ATSI COMMUNICATIONS INC/DE
Form 10-K
October 29, 2008

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

FORM 10-K

(mark one)

x **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended July 31, 2008

or

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _______to _________

Commission File Number: 001-15687

ATSI COMMUNICATIONS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Nevada	**74-2849995**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
3201 Cherry Ridge, Building C, Suite 300 **San Antonio, Texas**	**78230**
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Cod: **(210) 614-7240**

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

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

Common Stock, Par Value $0.001 Per Share
(Title of Class)

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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-KSB. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer was $6,723,569 based on the closing price of $0.17 per share on October 27, 2008, as reported on the over-the-counter bulletin board.

There were 39,550,415 shares of issuer's Common Stock outstanding as of October 27, 2008.

TABLE OF CONTENTS

PART I

ITEM I. DESCRIPTION OF BUSINESS.

Overview

We are an international telecommunications carrier that utilizes the Internet to provide cost-efficient and economical international telecommunication services. Our current operations consist primarily of providing digital voice communications over the Internet using Voice-over-Internet-Protocol (“VoIP”). We provide high quality voice and enhanced telecommunication services to carriers, telephony resellers and other VoIP carriers through various agreements with service providers in the United States, Mexico, Asia, the Middle East and Latin America utilizing VoIP technology. Typically, these telecommunications companies offer their services to the public for domestic and international long distance services. In addition, we provide private communications links and VoIP gateway services.

History

ATSI Communications, Inc., a Nevada corporation, was formed in 2004 as the successor to the business originally incorporated in 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 operate through our wholly owned subsidiary, Digerati Networks, Inc. (“Digerati”). Digerati is a premier global VoIP carrier providing international communication services that consist primarily of transporting voice traffic across the world via the Internet. Additionally, we own 49% of ATSI Comunicaciones S.A de C.V. (ATSICOM), 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 in Mexico.

Recent Developments

During the year ended July 31, 2008 (“fiscal 2008”):

- We entered into a $5 Million accounts receivable financing agreement with Wells Fargo Bank. The financing arrangement provides us with access to capital to fund our growth initiatives and allows us to service top tier customers that required extended payment terms.
- Our Board of Directors approved a $1 million stock repurchase plan allowing us to buy back our stock in the open market through December 31, 2008 based on price and market conditions.
- We expanded our IP network capacity with XO Communications. The expansion with XO Communications doubled our fixed capacity and gave us the ability to increase the same fixed capacity by 400% through the on-demand capabilities of XO’s Ethernet services.
- On May 1, 2008, ATSI entered into a “Purchase Agreement” with Fiesta Communications, Inc. Under the agreement ATSI agreed to sell all of the outstanding shares of Telefamilia Communications, Inc. to Fiesta Communications, Inc. for 975,000 shares of common stock in Fiesta Communications and $30,000 in cash.
- We received an opinion from our auditors that does not contain a “going concern” qualification.

Services and Products

We provide two types of services: VoIP Services and Network Services

VoIP Services: We currently provide VoIP communication services to U.S. and foreign telecommunications companies that lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically, these telecommunications companies offer their services to the public for domestic and international long distance services. Revenues from this service accounted for approximately 99% of our total revenue during the year ended July 31, 2008. The percentage of our total volume of carrier services traffic sent by customers can fluctuate dramatically, on an annual, quarterly and daily basis. During fiscal 2008, we entered into various reciprocal agreements with our customers that allow them to transport and terminate traffic over our network and allowed us to transmit and terminate traffic over their networks. These reciprocals agreements with our customers are not for a specific period of time and do not require either party to transmit or terminate a specific volume of minutes on the others network. Under the reciprocal agreements, both parties receive set of rates for services and each party decides the volume of minutes it will send to be processed by the other party. Both parties are free to re-route their traffic away from the other party to a lower priced provider.

Network Services: We provide network links and VoIP gateway services to multi-national and foreign carriers and enterprise customers who use a high volume of telecommunications services to communicate with their U.S. offices or businesses and need greater dependability than is currently available through the foreign telecommunication networks. These services include data, voice and fax transmission between multiple international offices and branches as well as Internet and collocation services in the United States.

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 all circuit 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 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 to its destination and they automatically route packets around blockages, congestion or outages.

Packet switching 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 allow for the integration and transmission of voice, data, and images using the same network equipment.

- **Simplification:** An integrated infrastructure that supports all forms of communication allows more standardization, a smaller equipment complement, and less equipment management.

- **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 over 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, and new software algorithms and improved hardware have substantially reduced delays in packet transmissions and resulted in better sound quality. Nevertheless, certain VoIP routes into countries with limited or poor Internet infrastructure continue to lack the consistent quality required for voice transport and termination.

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 acquire and deploy on their own. As a result, many companies use a network consisting of 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 Systems, Inc. has 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 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 to or 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. Our competitors include major telecommunications carriers in the U.S., foreign telecommunications carriers (which may be owned by foreign governments), and numerous small competitors. 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, coverage, customer service, technical response times, reliability, and network size/capacity. The competitive landscape is rapidly altering the number, identity and competitiveness of the marketplace, and we are unable to determine with certainty the impact of potential consolidation in our industry.

