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ATSI COMMUNICATIONS INC/DE

Form 10-K

November 09, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(mark one)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED JULY 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.
(Name of Small Business Issuer as Specified in its Charter)

NEVADA
(State or Other Jurisdiction of Incorporation or Organization)

74-2849995
(IRS Employer Identification No.)

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

78240
(Zip Code)

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

Securities registered under Section 12(b) of the Exchange Act: NONE

Securities registered under Section 12(g) of the Exchange Act:

COMMON STOCK, PAR VALUE \$0.001 PER SHARE
SERIES H CONVERTIBLE PREFERRED STOCK, PAR VALUE \$0.001 PER SHARE
(Title of Class)

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. X Yes No
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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 herein, and will not be contained, to the best of 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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) Yes No X
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As of October 25, 2004, the aggregate market value of the voting common equity held by non-affiliates of the Registrant was \$3,128,727 based on the

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closing price of \$0.68 per share on October 25, 2004 as reported on the over-the-counter bulletin board.

There were 4,601,069 shares of Registrant's Common Stock outstanding as of October 25, 2004.

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PART I

ITEM I. BUSINESS.

OVERVIEW

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

We have had operating losses for almost every quarter since we began operations in 1994. Our operating losses from continuing operations were approximately \$8,529,000 and \$5,780,000, for the years ending July 31, 2004 and 2003, respectively. Additionally, we had a working capital deficit of approximately \$18,948,000 at July 31, 2004. We have experienced difficulty in paying our vendors and lenders on time in the past, and we expect this trend to continue over the next 12 months as we continue to rebuild our operations. Moreover, we are currently pursuing various alternatives including equity offerings, exchanging some portion or all of our debt for equity, and restructuring our debt to extend the maturity. However, in the event we fail to execute on our current plan or that circumstances currently unknown or unforeseen by us arise, we may not succeed in re-capitalizing the Company or be able to obtain additional funding to allow us to meet our obligations.

Two of our subsidiaries, ATSI (Texas), 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 these cases on April 9, 2003 and on May 14, 2003 converted the cases to a Chapter 7 proceeding. The two bankrupt subsidiaries were our two primary operating companies and they have ceased operations. These bankruptcies did not include the reporting entity ATSI Communications, Inc. (the "Company").

Due to the bankruptcies of our principal operating subsidiaries, recurring losses, negative cash flows generated from our operations and our substantial working capital deficit, our 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 the end of our next fiscal year, July 31, 2005. In order to remain a going concern, we intend to attract new customers to generate additional revenues and/or generate cash from debt or equity offerings. There is no assurance that we will be able to obtain sufficient additional customers or funding to continue as a going concern.

Our strength is based on our interconnection agreement with carriers such as Telefonos de Mexico S.A de C.V. ("Telmex") and Bestel S.A de C.V. ("Bestel"). Our interconnection agreements with these Mexican long-distance concessionaires provide us with nationwide network coverage at a competitive cost structure. Currently, Telmex owns and operates the only nationwide network in Mexico with more than 14.1 million phone lines in over 105,000 communities throughout Mexico. Bestel operates a fiber optic network that extends over 6,356 kilometers with points of presence in 19 Mexican metropolitan areas. Under these interconnection agreements our cost to provide service over these networks is based on a per minute rate and the volume of minutes transported through their respective networks. We also own 49% of a Mexican company, ATSI

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Comunicaciones, S.A. de C.V. ("ATSIKOM"), that holds a 30 year concession license, allowing for the sale of voice and data services, long distance transport, and the operation of a telecommunications network throughout Mexico.

Additionally, during the fourth quarter of Fiscal year 2004, we acquired a NexTone Communications Session Controller (soft-switch) to enhance our VoIP network. This enhancement has allowed us to route our traffic more efficiently, improve our call processing, monitor quality of service and enable us to share port resources with

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our customers. We expect that the NexTone technology will allow us to be more competitive and allow us to obtain higher margins in our wholesale international telecommunication services. As a result of these enhancements to our VoIP Network our customer base has grown to approximately 26 customers and generated revenues of approximately \$125,000 during the last month of fiscal year 2004.

HISTORY

ATSI Communications, Inc., a Nevada corporation, was formed in 2004 as the successor to the business originally incorporated 1994 as a Canadian holding company, Latcomm International, Inc., with a Texas operating subsidiary, Latin America Telecomm, Inc. Both corporations were renamed "American TeleSource International, Inc." in 1994. In May 1998, the Canadian corporation completed a share exchange with a newly formed Delaware corporation, also called American TeleSource International, Inc., which resulted in the Canadian corporation becoming the wholly owned subsidiary of the Delaware Corporation. Our stockholders voted to change our name from American TeleSource International, Inc. to ATSI Communications, Inc in 2003 and to reincorporate in the State of Nevada by merger into our wholly owned subsidiary in 2004. We own 49% of ATSI Comunicaciones S.A de C.V., a Mexican corporation, that holds a 30-year concession, allowing for the sale of voice and data services, long distance transport, and the operation of a telecommunications network.

