ATSI COMMUNICATIONS INC/DE
Form 10QSB/A
April 14, 2006

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

FORM 10-QSB/A

(**Mark One**)
x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934** For the quarterly period ended April 30, 2005

o **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 001-15687

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

Nevada	**74-2849995**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

8600 Wurzbach, Suite 700W
San Antonio, Texas 78240
(Address of Principal Executive Offices)

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

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

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

Class	**Outstanding As Of June 14, 2005**
Common Stock, $.001 par	9,514,190

Transitional Small Business Disclosure Format: Yes o No x

ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-QSB/A
FOR THE QUARTER ENDED APRIL 30, 2005

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Statement Regarding This Amendment

This amendment to the Form 10-QSB for the period ended April 30, 2005, as previously filed on June 14, 2005 includes restated financial statements to properly reflect the warrants issued to consultants, the conversion features of the Note Payable to Franklin Cardwell & Jones and the accounting of the 9% Convertible Debentures and associated warrants as derivative instrument liabilities instead of as equity. Additionally, the embedded conversion features of the Note Payable to Franklin Cardwell and Jones and the embedded conversion features of the 9% Convertible Debentures and warrants related to the debt, have been bifurcated from the debt and accounted for separately as derivative instrument liabilities. We have added footnote 6 further explaining the derivative instrument liabilities and provided information on subsequent changes. In addition, we have modified the estimated volatility used in the Black-Scholes option pricing model used to value the warrants issued to consultants, the warrants issued to the 9% Convertible Debentures holders and the conversion features embedded in our Note Payable to Franklin, Cardwell & Jones and 9% Convertible Debentures.

We are required to record the fair value of the conversion features and the warrants on our balance sheet at fair value with changes in the values of these derivatives reflected in the consolidated statement of operations as “Gain (loss) on embedded derivative liability.” The effect of the (non-cash) changes related to accounting separately for these derivative instrument liabilities and modifying the estimated volatility; on our consolidated statement of operations for the quarter and nine months ended April 30, 2005, was a increase in our net income attributable to common shareholders of $347,000 and $72,000, respectively. The effect on our consolidated balance sheet as of April 30, 2005 was a net decrease in stockholders equity of $398,000.

We have also recorded an additional liability and a corresponding adjustment of $404,774 to additional paid in capital to present our Series E Convertible Preferred Stock at its full redemption value of $1,463,000.

In all other material respects, this Amended Quarterly Report on Form 10-QSB is unchanged from the Quarterly Report on Form 10-QSB previously filed by the Company on June 14, 2005. This amendment should also be read in conjunction with our amended Annual Report on Form 10-KSB/A for the fiscal year ended July 31, 2005 and our Quarterly Reports on Form 10-QSB/A for the quarters ended October 31, 2005 and January 31, 2006, together with any subsequent amendments thereof.

PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

		April 30, 2005 (unaudited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$	63
Accounts receivable		145
Prepaid & other current assets		44
Total current assets		252
PROPERTY AND EQUIPMENT		228
Less - accumulated depreciation		(65)
Net property and equipment		163
OTHER ASSETS		
Intangible assets, net of accumulated amortization of $24		8
OTHER ASSETS, net		
Note receivable		-
Investment in joint venture		-
Total assets	$	423
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES:		
Accounts payable	$	506
Accrued liabilities		558
Current portion of obligation under capital leases		3
Notes payable, related party		24
Notes payable, Franklin, Cardwell & Jones		77
Convertible debentures		234
Series D Cumulative Preferred Stock, 3,000 shares authorized, 742 shares issued and outstanding		1,171
Series E Cumulative Preferred Stock, 10,000 shares authorized, 1,170 shares issued and outstanding		1,732
Derivative financial instrument liabilities		23
Liabilities from discontinued operations, net of assets		1,152
Total current liabilities		5,480
LONG-TERM LIABILITIES:		
Notes payable		500
Obligation under capital leases, less current portion		9
Other		8
Total long-term liabilities		517