A number of large long distance carriers have introduced services that make Internet telephony or voice services over the Internet available to other carriers. All major telecommunications companies either presently do or could route traffic to destinations worldwide and compete directly with us. 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. In addition, Internet service providers and other 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 migrate into the Internet telephony market as direct competitors.

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.

Our strategy is to take advantage of the increasing demand for international communication services and the global shift from the traditional circuit switched network to the Internet for transporting voice traffic. We target traditional telephone companies migrating towards voice over Internet protocol (“VoIP”) and emerging VoIP service providers seeking reliable and competitively priced worldwide routes. We are also capitalizing on the continued global trend of demonopolization of foreign telecommunications markets. Historically, telecommunication services in most foreign countries have been provided by state-run companies, operating as a legal or *de facto* monopoly. Although these companies historically failed to satisfy the demand for services in their countries, the regulatory scheme effectively precluded competition by foreign carriers. As the demonopolization trend continues in the telecommunications industry throughout the world, many foreign countries are in various stages of migration toward a competitive, multi-carrier market. This has created an opportunity for emerging operators, that typically “leap frog” to the most recent VoIP technology, to enter their respective market.

Our global strategy also benefits from the continued growth in immigration to the United States from foreign countries such as Mexico, Philippines and India. In addition U.S. based corporations expanding globally to decrease labor costs has contributed to the increased demand for global communication services.

The worldwide demand for telecommunications services has been strengthened by:

- An expanding global market for voice communications growing at approximately 10% per year
- A growing demand for VoIP services that was approximately 30% of all international voice traffic in 2007

- Deregulation and demonopolization of government-owned telecommunication companies in foreign countries
- Global proliferation of communications devices such as mobile and VoIP phones
- Growth in ethnic communities in the United States; approximately 90 million people belong to an ethnic minority group
- Increase in global trade and travel
- Declining rates for communication services as a result of increased competition

We operate through our wholly owned subsidiary, Digerati Networks, Inc., a premier global VoIP carrier providing international communication services that consist primarily of transporting voice traffic across the world via the Internet. Digerati owns and operates its own VoIP network in San Antonio, Texas for processing voice communication traffic between the United States and rapidly expanding markets in Asia, Europe, the Middle East, and Latin America. Digerati has placed a strong emphasis on Mexico as it is the top producer of voice traffic with the U.S. and is considered the most lucrative communications corridor in the world in terms of revenue.

Through Digerati, we have established numerous partnerships with foreign carriers and network operators to provide our international voice services. In our VoIP operations, Digerati receives voice traffic from originating carriers who are interconnected to its network via the Internet and routes that traffic over the Internet to local service providers and carriers in the destination countries with whom the Company has agreements or partnerships to manage the completion of the call. Our global VoIP service enables carriers and other communications service providers to outsource international voice and fax traffic.

Our customers, while cost conscious, are increasingly demanding high reliability and quality in service delivery. Sustainability and growth in this segment depends on specific competitive advantages including foreign partnerships or presence of an in-country business infrastructure, network reliability, and favorable termination agreements for voice traffic. We compete with other telecom operators, including dominant providers such as Qwest, IBASIS, and AT&T, for transport and termination of international voice services. We believe that our low cost of operations, international relationships, and cost competitive strategy utilizing VoIP technology provides us with a competitive advantage. Our strengths include our in-depth knowledge of, and relationships within, the telecommunications industry in the United States and select foreign markets.

Our strategy has been successful to date as evidenced by our growth over the last 3 fiscal years. The following table provides the total revenue and minutes for the fiscal years ended July 31, 2006, 2007 and 2008:

Period	Revenue	Minutes
FY-2006	$ 14,695,000	266,366,712
FY-2007	$ 31,692,000	450,557,632
FY-2008	$ 41,961,000	564,064,005

Government Regulation

Our operations are subject to federal, state and foreign laws and regulations. There is significant uncertainty regarding the application of the Communications Act of 1934 and the regulations adopted by the Federal Communications Commission to Internet telephone and there is a risk that either the FCC or Congress will impose common carrier restrictions and other requirements of traditional telecommunications providers to providers of VoIP services.

U.S Federal and State Regulation of Carrier Services

We believe that, under U.S. law, the Internet-related services that we provide constitute information services as opposed to regulated telecommunications services, and, as such, are not currently regulated as telecommunications common carriers by the Federal Communications Commission (FCC) or state agencies charged with regulating telecommunications carriers. Nevertheless, aspects of our operations may be subject to state or federal regulation, including regulations governing universal service funding, disclosure of confidential communications and excise tax issues. We 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 our business, operating results, financial condition and future prospects.

To date, the FCC has declined to classify VoIP providers as telecommunications carriers for regulatory purposes. However, the FCC has ruled that certain traffic carried in part utilizing the Internet protocol format was nonetheless regulated telecommunications for which certain regulatory obligations applied. The FCC has considered whether to impose surcharges or other common carrier regulations upon certain providers of Internet telephony, primarily those which, unlike us, provide Internet telephony services directly to end users. The FCC ruled that interconnected VoIP service providers must make contributions to the Universal Service Fund. Additionally, the FCC has a pending proceeding to further examine the question of whether certain forms of 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 issues as to applicability of access charges and other matters will be considered in that context. Adverse rulings or rulemakings could subject us to licensing requirements and additional fees and subsidies.

