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ATSI COMMUNICATIONS INC/DE  
Form 10QSB  
December 15, 2004

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

FORM 10-QSB

(mark one)

- QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED OCTOBER 31, 2004
  
- 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 74-2849995  
(State or Other Jurisdiction of (IRS Employer Identification No.)  
Incorporation or Organization)

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

As of December 08, 2004, there were outstanding 6,180,787 shares of the registrant's common stock, \$.001 par value per share.

Transitional Small Business Disclosure Format: Yes  No

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ATSI COMMUNICATIONS, INC.  
AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-QSB  
FOR THE QUARTER ENDED OCTOBER 31, 2004

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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)

	Octob 20 -----
ASSETS	
-----	
CURRENT ASSETS:	
Cash and cash equivalents	\$
Accounts receivable	
Prepaid & other current assets	
	-----
Total current assets	-----
PROPERTY AND EQUIPMENT	
Less - Accumulated depreciation and amortization	
	-----
Net property and equipment	-----
OTHER ASSETS, net	
Intangible Assets, net	
	-----
Total assets	\$

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LIABILITIES AND STOCKHOLDERS' DEFICIT

CURRENT LIABILITIES:

Pre-petition liabilities of bankrupt subsidiaries, net of assets \$  
 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 and 1,170 shares issued and  
 outstanding  
 Liabilities from discontinued operations, net of assets

Total current liabilities

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, 14,114,716 issued  
 and outstanding  
 Common stock, \$0.001, 150,000,000 shares authorized, 5,478,340 issued and outstanding  
 Additional paid in capital  
 Accumulated deficit  
 Other comprehensive Income

Total stockholders' deficit

Total liabilities and stockholders' deficit \$

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

Three months ended October 31,	
2004	2003

OPERATING REVENUES:

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Services		
Carrier services	\$ 769	\$ 33
Network services	73	42
	-----	-----
Total operating revenues	842	75
OPERATING EXPENSES:		
Cost of services (exclusive of depreciation and amortization, shown below)	772	50
Selling, general and administrative	250	196
Legal and professional fees	239	-
Bad debt expense	-	4
Depreciation and amortization	23	-
	-----	-----
Total operating expenses	1,284	250
	-----	-----
OPERATING LOSS	(442)	(175)
OTHER INCOME (EXPENSE):		
Other income (expense), net	-	1
Debt forgiveness income	460	-
Loss on an unconsolidated affiliate	-	(7)
Interest expense	(31)	(26)
Gain/(loss) from sale of assets	-	-
	-----	-----
Total other income (expense)	429	(32)
NET INCOME / (LOSS)	(13)	(207)
LESS: PREFERRED DIVIDENDS	(38)	(94)
	-----	-----
NET INCOME / (LOSS) TO COMMON STOCKHOLDERS	(\$51)	(\$301)
	=====	=====
BASIC AND DILUTED GAIN / (LOSS) PER SHARE	(\$0.01)	(\$0.29)
	=====	=====
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	3,598,383	1,036,390
	=====	=====

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ATSI COMMUNICATIONS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
(In thousands)  
(unaudited)

For the three months ended October 31,

-----  
2004

-----  
2003

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Net loss to common stockholders		
Other comprehensive income (loss), net of tax:	(\$51)	(\$301)
Foreign currency translation adjustment	-	-
Comprehensive loss to common stockholders	(\$51)	(\$301)