STOCKHOLDERS' DEFICIT:		
Series A Cumulative Convertible Preferred Stock, 50,000 shares authorized, 3,750 issued and outstanding		-
Series H Convertible Preferred Stock, 16,000,000 shares authorized, 13,912,572 issued and outstanding		14
Common stock, $0.001, 150,000,000 shares authorized, 9,514,190 issued and outstanding		10
Additional paid in capital		66,771
Accumulated deficit		(72,871)
Other comprehensive income		502
Total stockholders' deficit		(5,574)
Total liabilities and stockholders' deficit	$	423

See accompanying summary of accounting policies and notes to financial statements.

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ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (RESTATED)
(in thousands, except share information)
(unaudited)

	Three months ended April 30, 2005	Three months ended April 30, 2004	Nine months ended April 30, 2005	Nine months ended April 30, 2004
OPERATING REVENUES:				
Services				
Carrier services	$ 1,727	$ 484	$ 3,943	$ 726
Network services	70	77	217	161
Total operating revenues	1,797	561	4,160	887
OPERATING EXPENSES:				
Cost of services (exclusive of depreciation and amortization, shown below)	1,660	501	3,854	768
Selling, general and administrative expense (exclusive of legal and professional fees, non cash stock compensation to employees and warrants for services, shown below)	139	164	314	413
Legal and professional fees	60	52	365	201
Non-cash issuance of common stock and warrants for services	-	-	533	30
Non-cash stock-based compensation, employees	-	-	474	-
Bad debt expense	-	-	4	4
Depreciation and amortization	32	6	79	6
Total operating expenses	1,891	723	5,623	1,422
OPERATING INCOME (LOSS)	(94)	(162)	(1,463)	(535)
OTHER INCOME (EXPENSE):				
Other income (expense)	9	-	13	1
Debt forgiveness income	-	-	460	-
Gain on disposal of investment	12,104	-	12,104	-
Gain from sale of assets	-	25	-	25
Loss on an unconsolidated affiliate	-	(25)	-	(85)
Gain (loss) on derivative instrument liabilities	135	-	(317)	-
Interest income (expense)	11	(32)	(68)	(90)

Total other income (expense)		12,259	(32)		12,192	(149)
NET INCOME (LOSS)		12,165	(194)		10,729	(684)
LESS: PREFERRED DIVIDENDS		(38)	(82)		(114)	(268)
NET INCOME (LOSS) TO COMMON STOCKHOLDERS	$	12,127	($276)	$	10,615	($952)
BASIC AND DILUTED INCOME (LOSS) PER SHARE	$	1.39	($0.23)	$	1.69	($0.88)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING		8,719,307	1,174,662		6,272,332	1,081,806

See accompanying summary of accounting policies and notes to financial statements.

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

	Three months ended April 30, 2005	Three months ended April 30, 2004	Nine months ended April 30, 2005	Nine months ended April 30, 2004
Net income (loss) to common stockholders	$ 12,127	($276)	$ 10,615	($952)
Foreign currency translation adjustment	-	-	-	-
Comprehensive income (loss) to common stockholders	$ 12,127	($276)	$ 10,615	($952)

See accompanying summary of accounting policies and notes to financial statements.

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ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (RESTATED)
(in thousands)
(unaudited)

	Nine months ended April 30, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	$ 10,729	($684)
Adjustments to net income (loss):		
Gain on disposal of investment	(12,104)	-
Debt forgiveness income	(460)	-
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	79	6
Loss on an unconsolidated affiliate	-	85
Non-cash issuance of stock grants and options, employees	474	-
Non-cash issuance of common stock and warrants for services	533	32
Provision for losses on accounts receivable	4	4
Loss on derivative instrument liability	317	-
Changes in operating assets and liabilities:		
Increase in		
Accounts receivable	(120)	(11)
Prepaid expenses and other	(18)	(21)
Increase in		
Accounts payable	62	116
Accrued liabilities	77	86
Net cash used in operating activities	(427)	(387)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property & equipment	(8)	-
Cash proceeds from sale of ATSICOM	-	187
Investment in joint venture in ATSICOM	-	(47)
Acquisition of business	(8)	-
Net cash (used in) provided by investing activities	(16)	140
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from notes payable	810	215
Payments on notes payable	(810)	(6)
Proceeds from the exercise of warrants	414	-
Principal payments on capital lease obligation	(2)	-
Net cash provided by financing activities	412	209
DECREASE IN CASH	(31)	(38)
CASH AND CASH EQUIVALENTS, beginning of period	94	140
CASH AND CASH EQUIVALENTS, end of period	$ 63	$ 102