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 payment of access charges to local telephone companies. A decision to impose such charges could also have retroactive effect. 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 our 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.

Other regulations affecting the Internet in the United States.

Congress has enacted 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.

Domestic Service Regulation.

We are considered a non-dominant domestic interstate carrier subject to minimal regulation by the FCC. We are not required to obtain FCC authority to initiate or expand our domestic interstate operations, but we are required to obtain FCC approval to transfer control or discontinue service and to file various reports and pay various fees and assessments. Among other things, interstate common carriers must offer service on a nondiscriminatory basis at just and reasonable rates. In addition, as a non-dominant carrier, we are subject to the FCC's complaint jurisdiction.

All interstate telecommunications carriers are required to contribute to the federal universal service programs. The FCC currently is considering revising its universal service funding mechanism. We cannot predict the outcome of these proceedings or their potential effect on us. Although we currently do not provide VoIP services to the end users or consumers, VoIP services that we may provide in the future are not currently subject to direct regulation by the FCC or state regulatory commissions to the extent that they qualify as “enhanced” or “information” services. The FCC defines enhanced services as services that (1) employ computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber’s transmitted information, (2) provide the subscriber additional, different or restructured information, or (3) involve subscriber interaction with stored information. In 1998, in a non-binding report, the FCC observed that “computer-to-computer” VoIP may be appropriately considered to be unregulated but that “phone-to-phone” VoIP may lack the characteristics that would render them unregulated “information” services. In February 2004, the FCC ruled that free computer-to-computer VoIP service is not “telecommunications service” and that it is an interstate “information service.” Although this order clarifies some of the relevant VoIP issues, the FCC has not yet issued a formal decision as to whether other variations of VoIP services should be subject to traditional common carrier telecommunications service regulation, such as access charge obligations. In March 2004, the FCC released a Notice of Proposed Rulemaking (“NPRM”) regarding VoIP service. The NPRM specifically addresses the regulatory classification and jurisdiction of VoIP; the application of access charges; and how to preserve key public policy objectives such as universal service, 911/emergency services, law enforcement surveillance requirements, and the needs of persons with disabilities. In November 2004, the FCC ruled that services provided by a particular VoIP provider are interstate in nature, and not subject to entry regulations of the various state Public Service Commissions. The FCC, however, declined to rule on whether the service is a regulated telecommunications service or an unregulated information service. In addition, in December 2004, the United States Court of Appeals for the 8th Circuit ruled that such VoIP provider’s service is not subject to state regulation. Subsequently, in a series of orders, the FCC has decided to apply universal service, 911/emergency services, law enforcement surveillance requirements, customer privacy requirements, and requirements relating to the provision of services to speech and hearing-impaired persons to providers of “interconnected” VoIP services (i.e., those that are capable of both originating calls from and terminating calls to users of the public switched telephone network), but in each case the FCC has explicitly declined to decide whether such services are “telecommunications” services subject to more comprehensive regulation. Instead, the FCC continues to examine the appropriate regulatory treatment of VoIP on a piecemeal basis. While initial indications from the FCC suggest that regulation of VoIP will be limited in nature, the future regulatory treatment of other variations of VoIP by the FCC and state regulatory bodies continues to be uncertain. Furthermore, Congressional dissatisfaction with the FCC’s treatment of IP telephony could result in legislation requiring the FCC to impose greater or lesser regulation. Changes to, and further clarifications of, the treatment of VoIP services could result in the imposition of burdensome regulation and fees on some of our services and/or increase certain of our operating costs.

International Regulation

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. 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.

The International Settlements Policy governs settlements between U.S. carriers’ and foreign carriers’ costs of terminating traffic over each other’s networks. The FCC recently enacted certain changes in 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 competitors to terminate traffic in the United States and are contributing to the downward pricing pressure facing us in the carrier market.

Other General regulations

Congress has recently enacted 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 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. The Company has no way of knowing whether legislation will pass or what form it might take.

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. The FCC has now granted such in-region long distance authorization to BOCs throughout the nation. Given their extensive resources and established customer bases, the entry of the BOCs into the long distance market, specifically the international market, has created increased competition for us.

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 example, the FCC is currently considering rules that govern how Internet providers 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 these 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 downward pricing pressure facing us in the carrier market.

Concession License

The Secretaría de Comunicaciones y Transportes and Comisión Federal de Telecomunicaciones or Federal Telecommunications Comisión (“COFETEL”) issued ATSICOM a 30-year license in June 1998 to install and operate a public network. Under this license, ATSICOM is required to:

General requirements

· Maintain approximately $10 million in registered and subscribed capital.
· Install and operate a network in Mexico according to an operating plan approved by the Mexican government..
· Continuously develop and conduct training programs for its staff.
· Designate an individual responsible for the technical functions to operate the concession.

Concession services requirements

- Provide continuous and efficient services at all times to its customers.
- Establish a complaint center and correction facilities center and report to the Mexican government on a monthly basis the complaints received and the actions taken to resolve the problems.

Tariff Requirements

- Invoice its customer only tariffs rates that have been approved by the Mexican government.

Verification and Information requirements

- Provide audited financial statements on a yearly basis that include a detailed description of the fixed assets utilized in the network and reporting by region and location of where the services are being provided.
- 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.
- Provide statistical reports of traffic, switching capacity and other parameters in the network.