RECENT DEVELOPMENTS

During our fiscal year ending July 31, 2004:

- We acquired a NexTone Communications Session Controller (soft-switch) to enhance our Voice over Internet Protocol (VoIP) network. The acquisition of the NexTone(TM) Communication Session Controller (soft-switch) will allow us to expand our network, allow for more efficient routing of traffic and improve our call processing and quality.
- Our stockholders approved the reincorporation of the Company in the State of Nevada by merger with and into a wholly owned subsidiary, ATSI Merger Corporation. Stockholders of record as of May 24, 2004 were entitled to receive one (1) share of New ATSI Common Stock and ten (10) shares of New ATSI Series H Convertible Preferred Stock for each 100 shares of Old ATSI Common Stock surrendered.

SERVICES AND PRODUCTS

We provide two types of services: Carrier Services and Network Services.

Carrier Services

We provide transmission and termination services to U.S. and Foreign telecommunications companies who lack transmission facilities, require

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additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically these telecommunications companies offer their services to the public for local and international long distance services. Revenues from this service accounted for approximately 94% of our total revenue in the year ended July 31, 2003 ("fiscal 2003") and 81% of our total revenue in the year ended July 31, 2004 ("fiscal 2004"). The percentage of our total volume of carrier services traffic sent by customers can fluctuate dramatically, on a quarterly, and sometimes, daily basis. Historically, a handful of customers have accounted for a majority of the total carrier services volume, although not necessarily the same customers from period to period. During fiscal 2004, our agreements with customers were not for a specific period of time or volume of minutes. The customer was given a set rate for services and the customer would decide the volume of minutes it would send to us to terminate. Therefore on a month-to-month basis there was not a required volume commitment from any customer and customers were free to re-route their traffic away from us to a lower priced carrier.

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Due to our limited resources and lack of a line of credit with our carriers, we were required to prepay or maintain substantial deposits with our carriers to minimize their risk as they provide us with their services. During fiscal 2004 our carriers required deposits and prepayments equal to 25% or \$30,000 of our weekly estimated traffic. These deposit requirements were calculated by our carriers using historical weekly traffic volumes and estimated future weekly traffic. We have attempted to minimize the amount of deposits that are required by our carriers by entering into various reciprocal agreements with our customers that permit them to transport and terminate traffic over our network and allow us to transmit and terminate traffic over their networks, thus reducing the prepayment requirements. However, there can be no assurance that we will be able to enter into reciprocal agreements in the future and we may be required to prepay for services in the future.

During the fourth quarter of 2004 we were able to utilize our interconnection agreement with Bestel S.A de C.V. ("Bestel"), to reduce our cost per minute to access the local carriers networks in Mexico. Bestel operates a fiber optic network that extends over 6,356 kilometers with points of presence in 19 Mexican metropolitan areas. We believe that this broad range of coverage through our interconnection agreement with Bestel provides us with the tools to be competitive and attract additional customers.

Network Services

A private satellite network is a secure communication connection or link between various remote locations for the transmission of voice or data. This connection is accomplished by having all of the various remote locations from one customer connected to a common satellite destination, where information is allowed to be exchanged, transported and shared. We provide these services to multi-national and Latin American corporations or enterprise customers who require a high volume of communications services to their U.S. offices or businesses and need greater dependability than is available through public networks. These services include the transportation of data, voice and fax transmission and Internet services between the customers multiple international offices and branches. We currently provide network services to Bell Canada, a Canadian corporation on a month-to-month basis and generate approximately \$23,000 per month in revenue. There is no assurance that we will continue to generate this level of revenue in the future or that we will be able to enter into a long-term contract with Bell Canada or any other customer.

We compete with MCI and Americatel, as well as the former telecommunication monopolies in the Latin American countries, in providing network services.

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Factors contributing to our competitiveness include reliability, network quality, speed of installation, and in some cases, geography, network size, and hauling capacity. We are at a competitive disadvantage with respect to larger carriers who are able to provide networks for corporations that encompass more countries in Latin America, as well as Europe, Asia and other parts of the globe. As a result of these disadvantages we do not expect a significant increase in revenue from this source in the near future.

We lease our satellite capacity and space segment on a month-to-month basis directly from Satellites Mexicanos, S.A. de C.V. ("Satmex") for the connectivity for our network services customer. We also have a monthly Termination Agreement with Telecomunicaciones de Mexico S.A de C.V. ("Telecomm"). Under the month-to-month agreements with these two vendors we incur fixed charges of approximately \$5,600 and \$2,200, respectively, for the space segment and termination services. Under the monthly agreements with Satmex and Telecomm we can increase or decrease capacity as the customer usage changes with demand and can terminate these agreements at any time without any penalties.

VOICE OVER INTERNET PROTOCOL NETWORKS

The basic technology of traditional telecommunications systems was designed for slow mechanical switches. Communications over the traditional telephone network are routed through circuits that must dedicate resources to each call from its inception until the call ends, regardless of whether anyone is actually talking on the circuit. This circuit-switching technology incurs a significant cost per call and does not efficiently support the integration of voice

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with data services. Data networks, however, were designed for electronic switching. They break the data stream into small, individually addressed packages of data ("packets") that are routed independently of each other from the origin to the destination. Therefore, they do not require a fixed amount of bandwidth to be reserved between the origin and destination of each call and they do not waste bandwidth when it is not being used for actual transmission of information. This allows multiple voice or voice and data calls to be pooled, resulting in these networks being able to carry more calls with an equal amount of bandwidth. Moreover, they do not require the same complex switching methods required by traditional voice telephone networks, instead using a multiplicity of routers to direct each packet in the direction of its destination and they automatically route packets around blockages, congestion or outages.