NON-CASH TRANSACTIONS				
Issuance of common stock for conversion of debt	$	829	$	-
Issuance of common stock for purchase of intangible assets		24		-
Fair value of the derivative instrument		26		6,569
Change in derivative liabilities on warrants exercised		1,668		1,668

See accompanying summary of accounting policies and notes to financial statements.

ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited interim financial statements of ATSI Communications, Inc. have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the Securities and Exchange Commission ("SEC"), and should be read in conjunction with the audited financial statements and notes thereto of ATSI Communications Inc. filed with the SEC on Form 10-K for the year ended July 31, 2004. In the opinion of management, these interim financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year. The Company amended this quarterly report to reflect a net loss for the period ended April 30, 2005, related to embedded derivatives in certain securities. See Note 6 to the Financial Statements.

Derivative financial instruments
The Company does not use derivative instruments to hedge exposures to cash flow, market, or foreign currency risks. Derivative financial instruments are initially measured at their fair value. For derivative financial instruments that are accounted for as 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.

NOTE 2 - STOCK BASED COMPENSATION

ATSI accounts for its employee stock-based compensation plans under Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees. ATSI granted 2,104,001 options to purchase common stock to employees in the nine months ending April 30, 2005. Sixty percent of these options vest immediately and the remaining balance vest over three years. ATSI recorded compensation expense of $42,000 under the intrinsic value method during the nine months ended April 30, 2005.

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

	Three months ended April 30,		Nine months ended April 30,	
	2005	2004	2005	2004
		(Restated)		
Net income (loss) to common shareholders, as reported	$ 12,127,000	($276,000)	$ 10,615,000	($952,000)
Add: stock based compensation determined under-the intrinsic value-based method	-	-	42,080	

Less:	stock based compensation determined under-the fair value-based method		-			(1,000,493)	
Pro forma net income (loss)		$	12,127,000	($276,000)	$	9,656,587	($952,000)
Basic and diluted net income (loss) per share							
As reported		$	1.39	($0.23)	$	1.69	($0.88)
Pro forma		$	1.39	($0.23)	$	1.54	($0.88)

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The fair value of each option and warrant granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Nine Months Ended April 30,	
	2005	2004
Expected dividends yield	0.00%	0.00%
Expected stock price volatility	126%	248%
Risk-free interest rate	2%	2%
Expected life of options	1-3 years	1-3 years

Additionally, during the nine months ended April 30, 2005, ATSI issued 900,000 shares to its employees and 333,170 shares to consultants with a market value of $432,000 and $132,240, respectively.

NOTE 3 - GAIN ON DISPOSAL OF INVESTMENT

During the quarter ending April 30, 2005 ATSI recognized a gain on disposal of investment of approximately $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries were ATSI's primary operating companies and they have ceased operations. These bankruptcies did not include ATSI Communications, Inc., the reporting entity. On July 2, 2003, the U.S. Bankruptcy Court handling the Chapter 7 cases for ATSI Texas and TeleSpan approved the sale of two of their subsidiaries, ATSI de Mexico S.A de C.V. (ATSI Mexico) and Servicios de Infraestructura S.A de C.V. (SINFRA), to Latingroup Ventures, L.L.C. (LGV), a non-related party. Under the purchase agreement LGV acquired all the communication center assets and assumed all related liabilities. Additionally, under the agreement, LGV acquired the *"Comercializadora"* License owned by ATSI Mexico and the Teleport and Satellite Network License and the 20-year Packet Switching Network license owned by SINFRA. The Chapter 7 Bankruptcy Trustee received $17,500, which represents all the proceeds from the sale of these entities. The Chapter 7 Bankruptcy Trustee has managed the designation of these funds for the benefit of the creditors of ATSI Texas and TeleSpan. Upon liquidation of all the assets owned by ATSI Texas and TeleSpan, the Chapter 7 Trustee will manage all claims with the related creditors. ATSI did not receive any creditor objections to these court proceedings.