Guarantee requirements

- Post a bond/insurance policy for approximately $500,000 payable to the Mexican Federal Treasury Department in the event the concession is revoked for failure to perform any of the requirements.

Under this concession, we have the right to terminate voice and data communications in Mexico. The revocation or modification of this concession would not have a material adverse effect on our business.

Customers and Suppliers

We rely on various suppliers to provide services in connection with our communication services. We use various global VoIP companies to complete our voice over Internet (VoIP) traffic between US, Mexico, Asia, the Middle East and Latin America. We are not dependent upon any single supplier.

Employees

As of July 31, 2008, we had twelve 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 1A. RISK FACTORS.

Our business is subject to various operational and financial risks that could have an adverse effect on our financial condition or our results of operations. In addition the general economic risks associated with operation of a small company in a regulated industry dominated by large well-financed competitors, some of the risk factors that may apply specifically to us are set forth below.

Our results of operations fluctuate from period to period. Our revenue and results of operations have fluctuated and will continue to fluctuate from quarter to quarter in the future due to a number of factors over which we have no control, including:

11

- Many of our customers are not obligated to route a minimum amount of traffic over our system and the amount of traffic we handle may decline if our customers elect to route traffic over systems they operate or systems operated by other providers;
- increased competition from other telecommunication service providers or from service companies in related fields that offer telecommunication services may adversely affect the amount we can charge for traffic routed over our system;
- we may be required to reduce our charges for routing traffic to maintain high utilization of our equipment;
- the termination fees, connection fees and other charges from our suppliers;
- fraudulently sent or received traffic for which we are obligated to pay but which we are unable to bill to any customer;
- changes in call volume among the countries to which we complete calls;
- technical difficulties or failures of our network systems or third party delays in expansion or provisioning system components; and
- our ability to manage our traffic on a constant basis so that routes are profitable.

We rely on third parties to provide and maintain the networks over which we transmit traffic. Our business model depends on the availability of the Internet and traditional telephone networks to transmit voice and data. Third parties own and maintain the equipment that translates calls from traditional voice networks to the Internet and vice versa. If the owners of these systems fail to maintain their lines properly, fail to maintain the ability to terminate calls, or otherwise disrupt our ability to provide service to our customers, our ability to complete calls or provide other services could be interrupted.

Our suppliers could increase the cost of services they provide or deny us access to systems that they operate. We maintain relationships with communications service providers in many countries and with other carriers to carry traffic on their systems. There is no assurance that these services will continue to be available to us on acceptable terms, if at all. If we are unable to replace any provider that ceases to provide services to us on acceptable terms, or to identify and develop relationships with new service providers, our ability to provide services in certain countries may be adversely affected.

We are subject to downward pricing pressures and a continuing need to renegotiate overseas rates. As a result of numerous factors, including increased competition and global deregulation of telecommunications services, prices for international long distance calls have been decreasing. This downward trend of prices to end-users has caused us to lower the prices we charge communication service providers for call completion on our network. If this downward pricing pressure continues, we may not be able to offer VoIP services at costs lower than, or competitive with, the traditional voice network services with which we compete. Moreover, in order for us to lower our prices, we have to renegotiate rates with our foreign service providers who complete calls for us. We may not be able to renegotiate these terms favorably enough, or fast enough, to allow us to continue to offer services in a particular country on a cost-effective basis. The continued downward pressure on prices and our inability to renegotiate favorable terms in a particular country could have a material adverse effect on our ability to operate our network.

We are subject to risks relating to operations in foreign countries. Because we provide many of our services internationally, we are subject to additional risks related to providing services into foreign countries. Associated risks include:

- unexpected changes in tariffs, trade barriers and regulatory requirements relating to Internet access or VoIP;
- economic weakness, including inflation, or political instability in particular foreign economies and markets;
- difficulty in collecting accounts receivable;
- tax, consumer protection, telecommunications, and other laws;
- foreign currency fluctuations, which could result in increased operating expenses and reduced revenues; and
- unreliable government power to protect our rights;

12

International governmental regulation and legal uncertainties and other laws could limit our ability to provide our services, make them more expensive, or subject us to legal liability. Many countries currently prohibit or limit competition in the provision of traditional voice telephony services. In some of those countries, licensed telephony carriers as well as government regulators and law enforcement authorities have questioned the legal authority of VoIP services. Our failure to qualify as a properly licensed service provider, or to comply with other foreign laws and regulations, could materially adversely affect our business, financial condition, and results of operations. It is also possible that countries may apply to our activities laws relating to services provided over the Internet, including laws governing:

- user privacy;
- pricing controls and termination costs;
- characteristics and quality of products and services;
- qualification to do business;
- consumer protection;
- cross-border commerce, including laws that would impose tariffs, duties and other import restrictions;
- copyright, trademark and patent infringement; and
- claims based on the nature and content of Internet materials, including defamation, negligence and the failure to meet necessary obligations.

If foreign governments or other bodies begin to impose related restrictions on VoIP or our other services or otherwise enforce other laws against us or our foreign suppliers, such actions could have a material adverse effect on our operations.