Packet switching is a method of transmitting messages that can be used within a data network or across networks, including the public Internet. The Internet itself is not a single data network owned by any single entity, but rather a loose interconnection of networks belonging to many owners that communicate using the Internet Protocol ("IP"). By converting voice signals to digital data and handling the voice signals as data, it can be transmitted through the more efficient switching networks designed for data transmissions and through the Internet using the IP. The transmission of voice signals as digitalized data streams over the Internet is known as Voice over Internet Protocol or "VoIP". A VoIP network has the following advantages over traditional networks:

- INTEGRATION OF VOICE AND DATA: VoIP networks allows for the integration of voice, data traffic and images into the same network.
- SIMPLIFICATION: An integrated infrastructure that supports all forms of communication allows more standardization and less equipment management. The result is a fault tolerant design.

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- NETWORK EFFICIENCY: The integration of voice and data fills up the data communication channels efficiently, thus providing bandwidth consolidation and reduction of the costs associated with idle bandwidth. The sharing of equipment and operations costs across both data and voice users can also improve network efficiency since excess bandwidth on one network can be used by the other, thereby creating economies of scale for voice (especially given the rapid growth in data traffic). An integrated infrastructure that supports all forms of communication allows more standardization and reduces the total equipment complement. This combined infrastructure can support dynamic bandwidth optimization and a fault tolerant design. The differences between the traffic patterns of voice and data offer further opportunities for significant efficiency improvements.
- CO-EXISTENCE WITH TRADITIONAL COMMUNICATION MEDIUMS: IP telephony can be used in conjunction with existing PSTN switches, leased and dial-up lines, PBXs and other customer premise equipment (CPE), enterprise LANs, and Internet connections. IP telephony applications can be implemented through dedicated gateways, which in turn can be based on open standards platforms for reliability and scalability.
- COST REDUCTION: Under the VoIP network, the connection is directly to the Internet backbone and as a result the telephony access charges and settlement fees are avoided.

The growth of voice on the Internet was limited in the past due to poor sound quality caused by technical issues such as delays in packet transmission and by bandwidth limitations related to Internet network capacity and local access constraints. However, the continuing addition of data network infrastructure, recent improvements in packet switching and compression technology, new software algorithms and improved hardware have substantially reduced delays in packet transmissions and the effect of these delays. Nevertheless, certain VoIP routes into countries with limited or poor Internet infrastructure continue to lack the consistent quality required for voice transport and termination.

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A number of large long distance carriers have announced Internet telephony service offerings. Smaller Internet telephony service providers have also begun to offer low-cost Internet telephony services from personal computers to telephones and from telephones to telephones. Traditional carriers have substantial investments in traditional telephone network technology, and therefore have been slow to embrace Internet technology.

We believe that the infrastructure required for a global network is too expensive for most companies to deploy on their own. This mandates that the network be a combination of gateways owned by different operators. For a network to achieve optimal functionality and quality, however, the gateways need to be interoperable, or able to communicate with one another. Interoperability continues to be a challenge for VoIP providers and recently, technological solutions have emerged that support interoperability between different protocols and/or gateways. Cisco appears to have emerged as a dominant supplier of VoIP gateways and other manufacturers often seek to make their equipment interoperable with Cisco.

Long distance telephone calls transported over the Internet are less expensive than similar calls carried over the traditional telephone network primarily because the cost of using the Internet is not determined by the distance those calls need to travel. Also, routing calls over the Internet is more cost-effective than routing calls over the traditional telephone network

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because the technology that enables Internet telephony is more efficient than traditional telephone network technology. The greater efficiency of the Internet creates cost savings that can be passed on to the consumer in the form of lower long distance rates or retained by the carrier as higher margins.

By using the public Internet, VoIP providers like ATSI are able to avoid direct payment for transport of communications, instead paying for large "pipes" into the public Internet, billed by bandwidth rather than usage, which transmits calls to a distant gateway. The Internet, which has its origins in programs devised by the Department of Defense to provide multiple routes and therefore redundancy which was largely immune from the failure of a single network element, provides great redundancy and can be "self healing" in the event of an outage in a particular network element or transmission path. Moreover, adding an additional entry or exit point (a Point of Presence or "PoP") does not require any expensive or time consuming reconfiguration or reprogramming of existing network elements. The new element is simply installed with a specific IP address and it can send or receive information from any other IP address on the Internet.

STRATEGY AND COMPETITIVE CONDITIONS

The long distance telephony market and the Internet telephony market are highly competitive. There are several large and numerous small competitors, and we expect to face continuing competition based on price and service offerings from existing competitors and new market entrants in the future. The principal competitive factors in our market include price, quality of service, coverage, customer service, reliability, and network size/capacity. Our competitors include major and emerging telecommunications carriers in the U.S. and foreign telecommunications carriers. The financial difficulties of many telecommunications providers are rapidly altering the number, identity and competitiveness of the marketplace, and we are unable to determine with certainty the eventual result of the consolidation occurring in our industry.