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

	Three months ended October 31,	
	2004	2003
NET INCOME (LOSS)	(\$13)	(\$207)
Adjustments to net income (loss)		
Debt forgiveness income	(460)	-
CASH FLOWS FROM OPERATING ACTIVITIES:		
Adjustments to reconcile net loss operating activities-		
Depreciation and amortization	23	-
Loss on an unconsolidated affiliate	-	7
Issuance of common stock for services	40	-
Issuance of warrants for services	-	14
Provision for losses on accounts receivable	-	4
Changes in operating assets and liabilities:		
(Increase) decrease in		
Accounts receivable	(131)	5
Prepaid expenses and other	(20)	(6)
Increase (decrease) in		
Accounts payable	90	58
Accrued liabilities	105	29
Net cash used in operating activities	(366)	(96)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property & equipment	(6)	-
Cash proceeds from sale of ATSI COM	-	62
Investment in joint venture in ATSI COM	-	(36)
Acquisition of business, net of assets	(8)	-
Net cash (used in) provided by investing activities	(14)	26
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from notes payable	286	50

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Proceeds from the exercise of warrants	14	-
	-----	-----
Net cash provided by financing activities	300	50
	-----	-----
NET (DECREASE) INCREASE IN CASH	(80)	(20)
CASH AND CASH EQUIVALENTS, beginning of period	94	140
CASH AND CASH EQUIVALENTS, Allocated to discontinued operations	-	-
	-----	-----
CASH AND CASH EQUIVALENTS, end of period	\$ 14	\$ 120
	=====	=====
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 - 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 centers 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

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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:	October 31, 2004
-----	-----
Accounts payable	\$ 7,496
Accrued liabilities	2,015
Notes payable	386
Capital leases	2,207
	-----
 TOTAL CURRENT LIABILITIES:	 \$ 12,104
	=====

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### NOTE 3 - NOTES PAYABLE

During the first quarter of fiscal 2005, ATSI borrowed a total of \$300,000 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	\$ 25,000	August 23, 2005
August 30, 2004	25,000	August 30, 2005
September 15, 2004	25,000	September 15, 2005
September 20, 2004	150,000	September 20, 2005
October 8, 2004	25,000	October 8, 2005
October 12, 2004	25,000	October 12, 2005
October 15, 2004	10,000	October 15, 2005
October 25, 2004	15,000	October 25, 2005
	-----	
	\$300,000	
	=====	

Additionally, during the first quarter of fiscal 2005, individual affiliates of Recap Marketing & Consulting LLP elected to exercise 1,348,000 warrants and Recap Marketing & Consulting LLP forgave notes in the amount of \$13,473 as the conversion price. As a result ATSI issued 1,348,000 common shares.

### NOTE 4 - 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 \$7,052,999 of non-cash compensation expense associated with the issuance of these warrants.

COMMON SHARES	EXERCISE PRICE
-----	-----
2,000,000	\$ 0.01/share

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800,000	\$	0.25/share
850,000	\$	0.50/share
250,000	\$	0.75/share

During first quarter of fiscal 2005, individual affiliates of Recap Marketing & Consulting, LLP or their assignees exercised the following warrants:

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
		-----
		1,348,000
		=====

### NOTE 5 - 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 COM in July 2000. Under the settlement

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agreement all amounts owed of \$1,359,500 were restructured and settled in exchange for the issuance by ATSI of 687,600 common shares for the payment of \$859,500 of the related obligation. The 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 \$500,000. The note accrues interest at the rate of 6% per annum and has a maturity date of October 1, 2007, with no monthly payments.

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 \$250,000. This note was originally entered into on March 22, 2001 and subsequently restructured on September 12, 2002.

### NOTE 6 - 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 \$31,500, paid in 40,000 shares of ATSI common stock and \$7,500 in cash.

### NOTE 7 - SUBSEQUENT EVENTS

NOTES PAYABLE

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Subsequent to October 31, 2004, ATSI borrowed a total of \$50,000 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
-----	-----	-----
November 5, 2004	\$25,000	November 5, 2005
November 15, 2004	15,000	November 15, 2005
December 1, 2004	10,000	December 1, 2005
	-----	
	\$50,000	
	=====	

Additionally, subsequent to October 31, 2004, individual affiliates of Recap Marketing & Consulting, LLP or their assignees exercise the following warrants:

EXERCISE DATE	EXERCISE PRICE	COMMON SHARES
-----	-----	-----
November 2, 2004	\$ 0.01/share	50,000
November 11, 2004	\$ 0.01/share	36,100
November 11, 2004	\$ 0.25/share	495,072
		-----
		581,172
		=====

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### 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," "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 months ended October 31, 2004 and 2003. 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,

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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.