If we are not able to keep up with rapid technological change in a cost-effective way, the relative quality of our services could suffer. The technology upon which our services depend is changing rapidly. Significant technological changes could render the hardware and software that we use obsolete, and competitors may begin to offer new services that we are unable to offer. If we are unable to respond successfully to these developments or do not respond in a cost-effective way, we may not be able to offer competitive services and our business results may suffer.

We may not be able to expand and upgrade our network adequately and cost-effectively to accommodate any future growth. Our VoIP business requires that we handle a large number of international calls simultaneously. As we expand our operations, we expect to handle significantly more calls. If we do not expand and upgrade our hardware and software quickly enough, we will not have sufficient capacity to handle the increased traffic and growth in our operating performance would suffer as a result. Even with such expansion, we may be unable to manage new deployments or utilize them in a cost-effective manner. In addition to lost growth opportunities, any such failure could adversely affect customer confidence in our network and services.

Single points of failure on our network may make our business vulnerable. We operate one network control center in San Antonio, Texas. We have not yet designed a redundant system, provided for excess capacity, or taken other precautions against platform and network failures as well as facility failures relating to power, air conditioning, destruction, or theft. We are vulnerable to a network failure that may prohibit us from offering services.

We depend on our current personnel and may have difficulty attracting and retaining the skilled employees we need to execute our business plan. Our future success will depend, in large part, on the continued service of our key management and technical personnel. If any of these individuals or others we employ are unable or unwilling to continue in their present positions, our business, financial condition and results of operations could suffer.

If the Internet infrastructure is not adequately maintained, we may be unable to maintain the quality of our services and provide them in a timely and consistent manner. Our future success will depend upon the maintenance of the Internet infrastructure, including a reliable network backbone with the necessary speed, data capacity and security for providing reliability and timely Internet access and services. To the extent that the Internet continues to experience increased numbers of users, frequency of use or bandwidth requirements, the Internet may become congested and be unable to support the demands placed on it and its performance or reliability may decline thereby impairing our ability to complete calls and provide other services using the Internet at consistently high quality. The Internet has experienced a variety of outages and other delays as a result of failures of portions of its infrastructure or otherwise. Future outages or delays could adversely affect our ability to complete calls and provide other services. Moreover, critical issues concerning the commercial use of the Internet, including security, cost, ease of use and access, intellectual property ownership and other legal liability issues, remain unresolved and could materially and adversely affect both the growth of Internet usage generally and our business in particular. Finally, important opportunities to increase traffic on our network will not be realized if the underlying infrastructure of the Internet does not continue to be expanded to more locations worldwide.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

Not Applicable

ITEM 2. PROPERTIES.

Our executive office is located at 3201 Cherry Ridge, Building C, Suite 300, San Antonio, Texas, in leased space consisting of 3,618 square feet. The lease for this facility will expire on November 15, 2011. We pay annual rent of $49,419. We believe that our leased facilities are suitable and adequate for their intended use.

ITEM 3. LEGAL PROCEEDINGS.

In August 2007, ATSI reached a confidential settlement agreement with the holders of the 1,170 shares of Series E Preferred Stock. Under the confidential settlement agreement ATSI paid $175,000 to the Series E Preferred Stock shareholders and the 1,170 shares of Series E Preferred Stock have been cancelled.

In June 2007, ATSI initiated a declaratory judgment action in the United States District Court for the Western District of Texas against The Shaar Fund, Ltd., holder of series 6% Series D Cumulative Convertible Preferred Stock, to declare that any right to convert or redeem the shares of the Series D Preferred Stock was barred by the applicable statute of limitations (the “Texas Case”). On August 2, 2007, The Shaar Fund Ltd. filed a separate suit against ATSI in the United States District Court for the Southern District Court of New York seeking damages and equitable relief for alleged defaults under the Securities Purchase Agreement dated February 18, 2000 under which it acquired the Series D Preferred Stock (the “New York Case”). The claims of the parties were consolidated in the New York Case by agreement. In December 2007, the parties entered into a settlement agreement in which they released each other from all claims relating to the Series D Preferred Stock. Under the terms of the settlement agreement, The Shaar Fund, Ltd. agreed to surrender all outstanding shares of Series D Preferred Stock. Additionally, The Shaar Fund waived its claims for alleged accrued and unpaid dividends thereon in the amount of approximately $340,000. The cancellation of the preferred stock was effective as of October 24, 2007. ATSI agreed to pay to The Shaar Fund, Ltd. the sum of $75,000 in cash in December 2007 and issue to The Shaar Fund a promissory note in the original principal amount of $450,000, bearing interest at the rate of 7.5% per annum and payable in 16 quarterly payments over 48 months. If paid in full within the first 18 months, ATSI will be entitled to a discount of 22.5% on the then outstanding principal balance.

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

None

PART II

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

Market for Common Equity

Our common stock is quoted on the OTC Bulletin Board under the symbol "ATSX". The following table sets forth the high and low bid prices for our common stock for the two most recently completed fiscal years, as reported by Bloomberg, LP. 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.

Fiscal 2007	Low	High
First Quarter	$ 0.19	$ 0.34
Second Quarter	$ 0.22	$ 0.36
Third Quarter	$ 0.19	$ 0.34
Fourth Quarter	$ 0.23	$ 0.24

Fiscal 2008	Low	High
First Quarter	$ 0.20	$ 0.30
Second Quarter	$ 0.17	$ 0.28
Third Quarter	$ 0.15	$ 0.23
Fourth Quarter	$ 0.16	$ 0.24

Holders

As of July 31, 2008 we had approximately 8,206 common stockholders of record.