During the past several years, a number of companies have introduced services that make Internet telephony or voice services over the Internet available to other carriers. All major telecommunications companies either presently or could potentially route traffic to destinations worldwide and compete or can compete directly with us. Other Internet telephony service providers focus on a retail customer base and may in the future compete with us in the carrier services business. In addition, companies currently in related markets have begun to provide voice over the Internet services or adapt their products to enable voice over the Internet services. These related companies may potentially migrate into the Internet telephony market as direct competitors.

Carriers buying wholesale termination into Mexico, while cost conscious, are increasingly demanding high reliability and quality in service delivery. Sustainability and growth in this segment depends on specific competitive advantages that companies may possess in specific markets. Competitive advantages like proper licenses, network

redundancy, favorable termination agreements, or the presence of a business infrastructure and relationships in the specific terminating market. The Company competes with the dominant providers, such as Qwest and MCI, as well as other, smaller providers for international long distance services to Mexico. The Company believes that in contrast to the dominant providers, it has a much more focused and cost competitive strategy that targets select higher margin telecommunication niches utilizing VoIP technology. Certain carriers provide termination services in Mexico at lower prices (e.g., \$0.015 to \$0.06) because

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they contract with other carriers that "leak" into the local network using unlicensed IP points of presence. These carriers, however, have several disadvantages including: (i) generally poor quality, (ii) limited capacity, and (iii) poor reliability, since Mexican authorities periodically shut down their operations. Additionally, there are a few market trends that affect our wholesale product's competitiveness in the market. First, unauthorized, non-conventional operators continue to have a major impact by offering prices below real costs. Second, the elimination of settlement rates in Mexico continues to drive down costs. The result of this trend is a significant reduction in revenue per minute. The combination of non-conventional termination and the new settlement rates have reduced U.S to Mexico termination prices from an average price of \$0.27 per minute in 1998 to a current \$0.045 per minute.

Many of our competitors have substantially greater financial, technical and marketing resources, larger customer bases, longer operating histories, greater name recognition and more established relationships in the industry than we have. As a result, certain of these competitors may be able to adopt more aggressive pricing policies that could hinder our ability to market our services. We believe that our key competitive advantages are our ability to deliver reliable, high quality voice service over the Internet in a cost-effective manner. We cannot provide assurances, however, that these advantages will enable us to succeed against comparable service offerings from our competitors. A large number of telecommunications companies, including AT&T, WorldCom, Qwest and Sprint currently provide wholesale voice telecommunications service which competes with our business. These companies, which tend to be large entities with substantial resources, generally have large budgets available for research and development, and therefore may further enhance the quality and acceptance of the transmission of voice over the Internet.

Our strategy is to position ourselves to take advantage of the demonopolization of the Latin American telecommunications markets, as well as the increasing demand for international communications services between these markets and the United States. Historically, telecommunications services in Latin America have been provided by state-run companies, operating as a legal or de facto monopoly. Although these companies failed to satisfy the demand for services in their countries, the regulatory scheme effectively precluded competition by foreign carriers. Currently, there is a trend toward demonopolization of the telecommunications industry in Latin America, and many of these countries are in various stages of migration toward a competitive, multi-carrier market. Many Latin American countries produce a significant number of immigrants to the United States, or are becoming homes to U.S. based corporations seeking lower labor costs. At the same time that Latin American markets have been opening up, the demand for telecommunications services between the United States and Latin America (particularly Mexico) has been strengthened by:

- the rapid growth of the Latino segment of the United States population
- Mexico's status as the top calling partner with the United States
- increase in trade and travel between Latin America and the United States
- the build-out of local networks and corresponding increase in the number of telephones in homes and businesses in Latin countries
- proliferation of communications devices such as faxes, mobile phones, pagers, and personal computers
- declining rates for services as a result of increased competition.

Our strengths include our knowledge of, and relationships within, the telecommunications industry in the United States and certain countries within Latin America, particularly Mexico. Our management and employees have in-depth knowledge of the Mexican culture, business environment and telecommunications industry. As a result, we have been able to obtain a key long distance concession through our 49% ownership in ATSI COM that allows us to both generate

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and carry traffic within Mexico and between Mexico and the United States.

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GOVERNMENT REGULATION / CONCESSION LICENSE

REGULATION OF INTERNET TELEPHONY

Our operations are subject to federal, state and foreign laws and regulations. The use of the Internet to provide telephone service is a fairly recent market development. At present, ATSI is not aware of any domestic, and is only aware of a few foreign, laws or regulations that prohibit voice communications over the Internet.

United States.

ATSI believes that, under U.S. law, the Internet-related services that ATSI provides constitute information services as opposed to regulated telecommunications services, and, as such, are not currently actively regulated by the FCC or any state agencies charged with regulating telecommunications carriers. Nevertheless, aspects of ATSI's operations may be subject to state or federal regulation, including regulation governing universal service funding, disclosure of confidential communications and excise tax issues. ATSI cannot provide assurances that Internet-related services will not be actively regulated in the future. Several efforts have been made in the U.S. to enact federal legislation that would either regulate or exempt from regulation services provided over the Internet. Increased regulation of the Internet may slow its growth, particularly if other countries also impose regulations. Such regulation may negatively impact the cost of doing business over the Internet and materially adversely affect ATSI's business, operating results, financial condition and future prospects.