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 \$19,000 in retail services revenue during the first quarter of fiscal 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 \$442,000, for the quarter ended October 31, 2004 and a working capital deficit of \$17,716,000 at October 31, 2004. Due to such losses and our 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 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 quarter ended October 31, 2004 management continued to pursue different avenues for funding and we entered into various short-term convertible promissory notes in the aggregate amount of \$300,000. 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.

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### RESULTS OF OPERATIONS

The following table sets forth certain items included in the Company's results of operations in dollar amounts and as a percentage of total revenues for the three-month periods ended October 31, 2004 and 2003.

	Three months ended October 31,			
	2004		2003	
	-----	-----	-----	-----
	\$	%	\$	%
	-----			
	(Unaudited)			
	-----			
Operating revenues				
-----				
Services				
Carrier services	\$ 769	91%	\$ 33	44%

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Network services	73	9%	42	56%
	-----	-----	-----	-----
Total operating revenues	842	100%	75	100%
Cost of services (Exclusive of depreciation and amortization, shown below)	772	92%	50	67%
	-----	-----	-----	-----
Gross Margin	70	8%	25	33%
Selling, general and administrative expense	250	30%	196	261%
Legal and professional fees	239	28%	-	0%
Bad debt expense	-	0%	4	5%
Depreciation and amortization	23	3%	-	0%
	-----	-----	-----	-----
Operating loss	(442)	-52%	(175)	-233%
Debt forgiveness income	460	55%	-	0%
Other income (expense), net	(31)	-4%	(32)	-43%
	-----	-----	-----	-----
Net loss	(13)	-2%	(207)	-276%
	-----	-----	-----	-----
Less: preferred stock dividends	(38)	-5%	(94)	-125%
	-----	-----	-----	-----
Net loss to applicable to common shareholders	(\$51)	-6%	(\$301)	-401%
	=====		=====	

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THREE MONTHS ENDED OCTOBER 31, 2003 COMPARED TO THREE MONTHS ENDED OCTOBER 31, 2002

Operating Revenues. Consolidated operating revenues increased 1,023% between periods from \$75,000 for the quarter ended October 31, 2003 to approximately \$842,000 for the quarter ended October 31, 2004.

Carrier services revenues increased approximately \$736,000, or 100% from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. Our carrier traffic increased from approximately 680,480 minutes in the first quarter of fiscal 2004 to approximately 16,304,526 minutes in the first quarter ended October 31, 2004. The increase in revenue and carrier traffic can mainly be attributed to the growth in carrier services revenue since implementation of the NexTone VoIP soft-switch during the last quarter of fiscal 2004.

Network services revenues increased approximately 74% or \$31,000 from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. 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 contract, 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 rate.

Cost of Services. (Exclusive of depreciation and amortization) The consolidated cost of services increased by approximately \$722,000 from the

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quarter ended October 31, 2003 to the quarter ended October 31, 2004. 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 680,480 minutes in the first quarter of fiscal 2004 to approximately 16,304,526 minutes in the quarter ended October 31, 2004, thus increasing our cost of services between quarters.

**Selling, General and Administrative (SG&A) Expenses.** SG&A expenses increased approximately \$54,000, or 28% from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. The increase is attributable to the recognition of approximately \$45,000 in wages and contract labor associated with the operations of the retail services acquired during the first quarter of fiscal 2005.

**Legal and professional Fees.** Legal and professional fees increased approximately \$240,000, or 100% from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. 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 quarter we recognized approximately \$90,000 in legal fees associated to the lawsuit for stock fraud and manipulation by various institutions, as describe in the legal preceding section of this report.