Dividends

We have not paid cash dividends on our common stock and we do not anticipate paying a dividend in the future.

Equity Compensation Plans

The following table provides information regarding securities that have been or are authorized to be issued under our equity compensation plans as of July 31, 2008:

	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity Compensation plans approved by security holders	-0-	N/A	-0-
Equity Compensation Plans not approved by security holders	8,239,000	$ .17	9,261,000
Total	8,239,000	$ .17	9,261,000

The material features of each equity compensation plan are described in Note 2 of the Notes to the Financial Statements.

Sales of Unregistered Securities

On June 1, 2008, the Company issued 391,348 shares of its common stock to the holders of its debentures dated June 1, 2006. The shares were exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, and were restricted from further transfer without registration.

ITEM 6. SELECTED FINANCIAL DATA.

Not Applicable

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

SPECIAL NOTE: This Annual Report on Form 10-KSB 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 listed in Item 1A of this Annual Report on Form 10-K .

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, 2008 and 2007. 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 2008 or 2008 refers to the year ended July 31, 2008 and fiscal 2007 or 2007 refers to the year ended July 31, 2007.

Sources of revenue and direct cost

Sources of revenue:

VoIP Services: We currently provide VoIP communication services to U.S. and foreign telecommunications companies that lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically, these telecommunications companies offer their services to the public for domestic and international long distance services

Network Services: We provide private communication links and VoIP gateway services to multi-national and foreign carriers and enterprise customers who require a high volume of telecommunications services to communicate with their U.S. offices or businesses and need greater dependability than is currently available through the foreign telecommunication networks. These services include data, voice and fax transmission between multiple international offices and branches as well as Internet and co-location services in the United States.

Direct Costs:

VoIP Services: We incur transmission and termination charges from our suppliers and the providers of the infrastructure and network. The cost is based on rate per minute, volume of minutes transported and terminated through the network. Additionally, we incur fixed Internet bandwidth charges and per minute billing charges. In some cases we incur installation charges from certain carriers. These installation costs are passed on to our customers for the connection to our VoIP network.

Network Services: Under the network services, we incur bandwidth and co-location charges. The bandwidth 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. We also incur co-location charges that are passed through to our customers.

Results of Operations

The following table sets forth certain items included in our results of operations in thousands of dollars amounts and variances between periods for the years ended July 31, 2008 and 2007.

	Years ended July 31,			
	2008	2007	Variances	%
TOTAL OPERATING REVENUES	$ 41,961	$ 31,692	$ 10,269	32%
COST OF SERVICES (exclusive of depreciation and amortization, shown below)	38,884	29,521	9,363	32%
GROSS PROFITS	3,077	2,171	906	42%
Selling, general and administrative expense (exclusive of legal and professional fees)	2,400	1,625	775	48%
Legal and professional fees	352	258	94	36%
Bad debt expense	(27)	98	(125)	-128%
Depreciation and amortization expense	160	99	61	62%
OPERATING INCOME (LOSS)	192	91	101	111%
OTHER INCOME (EXPENSE):				
Debt forgiveness income	41	-	41	100%
Minority Interest	(16)	-	(16)	-100%
Interest income (expense)	(105)	(348)	243	70%
Total other income (expense), net	(80)	(348)	268	77%
NET INCOME (LOSS)	112	(257)	369	144%
LESS: PREFERRED DIVIDEND	(12)	(56)	44	79%
ADD: REVERSAL OF PREVIOUSLY RECORDED PREFERRED DIVIDEND	340	828	(488)	-59%
NET INCOME TO COMMON STOCKHOLDERS	$ 440	$ 515	$ (75)	-15%

Year Ended July 31, 2008 Compared to Year ended July 31, 2007

Operating Revenues. Consolidated operating revenues increased by $10,269,000, or 32%, between periods from $31,692,000 for the year ended July 31, 2007 to $41,961,000 for the year ended July 31, 2008. The increase in VoIP services revenue is attributed to the increase in carrier minutes. Our carrier services minutes increased by 25% from approximately 450,557,632 minutes of voice traffic during the year ended July 31, 2007 to approximately 564,064,005 minutes of voice traffic during the year ended July 31, 2008. The increase in revenue and VoIP minutes is attributable primarily to the upgrade to our NexPoint® Soft Switch, which allows us to offer high quality and dependable VoIP services, serve more customers and efficiently process greater volume of data records and calls.

C*ost of Services (Exclusive of depreciation and amortization).* The consolidated cost of services increased by $9,363,000, or 32%, from the year ended July 31, 2007 to the year ended July 31, 2008. The increase in cost of services is a direct result of the increase in voice traffic, which required an increase in service fees paid to our vendors for transmission services. Consolidated cost of services, as a percentage of revenue, was comparable between periods at 93%. Despite the increase in cost of services (exclusive of depreciation and amortization), gross profits increased from $2,171,000 during the year ended July 31, 2007 to $3,077,000 during the year ended July 31, 2008 as a result of the increase in revenues.

