating results could be adversely affected.

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

Customers who subscribe to certain of our services typically subscribe to call-forwarding services from their local telephone service provider. Generally, these call-forwarding services are available to our subscribers at a reasonable price. If the service providers do not provide these services at a reasonable price, the overall price of obtaining our services may exceed the amount that our current and potential subscribers are willing to pay. If the prices for these services increase, a significant number of our subscribers may terminate their subscriptions for our services, which would have an adverse effect on our revenues, operating results, financial condition, and prospects for growth.

Customers who subscribe to certain of our services typically configure call-forwarding services from their wireless provider. Generally, these call-forwarding services are available to our subscribers at no additional charge. If the wireless service providers do not provide these services at a reasonable price, at all, or exclusively to another enhanced service provider, our ability to provide some of our services m