**Depreciation and Amortization.** Depreciation and amortization increased by approximately 100% or \$23,000 from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. The increase is attributed to the recognition of depreciation expense and amortization on the NexTone VoIP soft-switch that was acquired at the last quarter of fiscal 2004.

**Operating Loss.** The Company's operating loss increased by approximately \$267,000 or 153% from the quarter ended October 31, 2003 to the quarter ended October 31, 2004. The increase in operating loss is attributed to the increase of \$293,000 in SG&A and the increase of approximately \$23,000 in depreciation and amortization in the first quarter of fiscal 2005 compared to the first quarter of fiscal 2004. The increase in SG&A and depreciation and amortization were offset slightly by the increase in gross margin of approximately \$45,000.

**Debt forgiveness income.** Our debt forgiveness income increased approximately \$460,000 from the

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quarter ended October 31, 2003 to the quarter ended October 31, 2004. During the quarter ended October 31, 2004, we negotiated an exchange of 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 Revesz, 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 Income (expense).** Other income and expense is comparable between quarter at approximately \$31,000 for the quarter ended October 31, 2004 and \$32,000 for the quarter ended October 31, 2003.

**Preferred Stock Dividends.** Preferred Stock Dividends expense decreased by approximately \$56,000 between periods, from \$94,000 for the quarter ended October 31, 2003 to \$38,000 during the quarter ended October 31, 2004. 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

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the quarter ended October 2004 related to these securities.

Net loss to Common Stockholders. The net loss for the quarter ended October 31, 2004 decreased to \$51,000 from \$301,000 for the quarter ended October 31, 2003. The decrease in net loss to common stockholders was due primarily to the recognition of debt forgiveness income of \$460,000 during the quarter and the \$56,000 reduction of preferred stock dividends payable.

### LIQUIDITY AND CAPITAL RESOURCES

Cash used in operating activities: During the quarter ended October 31, 2004, operations consumed approximately \$366,000 in cash. This cash consumed by operations is primarily due to net losses of approximately \$13,000 incurred during the quarter ending October 31, 2004 and the non-cash income of \$460,000 arising from the forgiveness of debts. We recognized an increase in accounts payable of approximately \$90,000, increase in accrued liabilities of approximately \$105,000. The increase in accrued liabilities and accounts payable is primarily due to the company recognizing approximately \$31,000 in interest expense associated with various notes, the accrual of preferred stock dividends of \$38,000 and the accrual of professional fees of approximately \$16,000 associated with the first quarter review and legal consulting work rendered during the quarter. Also, we recognized an increase in accounts receivables of \$131,000 associated with the billing to our customers at the end of the quarter, which we collected subsequent to the quarter ending October 31, 2004. We also recognized an increase in prepaid expenses for \$20,000 related to the prepayments made to our vendors for the additional services and additional capacity required from our vendors.

Cash provided used in investing activities: During the quarter ended October 31, 2004, the Company acquired a new router, copier and printer for \$20,000. During the quarter we paid \$6,000 in cash towards this acquisition. The new router was acquired to compensate the increase in volume of minutes processed through our network during the quarter ending October 31, 2004.

Additionally, during 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.

Cash (used in)/ provided by financing activities: During the quarter ended October 31, 2004 we received approximately \$286,000 for the issuance of debt and received \$14,000 from the exercise of warrants.

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Overall, our net operating, investing and financing activities during the quarter ended October 31, 2004 provided a decrease of approximately \$80,000 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 October 31, 2004 was approximately \$17,716,000. This represents a decrease of approximately \$1,232,000 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

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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 October 31, 2004 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 \$690,861 owed to Recap Marketing & Consulting; LLP related various unsecured convertible promissory notes bearing interest at the rate of 12% per annum. We entered into these promissory notes during fiscal 2004 and the first quarter of fiscal 2005.