Selling, General and Administrative (SG&A) Expenses (exclusive of legal and professional fees). SG&A expenses increased by $775,000, or 48%, from the year ended July 31, 2007 to the year ended July 31, 2008. The increase is primarily attributable to an increase in salaries and wages of approximately $487,000 as a result of the hiring of four new employees and bonuses paid to officers. Non-cash compensation expense to employees and warrant expense increased by $268,000 from the year ended July 31, 2007 to the year ended July 31, 2008. The increase is attributed to the recognition during the year ended July 31, 2008 of approximately $695,000 of non-cash compensation expense associated with the stock options issued to employees and directors recorded under the adopted of FAS-123R, Modified Stock based Compensation. We incurred approximately $473,000 on non-cash compensation expense during the year ended July 31, 2007.

Legal and Professional Fees. Legal and professional fees increased by $94,000, or 36%, from the year ended July 31, 2007 to the year ended July 31, 2008. The increase is primarily attributable to $57,000 in legal fees incurred during the year ended July 31, 2008 in connection with the litigation and settlement of a dispute between ATSI and the holders of the 6% Series D Cumulative Convertible Preferred Stock. We did not incur similar expenses during the year ended July 31, 2007.

Bad debt expense. Bad debt expense decreased by $125,000, or 128%, from the year ended July 31, 2007 to the year ended July 31, 2008. During the year ended July 31, 2007 we recognized $98,000 in bad debt expense associated with uncollectible accounts. During the year ended July 31, 2008 we recognized an adjustment in bad debt of $27,000 as a result of changes in the VoIP market and historical uncollectible accounts, thus decreasing bad debt expense between periods.

Depreciation and amortization. Depreciation and amortization increased by $61,000, or 62%, from the year ended July 31, 2007 to the year ended July 31, 2008. The increase is attributed to the amortization during fiscal 2008 of the new computers and the upgrade to our Nextone soft-switch, which was acquired during the Fiscal 2008.

Operating income (loss). Our operating income improved by $101,000, or 111%, from the year ended July 31, 2007 to the year ended July 31, 2008. The improvement in operating income is primarily attributable to an increase in gross profits between periods, which was partially offset by increases in salaries and wages, non-cash compensation expenses and legal fees.

Other Income (expense). Other income (expense) during fiscal 2008 included debt forgiveness income of $41,000, which was attributed to the restructuring of the note payable and settlement with Alfonso Torres and the recognition of $16,000 of a minority interest in the loss of our ownership in Fiesta Communications. Neither of these categories of other income was recognized in fiscal 2007. Interest expense in fiscal 2008 decreased by $243,000, or 70%, from $348,000 for the year ended July 31, 2007 to $105,000 for the year ended July 31, 2008. The decrease can be attributed to the payoff of various promissory notes during fiscal 2008; and the related lower average balance of notes payable during the year ended July 31, 2008. Interest expense for the year ended July 31, 2007 also included $143,723 attributed to the beneficial conversion feature associated with the conversion of various notes payable and accrued interest and the amortization of approximately $93,000 in deferred financing fees as part of a private placement common stock financing.

Net income (loss). Net income (loss) improved by $369,000 from the year ended July 31, 2008 compared to the year ended July 31, 2007. The improvement in net income (loss) is attributed to the increase between periods in gross profit profits, the reduction in interest expense. These improvements were offset by the increase of approximately $775,000 in selling, general and administrative expenses.

Preferred stock dividends. Preferred stock dividends decreased by $44,000, or 79%, between periods, from $56,000 for the year ended July 31, 2007 to $12,000 during the year ended July 31, 2008. The decrease in preferred dividends between periods is mainly attributed to a decrease in dividends associated with Series A Convertible Preferred Stock, Series H Convertible Preferred Stock and Series D Convertible Preferred Stock. As of July 31, 2008 all Convertible Preferred Stock has been converted or redeemed to common stock.

Reversal of previously recorded preferred stock dividends. During the year ended July 31, 2008, we recognized a reversal of previously recorded dividend expense of $340,000. This reversal occurred as result of the settlement agreement reached between ATSI and The Shaar Fund. As a result of the settlement, The Shaar Fund agreed to surrender 742 shares of ATSI's 6% Series D Cumulative Convertible Preferred Stock and forgive accrued dividends of approximately $340,000 as of October 24, 2007. During the year ended July 31, 2007 we recognized a reversal of previously recorded dividend expense of $828,000. This reversal occurred as result of the conversion into common stock of 2,750 shares of Series A Convertible Preferred Stock and 11,802,381 shares of Series H Convertible

Preferred Stock.

Net income applicable to common stockholders. Net income applicable to common stockholders decreased by $75,000, or 15%, from the year ended July 31, 2007 to the year ended July 31, 2008 even though we recognized an increase in net income of $369,000. The decrease in net income applicable to common stockholders is attributed to the reversal of previously recorded preferred stock dividends of $828,000 recognized during the year ended July 31, 2007 compared to a reversal of previously recorded preferred stock dividend in the amount of $340,000 during the year ended July 31, 2008.