The FCC has considered whether to impose surcharges or other common carrier regulations upon certain providers of Internet telephony, primarily those which, unlike ATSI, provide Internet telephony services directly to end users. While the FCC has presently refrained from such regulation, the regulatory classification of Internet telephony remains unresolved. Additionally, the FCC has expressed an intention to further examine the question of whether certain forms of phone-to-phone VoIP services are information services or telecommunications services. The two are treated differently in several respects, with certain information services being regulated to a lesser degree. The FCC has noted that certain forms of phone-to-phone VoIP services bear many of the same characteristics as more traditional voice telecommunications services and lack the characteristics that would render them information services. The FCC has indicated that the mechanisms for contributing to the Universal Service Fund, issues as to applicability of access charges and other matters will be considered in that context.

If the FCC were to determine that certain Internet-related services including Internet telephony services are subject to FCC regulations as telecommunications services, the FCC could subject providers of such services to traditional common carrier regulation, including requirements to make universal service contributions, and pay access charges to local telephone companies. A decision to impose such charges could also have retroactive effect, which could materially adversely affect the Company. It is also possible that the FCC may adopt a regulatory framework other than traditional common carrier regulation that would apply to Internet telephony providers. Any such determinations could materially adversely affect ATSI's business, financial condition, operating results and future prospects to the extent that any such determinations negatively affect the cost of doing business over the Internet or otherwise slow the growth of the Internet. Congressional dissatisfaction with FCC conclusions

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could result in requirements that the FCC impose greater or lesser regulation, which in turn could materially adversely affect ATSI's business, financial condition, operating results and future prospects.

State regulatory authorities may also retain jurisdiction to regulate certain aspects of the provision of intrastate Internet telephony services. Several state regulatory authorities have initiated proceedings to examine the regulation of such services. Others could initiate proceedings to do so.

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Other regulations affecting the Internet in the United States.

Congress has recently adopted legislation that regulates certain aspects of the Internet, including online content, user privacy and taxation. In addition, Congress and other federal entities are considering other legislative and regulatory proposals that would further regulate the Internet. Congress has, for example, considered legislation on a wide range of issues including Internet spamming, database privacy, gambling, pornography and child protection, Internet fraud, privacy and digital signatures. Various states have adopted and are considering Internet-related legislation. Increased U.S. regulation of the Internet may slow its growth, particularly if other governments follow suit, which may negatively impact the cost of doing business over the Internet and materially adversely affect our business, financial condition, results of operations and future prospects. Legislation has also been proposed that would clarify the regulatory status of VoIP service. The Company has no way of knowing whether legislation will pass or what form it might take.

International.

The regulatory treatment of Internet telephony outside of the U.S. varies widely from country to country. A number of countries that currently prohibit competition in the provision of voice telephony also prohibit Internet telephony. Other countries permit but regulate Internet telephony. Some countries will evaluate proposed Internet telephony service on a case-by-case basis and determine whether it should be regulated as a voice service or as another telecommunications service. Finally, in many countries, Internet telephony has not yet been addressed by legislation or regulation. Increased regulation of the Internet and/or Internet telephony providers or the prohibition of Internet telephony in one or more countries could materially adversely affect our business, financial condition, operating results and future prospects.

Other General regulations

The Telecommunications Act of 1996 (the "Telecom Act"), which became law in February 1996, was designed to dismantle the monopoly system and promote competition in all aspects of telecommunications. The FCC has promulgated and continues to promulgate major changes to their telecommunications regulations. One aspect of the Telecom Act that is of particular importance to us is that it allows Bell Operating Companies or BOCs to offer in-region long distance service once they have taken certain steps to open their local service monopoly to competition. Given their extensive resources and established customer bases, the entry of the BOCs into the long distance market, specifically the international market, will create increased competition for us. Southwestern Bell's application to offer in region long distance was approved in June 2000.

Although we do not know of any other specific new or proposed regulations that will affect our business directly, the regulatory scheme for competitive telecommunications market is still evolving and there could be unanticipated changes in the competitive environment for communications in general. For

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example, the FCC is currently considering rules that govern how Internet providers share telephone lines with local telephone companies and compensate local telephone companies. These rules could affect the role that the Internet ultimately plays in the telecommunications market.

The International Settlements Policy governs settlements between top tier U.S. carriers' and foreign carriers' costs of terminating traffic over each other's networks. The FCC recently enacted certain changes in our rules designed to allow U.S. carriers to propose methods to pay for international call termination that deviate from traditional accounting rates and the International Settlement Policy. The FCC has also established lower benchmarks for the rates that U.S. carriers can pay foreign carriers for the termination of international services and these benchmarks may continue to decline. These rule changes have lowered the costs of our top tier competitors to terminate traffic in the United States and are contributing to the substantial downward pricing pressure facing us in the carrier market. And as a result of these substantial downward pricing pressures we have been forced to significantly reduce our termination rates to our customers to match the termination rates offered by our competitors

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in order to be competitive, retain and attract new customers. Additionally, as a result of the reduction in our termination rates to our customers our margins have declined slightly.