Our current liability includes approximately \$1,149,000 associated with the Series D Cumulative preferred stock. Of this balance, \$942,000 is associated with the full redemption of this security and \$207,000 is related to the accrued dividends as of October 31, 2004.

Our current liabilities include approximately \$1,292,000 associated with the Series E Cumulative preferred stock. Of this balance, \$1,058,000 is associated with the full redemption of this security and \$234,000 is related to the accrued dividends as of October 31, 2004. 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 \$2,441,000. 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

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taxing authorities related to a note assumed through the acquisition of Computel and approximately \$699,000 related to income taxes owed as of October 31, 2004.

### ONGOING OPERATIONS

We believe that, based on our limited access to capital resources and our current cash balances, that 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 3 and 7 to the financial statements, we have incurred amounts of debt to finance our working capital requirements. During the quarter ended October 31, 2004, we borrowed a total of \$300,000 and subsequent to the quarter ended October 31, 2004 we borrowed an additional \$50,000 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 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 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 1. LEGAL PRECEDINGS

In March 2001, Comdisco sued our subsidiary, ATSI-Texas, for breach of contract for failing to pay lease amounts due under a lease agreement for telecommunications equipment. Comdisco claims that the total amount owed pursuant to the lease was \$926,185 and that the lease terms called for 36 months

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of lease payments. Comdisco is claiming that ATSI-Texas only paid thirty months of lease payments. ATSI-Texas disputes that the

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amount owed was \$926,185 since it received only \$375,386 in financing and has paid over \$473,000 in lease payments and, thus, believe that it has satisfied its obligation under the lease terms. Comdisco has filed a claim with the United States Bankruptcy Court of the Western District of Texas in which the bankruptcy of ATSI-Texas is pending. The Company does not have a liability for the lease payments and expects the obligation of ATSI-Texas will be discharged in the pending Chapter 7 case.

In July 2002, we were notified by the Dallas Appraisal District that the administrative appeal from the appraisal of the ATSI-Texas office in the Dallas InfoMart was denied. The property was appraised at over \$6 million dollars. The property involved included a Nortel DMS 250/300 switch, associated telecommunications equipment and office furniture and computers. ATSI-Texas was unable to proceed in its appeal of the appraisal due to its failure to pay the taxes under protest. During fiscal 2002 we recorded approximately \$260,000 of property tax expense related to the ATSI-Texas Dallas office. Currently the Dallas County taxing authority has filed claim with the United States Bankruptcy Court of the Western District of Texas for approximately \$783,843. This amount also included a property tax estimate of approximately \$230,572 for calendar year 2003. We believe this amount is incorrect. All of the property was removed and impaired from the Dallas site as a result of ATSI-Texas filing for protection under Chapter 11 of the Bankruptcy code. We believe that this liability ATSI-Texas will be discharged upon the completion of the pending Chapter 7 case.

In October 2002, we filed a lawsuit in the Southern District of New York against several financial parties for stock fraud and manipulation. The case is based on convertible preferred stock financing transactions involving primarily two firms: Rose Glen Capital and the Shaar Fund. We believe that Rose Glenn and the Shaar Fund engaged in a scheme to defraud us into selling multiple series of convertible preferred stock and to manipulate the price of our stock downward in order to take advantage of increased conversion rates resulting from the decline in stock price. We are not able to determine the likelihood of an adverse outcome or the amount or range of any losses that could result from this matter. If we receive an adverse decision in this suit, it is likely we would be required to issue a substantial amount of our common shares to our Series D and Series E holders and the current owners of our common shares would be substantially diluted.

In December 2003, we filed a cause of action in the 407th Judicial District of Bexar County, Texas against James C. Cuevas, Raymond G. Romero, Texas Workforce Commission, ATSI-Texas and Martin W. Seidler seeking judicial review on the decision issued by the Texas Workforce Commission awarding a claim for \$81,092 against us for unpaid wages. The District Court has set a trial date for July 11, 2005. We are vigorously pursuing this action but cannot predict the outcome of this litigation or the amount or range of a potential loss. An adverse decision in this matter would have a material adverse effect on our financial condition in the period in which it is entered.