Liquidity and Capital Resources

Cash Position: We had a cash balance of $1,338,000 as of July 31, 2008. Net cash provided by operating activities during the year ended July 31, 2008 was approximately $965,000. Net cash provided by operating activities consisted primarily of operating revenues of $41,961,000 after deduction of cash expenses incurred in cost of services and selling, general and administrative expenses. Investing activities during the year ended July 31, 2008 consumed $163,000 as a result of advances of $100,000 to NetSapiens, notes receivables of $25,000 with Fiesta Communications, a related party, investments in certificates of deposit of $13,000 and purchases of $25,000 of equipment. Financing activities during the year ended July 31, 2008 consumed $514,000 in cash. This cash was primarily consumed by debt principal payments of $251,000 associated with various notes payable, acquisition of the Redeemable Preferred stock Series D&E of $250,000, acquisition of our common stock of $10,000 and principal payments of $3,000 associated with a capital lease obligation. Overall, our net operating, investing and financing activities during the year ended July 31, 2008 resulted in an increase of $288,000 in our available cash.

We are currently utilizing the factoring agreement with Wells Fargo Bank as necessary to provide cash for operations. Under the agreement we are able to factor up to $5,000,000 of our monthly accounts receivable. On average, we are factoring account receivables of $875,000 per month. As of July 31, 2008 we had $18,000 of outstanding receivables under the Wells Fargo Factoring agreement. We believe that the improvement in our cash flows from operations as a result of our growth will facilitate our ability to obtain debt and/or equity funding from institutional investors. Subsequent to our fiscal year end, we entered into various promissory notes payable for $850,000; we believe that this financing will allow us to support our growth during the following fiscal year.

Our current cash expenses are expected to be approximately $150,000 per month, including wages, rent, utilities and corporate professional fees. We are currently generating sufficient cash from operations to cover all monthly cash expenses. We anticipate that the July 31, 2008 balance of $1,338,000 in cash combined with expected net cash flow generated from operations, cash received from the subsequent financing of $850,000 and the factoring agreement with Wells Fargo Bank, will be sufficient to fund our operations, capital asset expenditures and potential common stock repurchases for the next twelve months.

Our working capital was $427,000 as of July 31, 2008. This represents an improvement of approximately $851,000 from our working capital deficit at July 31, 2007. The improvement can primarily be attributed to the reversal of previously recorded preferred stock dividends of $340,000 as a result of the settlement with The Shaar Fund and the net operating income generated from operations during Fiscal 2008.

Critical Accounting Policies

Revenue Recognition. We derive our revenue from VoIP Services and Network Services. Revenue is recognized when persuasive evidence of an arrangement exists, service or network capacity has been provided, the price is fixed or determinable, collectibility is reasonably assured and there are no significant obligations remaining.

We record and report our revenue on the gross amount billed to our customers in accordance with the following “gross indicators” discussed in EITF 99-19:

- ATSI is the primary obligor in its arrangements,
- ATSI has latitude in establishing pricing,
- ATSI changes the product or performs part of the service and is involved in the determination of the product or service specifications,
- ATSI has discretion in supplier selection; and
- ATSI assumes credit risk for the amount billed to the customer

We recognize revenue from VoIP Services in the period the service is provided, net of revenue reserves for potential billing credits. Such disputes can result from disagreements with customers regarding the duration, destination or rates charged for each call. ATSI recognizes network services revenue during the period the service is provided.

Direct Cost of Revenue. We incur termination charges in connection with providing VoIP services, installation charges connection to the VoIP network of our carriers, and Internet, co-location and fiber optic charges in connection with providing network services. Termination charges, connection charges and other direct costs of revenue are recognized in the period incurred.

Stock-based Compensation. We record compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R,*"Share-Based Payment",* as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to February 1, 2006, ATSI had accounted for stock options according to the provisions of Accounting Principles Board Opinion No. 25, *"Accounting for Stock Issued to Employees"*, and related interpretations, and therefore no related compensation expense was recorded for awards granted with no intrinsic value. ATSI estimates the fair market value of its stock options using the Black Scholes pricing model. ATSI uses the following key assumptions in determining the fair market value of its options:

	For the Years Ended July 31,	
	2008	2007
Expected dividends yield	0.00%	0.00%
Expected stock price volatility	75% - 105%	80%
Risk-free interest rate	3.15% - 4.65%	4.51%
Expected life of options	4 - 6 years	7 years

Derivative financial instruments. We do not use derivative instruments to hedge exposures to cash flow, market, or foreign currency risks. We evaluate the application of SFAS 133 and EITF 00-19 for all of its convertible financial instruments and freestanding warrants.

For derivative financial instruments that meet the definition of liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported as charges or credits to income. For option-based derivative financial instruments, ATSI uses the Black-Scholes option-pricing model to value the derivative instruments. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is re-assessed at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

ITEM 7A. QUANTITIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the board of directors and Stockholders
ATSI Communications, Inc.
San Antonio, Texas

We have audited the accompanying consolidated balance sheets of ATSI Communications, Inc. and subsidiaries as of July 31, 2008 and 2007, and the related consolidated statements of operations, stockholders’ equity (deficit) and cash flows for each of the two years then ended. These consolidated financial statements are the responsibility of ATSI’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. ATSI is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ATSI’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ATSI as of July 31, 2008 and 2007 and the consolidated results of their operations and its cash flows for each of the two years then ended in conformity with accounting principles generally accepted in the United States of America.

MALONE & BAILEY, PC
www.malone-bailey.com
Houston, Texas

October 23, 2008

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ATSI COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	July 31,	July 31,