Mexico

The Secretaria de Comunicaciones y Transportes or the SCT and COFETEL (Comision Federal de Telecomunicaciones or Federal Telecommunications Commission) have issued ATSI COM a 30-year license granted in June 1998 to install and operate a public network. Under this license, ATSI Comunicaciones S.A de C.V. is required to meet the following:

General requirements

- Maintain approximately 10 million dollars in registered and subscribed capital.
- Install and operate a network in Mexico, the Mexican government will need to approve the operating plan before is implemented, additionally the Mexican government will need to approve any future changes to the operating plan before it can be implemented.
- Continuously develop and conduct training programs for its staff.
- The Concessionaire, at all times needs to have an assigned individual responsible for the technical functions to operate the concession.

Concession services requirements

- The Concessionaire is required to provide continuous and efficient services at all times to its customers.
- The Concessionaire must establish a complaint center and correction facilities center. We are required to report to the Mexican Government on a monthly basis the complaints received and the actions taken to resolve the problems.

Tariff Requirements

- The Concessionaire will only be authorized to invoice its customer's tariffs rates that have been approved by the Mexican government.

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Verification and Information requirements

- The Concessionaire is required to provide audited financial statements on a yearly basis that includes a detailed description of the fixed assets utilized in the network and accounting reporting by region and location of where the services are being provided.
- The Concessionaire is required to provide quarterly reports and updates on the expansion of the network in Mexico and a description of the training programs and research and development programs.
- The Concessionaire is required to provide statistic reports of traffic, switching capacity and other parameters in the network.

Guarantee requirements

The Concessionaire is required to have a bond/ insurance policy for approximately \$500,000 dollars, where the Mexican Federal Treasury Department will be the beneficiary in the event the Mexican government revokes the concession license.

SUPPLIERS

We rely on various suppliers to provide services in connection with our communication services. Satmex and Telecomm provide us with the network required for our network services. We also depend on various Global

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VoIP companies to complete our voice over Internet (VoIP) traffic between US, Mexico, Asia, the Middle East and Latin America. Our critical suppliers include, Bestel, DialMex and Advance Global Communications.

EMPLOYEES

As of July 31, 2004, we had 6 employees, all of whom performed operational, technical and administrative functions. We believe our future success will depend to a large extent on our continued ability to attract and retain highly skilled and qualified employees. We consider our employee relations to be good. None of these aforementioned employees belong to labor unions.

ITEM 2. PROPERTIES.

Our executive office is located at our leased facilities in San Antonio, Texas, consisting of 3,042 square feet. The lease expired September 2004 and we continue to occupy the facility on a month-to-month basis. We pay annual rent of \$41,040. Management believes that our leased facilities are suitable and adequate for their intended use.

ITEM 3. LEGAL PROCEEDINGS.

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

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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. 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 June 2003, we filed a lawsuit in the 150th Judicial District Court, Bexar County, Texas against NIFTI Communications Systems, LLC for breach of contract, fraudulent misrepresentation, and negligent misrepresentation

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relating to a letter of intent for NIFTI to acquire the concession license in Mexico owned by ATSI-COM. NIFTI failed to provide proof of funding to consummate this transaction, lacked interest in the transaction and failed commit to a definite date for the completion of this transaction. As a result this transaction was never consummated and in May 2003 we sold 51% of ATSI-COM to Telemarketing. In July 21, 2003, NIFTI counterclaimed for damages allegedly arising from our failed to provide all the proper documentation related to the concession license liabilities, accounting and requirements by the Mexican Government. During fiscal 2004, the parties reached a settlement and agreed to dismiss both lawsuits without compensation.

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 unpaid wages against us. We are vigorously pursuing this action but cannot predict the outcome of this litigation or the financial impact on our ongoing operations.

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

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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 against ATSI-Texas that was pending in the Bankruptcy of ATSI-Texas and assert its claim for breach of contract against ATSI. The Bankruptcy Court then ordered the lawsuit to be remanded back to state court for hearing. We are a plaintiff in this case and are seeking declaratory relief from the Bexar County court. Currently we cannot predict the outcome of this litigation or the financial impact on our ongoing operations.

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

On May 6, 2004, during the 2004 Annual Stockholders meeting our stockholders approved the following:

The election of Murray R. Nye and Richard C. Benkendorf as Class B members of our Board of Directors, with their terms expiring at the Annual Meeting of Stockholders to be held in 2007. Arthur L. Smith and John R. Fleming continued to serve as directors after the meeting. The results of the vote on this item follow:

	FOR ---	WITHHELD -----
Murray R. Nye	130,283,400	6,886,458
Richard C. Benkendorf	130,642,345	6,527,513

The selection of Malone & Bailey, PLLC as independent public accountants for the fiscal year ending July 31, 2004. The results of the vote on this item follow:

	FOR ---	AGAINST -----	ABSTAIN -----
	136,075,890	864,847	229,121

The reincorporation of the Company in Nevada by merger with and into its wholly owned subsidiary. The results of the vote on this item follow:

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	FOR ---	AGAINST -----	ABSTAIN -----
	78,125,374	1,454,326	226,406

PART II. -----

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock is quoted on the OTC Bulletin Board under the symbol "ATX". From May 9, 2003 through July 31, 2004 our common stock traded in the pink sheets under the symbol "ATSC". Prior to January 15, 2003, our common

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stock was quoted on the AMEX under the symbol "AI". Our Series H Preferred Stock is not traded on any market. The following table sets forth the high and low bid prices for our common stock from August 1, 2002 through January 15, 2003 as reported by AMEX and the high and low bid prices for our common stock from May 9, 2003 through July 31, 2004 as reported by OTC bulletin board. Price quotations on the OTC bulletin board reflect inter-dealer prices, without retail mark-up, markdown or commission, and may not necessarily represent actual transactions. All prices have been adjusted for the 1:100 reverse split effective as of May 24, 2004.

FISCAL 2003	HIGH	LOW
FIRST QUARTER.	\$ 12.00	\$ 3.00
SECOND QUARTER (THROUGH JANUARY 14, 2003).	\$ 16.00	\$ 7.00
THIRD QUARTER (TRADING HALTED)	-----	-----
FOURTH QUARTER	\$ 7.00	\$ 1.00
FISCAL 2004.	HIGH	LOW
FIRST QUARTER.	\$ 2.00	\$ 2.00
SECOND QUARTER	\$ 1.00	\$ 1.00
THIRD QUARTER.	\$ 1.00	\$ 1.00
FOURTH QUARTER	\$ 6.00	\$ 1.25

The following table provides information relating to the grant of stock, options, and warrants pursuant to equity based compensation plans as of July 31, 2004. A description of each equity compensation plan adopted by the Company is included in the Notes to the Consolidated Financial Statements contained in this report.

PLAN CATEGORY	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (a)	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (b)	NUMBER OF SECURITIES REMAINING AVAILABLE FOR FUTURE ISSUANCE UNDER EQUITY COMPENSATION PLANS (EXCLUDING SECURITIES REFLECTED IN COLUMN (a)) (c)
EQUITY COMPENSATION PLANS APPROVED BY SECURITY HOLDERS	42,341	\$ 103.47	20,285
EQUITY COMPENSATION PLANS NOT APPROVED BY SECURITY HOLDERS	3,333,426	\$ 0.25	3,570,715
TOTAL	3,375,767	\$ 1.54	3,591,000

As of July 31, 2004, we had approximately 11,067 common shareholders of record. This amount does not include shares held in street name.

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We have never paid any cash dividends on our common stock. Additionally, the terms of our Series A, Series D, Series E, Series F and Series G Preferred Stock restrict us from paying dividends on our common stock until such time as all outstanding dividends have been fulfilled related to each series of preferred stock. There are presently a total of \$587,467 in unpaid dividends payable on outstanding series of preferred stock. Consequently, we do not anticipate paying any cash dividends in the foreseeable future.

During the year ended July 31, 2004, prior to the reincorporation to the state of Nevada, ATSI issued 400,965 common shares. Of this total, 101,786 shares were issued as a result of the conversions of ATSI's Series F Preferred Stock and accumulated dividends, 297,974 shares were issued as a result of the conversion of ATSI's Series G Preferred Stock and accumulated dividends, and 1,205 shares were issued as a result of the conversion of ATSI's Series A Preferred Stock. All shares were exempt from registration pursuant to Section 3(a)(9) of the Securities Act of 1933 as an exchange for other securities issued by the Company in which no person was paid any consideration.

Also during the year ended July 31, 2004, 165 shares were issued for services rendered to ATSI. These shares were exempt from registration pursuant to Section 4(2) of the Securities Act of 1933 since they were issued in a transaction not involving a public offering.

On May 6, 2004 ATSI's stockholders approved the reincorporation of ATSI in Nevada through the merger of the Company into a wholly owned subsidiary, ATSI Merger Corporation. As a result of the merger, ATSI's stockholders of record as of May 24, 2004 received one (1) share of New ATSI Common Stock and ten (10) shares of New ATSI Series H Convertible Preferred Stock for each 100 shares of Old ATSI Common Stock surrendered. As a result of the merger ATSI exchanged 143,751,710 common shares of the Old ATSI for 1,437,517 shares of the New ATSI Common stock and 14,385,000 shares of the New ATSI Series H Convertible Preferred Stock. These shares were exempt from registration pursuant to Rule 145 and Rule 414 under the Securities Act of 1933 as an exchange for the purpose of changing the domiciling the Company.

ITEM 6. SELECTED FINANCIAL DATA.

The following selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and The Company's Consolidated Financial Statements and the Notes thereto included elsewhere herein.