In January 2004, we filed a petition in the 150th Judicial District of Bexar County, Texas against Inter-tel.net, Inc. and Vianet Communications, Inc. d/b/a Inter-tel.net seeking declaratory relief that ATSI Communications, Inc. is not bound by the Carrier Services Agreement between Vianet Communications, Inc. and ATSI-Texas. On February 27, 2004 the Bankruptcy Court in the ATSI-Texas Bankruptcy case allowed Vianet Communications, Inc. to amend its claim pending in the Bankruptcy of ATSI-Texas and assert against ATSI its claim for \$1,720,387



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arising from an alleged breach of contract by ATSI-Texas. The Bankruptcy Court then ordered the lawsuit to be remanded back to state court for hearing. The District Court has set a trial date for March 9, 2005. We cannot predict the outcome of this litigation or the amount or range of a potential loss. An adverse decision in our declaratory judgment action and in the claim by Vianet Communications, Inc. would have a material adverse effect on our financial condition in the period in which it is entered.

We are also a party to additional claims and legal proceedings arising in the ordinary course of business. We believe it is unlikely that the final outcome of any of the claims or proceedings to which we are a party would have a material adverse effect on our financial statements; however, due to the inherent uncertainty of litigation, the range of possible loss, if any, cannot be estimated with a reasonable degree of precision and there can be no

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assurance that the resolution of any particular claim or proceeding would not have an adverse effect on our results of operations in the period in which it occurred.

### ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table contains the names, number of shares, dates and consideration paid for common stock by persons who purchased securities in private placements during the three months ended October 31, 2004. All such transactions were exempt from registration under the Securities Act under Section 4(2) as transactions not involving a public offering because of the limited number of persons involved in each transaction, the access of such persons to information about the Company that would have been available in a public offering, and the absence of any public solicitation or advertising.

PURCHASE	NUMBER OF SHARES	CONSIDERATION	DATE
Alexandro Hinojosa Sr.	40,000	Acquisition of Hinotel for \$24,000	August 1, 2004
Alfonso Torres Roqueni	687,600	Settlement of debt for \$859,500	October 1, 2004
Tomas Revesz	30,000	Settlement of debt for \$250,000	October 26, 2004

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

The exhibits listed below are filed as part of this report.

#### EXHIBIT NUMBER

4.1	Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. *
10.1	Confidential Settlement Agreement and Mutual Release, Note Payable and Lock out agreement between ATSI and Alfonso Torres Roqueni, dated October 1, 2004. *

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- 10.2 Confidential Settlement Agreement and Mutual Release between ATSI and Infraestructura Especial and Tomas Revesz, dated October 26, 2004. \*
- 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 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. \*
- 99.1 Public Utility Commission of Texas ("PUC") approval of transfer of the Service Provider Certificate of Authority ("SPCOA") from Hinotel, Inc. to ATSI's subsidiary, Telefamilia Communications, Inc. Dated October 25, 2004. \*

\* Filed herewith

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(b) Reports on Form 8-K

- On August 1, 2004, we filed a Current Report on Form 8-K under Items 1.01, 2.01, 3.02 and 9.01, we announced that ATSI Communications, Inc. and Hinotel, Inc. entered into an asset purchase agreement under which ATSI acquired all of Hinotel's retail customer base, a customer management and billing system, certain supplier contracts and the Competitive Local Exchange Carrier (CLEC) license in exchange for \$7,500 in cash and 40,000 shares of ATSI common stock.

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: December 15, 2004  
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By: /s/ Arthur L. Smith  
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Name: Arthur L. Smith  
Title: President and  
Chief Executive Officer

Date: December 15, 2004  
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By: /s/ Antonio Estrada  
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Name: Antonio Estrada  
Title: Corporate Controller  
(Principal Accounting and Financial Officer)

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