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

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

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NOTE 4 - NOTES PAYABLE

During the nine months of fiscal 2005, ATSI borrowed a total of $414,000 from Recap Marketing & Consulting, LLP and entered into a series of unsecured convertible promissory notes bearing interest at the rate of 12% per annum, with the following maturity dates:

Origination Date		Amount	Maturity Date
August 23, 2004	$	25,000	August 23, 2005
August 30, 2004		25,000	August 30, 2005
September 15, 2004		25,000	September 15, 2005
September 20, 2004		150,000	September 20, 2005
October 8, 2004		25,000	October 8, 2005
October 12, 2004		25,000	October 12, 2005
October 15, 2004		10,000	October 15, 2005
October 24, 2004		15,000	October 24, 2005
November 5, 2004		25,000	November 5, 2005
November 15, 2004		15,000	November 15, 2005
December 1, 2004		10,000	December 1, 2005
December 21, 2004		10,000	December 21, 2005
January 4, 2005		10,000	January 4, 2006
February 2, 2005		10,000	February 2, 2006
February 3, 2005		4,000	February 3, 2006
February 17, 2005		10,000	February 3, 2006
March 22, 2005		10,000	March 22, 2006
April 6, 2005		10,000	April 6, 2006
Total During FY2005	**$**	**414,000**	

On November 1, 2004, ATSI entered into a note payable with Franklin Cardwell & Jones, PC, for $103,454 associated with legal and professional services previously rendered. The promissory note payable has a maturity date of December 1, 2005 and has an annual interest rate of 6%. The note is secured by ATSI equipment and accounts receivable. Beginning November 1, 2005, the holder of the note may convert all or any part of the outstanding balance and accrued and unpaid interest to shares of ATSI's common stock equal to the amount converted divided by the product of (a) 0. 90 times (b) the five-day average of the last sales of the common stock prior to the conversion day. The conversion feature was determined to be an embedded derivative and, accordingly, the embedded derivative portion of the value of the note is attributable to the conversion feature. The embedded derivative value at April 30, 2005, is $15,741 and is included in Derivative Financial Instrument Liabilities on the balance sheet. During the quarter end nine months ended April 30, 2005 we recognized a gain on derivative instrument liabilities of $24,138 and $10,540, respectively.

NOTE 5 - WARRANTS

On October 13, 2003, ATSI entered into consulting agreements for twelve months with certain individual affiliates of Recap Marketing & Consulting, LLP that provided for the issuance of compensation warrants to purchase a total of 3,900,000 shares of ATSI's common stock at prices as indicated in the following table. These warrants expire on November 30, 2005. At issuance ATSI recognized $6,569,000 of non-cash compensation expense associated with the issuance of these warrants.

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

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During the first nine months of fiscal 2005, individual affiliates of Recap Marketing & Consulting LLP elected to exercise 3,799,930 warrants and Recap Marketing & Consulting LLP forgave notes in the amount of $810,000 as the conversion price. The exercise price of the warrants ranged from $0.01 per share to $0.50 per share.

On November 1, 2004, ATSI extended the consulting agreements for an additional six months with certain individual affiliates of Recap Marketing & Consulting, LLP that provided for the issuance of compensation warrants to purchase a total of 1,000,000 shares of ATSI's common stock at price of $0.50 per share. These warrants expire on October 31, 2005. At signing of the extension to the consulting agreements ATSI recognized $400,000 of non-cash compensation expense associated with the issuance of these warrants.