	Years ended July 31		
	2004	2003	2002
	(In thousands of \$, except per		
CONSOLIDATED STATEMENT OF OPERATIONS			
DATA:			
Operating revenues			
Carrier services	\$ 1,020	\$ 6,532	\$ 41,190
Network services	234	417	1,956
	1,254	6,949	43,146
Cost of services (exclusive of depreciation and amortization)	1,071	6,244	39,077

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Gross Margin	183	705	4,069
Selling, general and administrative expense	7,942	4,803	6,866
Impairment loss	702	418	3,119
Bad debt expense	4	35	388

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	Years ended July 31		
	2004	2003	2002

	(In thousands of \$, except per		
Depreciation and amortization	20	1,229	1,955
Operating loss	(8,485)	(5,780)	(8,259)
Debt forgiveness income	257	-	-
Other income (expense), net	(241)	(2,922)	1,475
Net loss from continuing operations before income tax expense	(8,469)	(8,702)	(6,784)
Income tax expense	-	-	-
Net loss from continuing operations	(8,469)	(8,702)	(6,784)
Net loss from discontinued operations	-	(2,919)	(8,815)
Net (loss)/income from sale of discontinued operations	-	(962)	1,082
Net loss	(8,469)	(12,583)	(14,517)
Less: preferred stock dividends	(306)	(653)	(472)
Net loss applicable to common shareholders	(\$8,775)	(\$13,236)	(\$14,989)
	=====	=====	=====
PER SHARE INFORMATION:			
Net loss-basic and diluted	(\$7.31)	(\$13.01)	(\$17.37)
Weighted average common shares outstanding-basic and diluted	1,199,892	1,017,670	862,750
	-----	-----	-----
CONSOLIDATED BALANCE SHEET DATA:			
Working capital (deficit)	(\$18,948)	(\$19,099)	(\$10,094)
Current assets	149	340	1,184
Total Assets	270	1,103	6,763
Pre-petition liabilities of bankrupt subsidiaries, net of assets	12,354	12,350	-
Current liabilities (Net of pre-petition liabilities)	3,177	3,635	12,528
Current liabilities from discontinued operations	1,152	1,152	2,444
Redeemable preferred shares	2,413	2,302	2,180
Total Liabilities	19,116	19,448	15,389
Total Stockholders' equity (deficit)	(18,846)	(18,345)	(7,112)

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

SPECIAL NOTE: This Annual Report on Form 10-K contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as

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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 this 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.

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The following is a discussion of the consolidated financial condition and results of operations of ATSI Communications, Inc., for the fiscal years ended July 31, 2004, 2003 and 2002. It should be read in conjunction with our Consolidated Financial Statements, the Notes thereto and the other financial information included elsewhere in this annual report on Form 10-K. For purposes of the following discussion, fiscal 2004 or 2004 refers to the year ended July 31, 2004, fiscal 2003 or 2003 refers to the year ended July 31, 2003 and fiscal 2002 or 2002 refers to the year ended July 31, 2002

SOURCES OF REVENUE AND DIRECT COST

Sources of revenue:

Carrier Services: We currently provide transmission and termination

services to U.S. and Foreign telecommunications companies who lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically these telecommunications companies offer their services to the public for local and international long distance services.

Network Services: We offer private communication links for multi-national

and Latin American corporations or enterprise customers who use a high volume of telecommunications services to their U.S. offices or businesses and need greater dependability than is available through public networks. These services include data, voice and fax transmission as well as Internet services between the customers multiple international offices and branches.

Direct Cost:

Carrier Services: We incur transmission and termination charges from our

suppliers and the providers of the infrastructure and network. The cost is based on a per minute rate and volume of minutes transported and terminated through the network. Additionally, we incur installation charges from certain carriers; this cost is passed on to our customers for the connection to our VoIP network.

Network Services: Under the network services, we incur satellite and fiber

optic charges. The satellite and fiber optic charges are incurred as part of the connection links between the customer's different remote locations and sites to transmit data, voice and Internet services.

RESULTS OF OPERATIONS

The following table sets forth certain items included in our results of operations in thousands of dollar amounts and as a percentage of total revenues

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for the years ended July 31, 2004, 2003 and 2002.

	Year ended July		
	2004		2003
	\$	%	\$
Operating revenues			

Services			
Carrier services	\$ 1,020	81%	\$ 6,532
Network services		19%	417
	234		
	-----	-----	-----
Total operating revenues	1,254	100%	6,949
Cost of services (exclusive of depreciation and amortization, shown below)	1,071	85%	6,244
	-----	-----	-----
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Gross Margin	183	15%	705
Selling, general and administrative expense	7,942	633%	4,803
Impairment expense	702	56%	418
Bad debt expense	4	0%	35
Depreciation and amortization	20	2%	1,229
	-----	-----	-----
Operating loss	(8,485)	-677%	(5,780)
Debt forgiveness income	257	20%	-
Other income (expense), net	(241)	-19%	(2,922)
	-----	-----	-----
Net loss from continuing operations before income tax expense	(8,469)	-675%	(8,702)
Income tax expense	-	0%	-
	-----	-----	-----
Net loss from continuing operations	(8,469)	-675%	(8,702)
Net loss from discontinued operations	-	0%	(2,919)
Net loss from sale of discontinued operations	-	0%	(962)
Net loss	(8,469)	-675%	(12,583)

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Less: preferred stock dividends	(306)	-24%	(653)
	-----	-----	-----
Net loss applicable to common shareholders	(\$8,775)	-700%	(\$13,236)
	=====	=====	=====