On March 1, 2005, ATSI amended the extension to the consulting agreement with certain individuals' affiliates of Recap Marketing & Consulting, LLP and extended the agreement for an additional 12 months. The amendment to the agreements allows for the repricing of 1,250,000 compensation warrants at a new exercise price's ranging from $0.30 per share to $0.40 per share. At signing of the amendment to the extension of the consulting agreement, ATSI recognized $0 of non-cash compensation expense associated with the issuance of these warrants.

At issuance, ATSI recognized $7,053,000 of non-cash compensation expense. In connection with the restatement, these warrants have been accounted for as derivative instruments and, accordingly, ATSI reduced compensation expense in 2004 by $483,000. The embedded derivative value is $7,360 at April 30, 2005 and is included in Derivative Financial Instrument Liabilities on the balance sheet. A corresponding gain (loss) of $0 and $106,404 is reflected in the statement of operations for the quarter ended April 30, 2004 and 2005, respectively, as loss on derivative instrument liability. Additionally, a corresponding gain (loss) of $0 and ($327,552) is reflected in the statement of operations for the nine months ended April 30, 2004 and 2005, respectively, as loss on derivative instrument liability. See Note 6.

NOTE 6 - DERIVATIVES

ATSI evaluated the application of SFAS 133 and EITF 00-19 for all of its financial instruments and identified the following financial instruments as derivatives:

1) Note Payable, Franklin Cardwell and Jones

2) 9% Convertible Debenture;
Warrants to purchase common stock associated with the 2003 Debentures the ("2003 Debenture Warrants");

3) Warrants to purchase common stock in connection with consulting agreements with two individuals ("Consulting Warrants")

Based on the guidance in SFAS 133 and EITF 00-19, we concluded that all of these instruments were required to be accounted for as derivatives. SFAS 133 and EITF 00-19 require ATSI to bifurcate and separately account for the conversion features of the Note Payable to Franklin Cardwell and Jones, the 9% Convertible Debentures & warrants issued to consultants as embedded derivatives.

Pursuant to SFAS 133, ATSI bifurcated the conversion feature from the Note Payable to Franklin Cardwell and Jones, because the conversion price is not fixed and it's not convertible into a fixed number of shares. Accordingly, the embedded derivative must be bifurcated and accounted for separately.

In addition, ATSI bifurcated the conversion feature from the 9% Convertible debenture and the associated warrants, since the conversion price is not fixed and it is not convertible into a fixed number of shares.

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Furthermore, ATSI concluded that the exercise price and the number of shares to be issued under the "Consulting Warrants" to two individuals are fixed. However, since the 9% Convertible debenture was issued prior to these warrants and these debentures might result in issuing an indeterminate number of shares, it cannot be concluded that the Company has a sufficient number of authorized shares to settle these warrants. As such, the warrants were accounted for as derivative instrument liabilities. ATSI is required to record the fair value of the conversion features and the warrants on its balance sheet at fair value with changes in the values of these derivatives reflected in the consolidated statement of operations as "Gain (loss) on embedded derivative liability." The derivative liabilities were not previously classified as such in ATSI's historical financial statements. In order to reflect these changes, ATSI has restated its financial statements for the year ended July 31, 2005 and the three months ended April 31, 2005, October 31, 2005 and January 31, 2006.

The impact of the application of SFAS 133 and EITF 00-19 on the balance sheet as of April 30, 2005 and July 31, 2004 as follows:

	Embedded derivative liability balance 4/30/2005	7/31/2004	Net Change in value
Note Payable, Franklin Cardwell and Jones	$ 15,741	-	$ 15,741
9% Convertible Debenture & warrants	6	10,503	(10,497)
Consulting warrants	7,360	1,338,375	(1,331,015)
Total:	$ 23,107	$ 1,348,878	($1,325,771)

And the impact on the statements of operations as the quarter and nine months ended of April 30, 2005 and 2004 as follows:

Gain (loss) on embedded derivative liabilities:	Three months ended April 30, 4/30/2005	4/30/2004	Nine months ended April 30, 4/30/2005	4/30/2004
Note Payable, Franklin Cardwell and Jones	$ 24,138	-	$ 10,540	-
9% Convertible Debenture & warrants	4,280	-	10,495	-
Consulting warrants	106,404	-	(337,552)	-
Total gain (loss) on embedded derivative liabilities:	$ 134,822	-	($316,517)	-

Since the conversion option for the Series D Preferred Stock is contingent, as a result of the ongoing litigation with the holders of these securities, the Series D Preferred Stock is not within the scope of SFAS 133 and EITF 00-19. If the contingency and lawsuit is resolved in the future and the holder becomes able to convert, ATSI will assess whether the conversion option meets the definition of a derivative under SFAS 133. However, as of July 31, 2003, the Series D Preferred Stock, which is carried as a current liability, is recorded at its stated redemption amount of $1,270 per share or approximately $942,000. ATSI continues to accrue dividends on the Series D Preferred Stock, pending resolution of the Company's lawsuit. At April 30, 2005, the carrying amount of the Series D Preferred Stock was $1,171,000, including accrued dividends of $229,000.

Because the conversion option for the Series E Preferred Stock is contingent, as a result of the ongoing litigation with the holders of these securities, the Series E Preferred Stock is not within the scope of SFAS 133 and EITF 00-19. If the contingency and lawsuit is resolved in the future and the holder becomes able to convert, ATSI will assess whether the conversion option meets the definition of a derivative under SFAS 133. However, as of July 31, 2003, the Series E Preferred Stock, which is carried as a current liability, is recorded at its stated redemption amount of $1,250 per share or approximately $1,463,000. ATSI continues to accrue an amount equivalent to dividends of 6% per annum on the Series E Preferred Stock, pending resolution of the Company's lawsuit. At April 30, 2005, the carrying amount of the Series E Preferred Stock was $1,732,000, including accrued dividends of $269,000.

NOTE 7 - RESTATEMENT

ATSI has restated its 2005 and 2004 quarterly financial statement from amounts previously reported. ATSI has determined that certain financial instruments issued by the Company contain features that require the Company to account for these features as derivative instruments. Accordingly, warrants issued to consultants, the conversion features of the Note Payable to Franklin Cardwell and Jones & the 9% Convertible Debentures and associated warrants have been accounted for as derivative instrument liabilities rather than as equity. Additionally, the embedded conversion features of the Note Payable to Franklin Cardwell & Jones and the embedded conversion features of the 9% Convertible Debentures and warrants related to the debt, have been bifurcated from the debt and accounted for separately as derivative instrument liabilities. Note 7 was added to disclose the derivative instrument liabilities and provided information on subsequent changes. In addition, ATSI has modified the estimated volatility used in the Black-Scholes option pricing model used to value the warrants issued to consultants, the warrants issued to the 9% Convertible Debentures holders and the conversion features embedded in the note payable to Franklin, Cardwell & Jones and 9% Convertible Debentures.

ATSI is required to record the fair value of the conversion features and the warrants on the balance sheet at fair value with changes in the values of these derivatives reflected in the consolidated statement of operations as “Gain (loss) on derivative instrument liabilities.” The effect of the (non-cash) changes related to accounting separately for these derivative instrument liabilities and modifying the estimated volatility, on the consolidated statement of operations for the quarter and nine months ended April 30, 2005, was an increase in the net income attributable to common shareholders of $347,000 and $72,000, respectively. Basic and diluted earnings per share attributable to common shareholders for the quarter and nine months ended April 30, 2005 increased by $0.04 and $0.01, respectively. The effect on the consolidated balance sheet as of April 30, 2005 was a decrease in stockholders equity of $398,000.

In all other material respects, the financial statements are unchanged. Following is a summary of the restatement adjustments:

	For the three months ended April 30, 2005			For the three months ended April 30, 2004		
	(in thousands, except share information)					
Summary Balance Sheet	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Total assets	$ 423	-	$ 423	$ 865	-	$ 865
Pre-petition Liabilities of bankrupt subsidiaries, net of assets	-	-	-	12,354	-	12,354
Accounts payable	506	-	506	427	-	427
Accrued liabilities	520	38	558	2,472	12	2,484
Current portion of obligation under capital leases	3	-	3	-	-	-
Notes payable	24	-	24	654	-	654
Notes payable, Franklin Cardwell & Jones	104	(27)	77	-	-	-
Convertible debentures	275	(41)	234	275	(41)	234
Series D Cumulative Preferred Stock	1,171	-	1,171	1,126	-	1,126

Series E Cumulative Preferred Stock	1,327	405	1,732	1,257	405	1,662
Derivative financial instrument liabilities	-	23	23	-	38	38
Liabilities from discontinued operations	1,152	-	1,152	1,152	-	1,152
Total current liabilities	5,082	398	5,480	19,717	414	20,131
Total long-term liabilities	517	-	517	52	-	52
Series A preferred stock	-	-	-	-	-	-
Series H preferred stock	14	-	14	-	-	-
Common stock	10	-	10	144	-	144
Additional paid in capital	72,185	(5,414)	66,771	61,201	(405)	60,796
Accumulated deficit	(77,887)	5,016	(72,871)	(80,751)	(9)	(80,760)
Other comprehensive income	502	-	502	502	-	502
Total Stockholder's deficit	(5,176)	(398)	(5,574)	(18,904)	(414)	(19,318)
Total liabilities and stockholder's deficit	$ 423	-	$ 423	$ 865	-	$ 865
<u>Summary statements of operations</u>						
Revenues	$ 1,797	-	$ 1,797	$ 561	-	$ 561
Operating expenses, COGS & depreciation	2,112	(221)	1,891	723	-	723
Operating loss	(315)	221	(94)	(162)	-	(162)
Other Income	12,133	126	12,259	(29)	(3)	(32)
Net income (loss) from continuing operations	11,818	347	12,165	(191)	(3)	(194)
Net income from discontinued operations	-		-			
Preferred Dividends	(38)	-	(38)	(82)	-	(82)
Net income (loss) to common stockholders	$ 11,780	347	$ 12,127	($273)	(3)	($276)
Basic Earnings (loss) per share	$ 1.35	$ 0.04	$ 1.39	($0.23)	$ 0.00	($0.23)
Diluted Earnings (loss) per share	$ 1.35	$ 0.04	$ 1.39	($0.23)	$ 0.00	($0.23)

	For the nine months ended April 30, 2005			For the nine months ended April 30, 2004		
	(in thousands, except share information)					
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated

Summary statements of operations

Revenues	$ 4,160	-	$ 4,160	$ 887	-	$ 887
Operating expenses, COGS & depreciation	6,034	(411)	5,623	1,422	-	1,422
Operating loss	(1,874)	411	(1,463)	(535)	-	(535)
Other Income	12,531	(339)	12,192	(141)	(8)	(149)
Net income (loss) from continuing operations	10,657	72	10,729	(676)	(8)	(684)
Net income from discontinued operations	-		-			
Preferred Dividends	(114)	-	(114)	(268)	-	(268)
Net income (loss) to common stockholders	$ 10,543	72	$ 10,615	($944)	(8)	($952)
Basic Earnings (loss) per share	$ 1.68	$ 0.01	$ 1.69	($0.87)	($0.01)	($0.88)
Diluted Earnings (loss) per share	$ 1.68	$ 0.01	$ 1.69	($0.87)	($0.01)	($0.88)

NOTE 8 - SETTLEMENT AND RESTRUCTURING OF DEBT

On October 1, 2004, ATSI entered into a Settlement Agreement and Mutual release with Alfonso Torres Roqueni, the former owner of the concession license purchased by ATSICOM in July 2000. Under the settlement agreement amounts owed of $1,360,000 were restructured and settled in exchange for the issuance by ATSI of 687,600 common shares for the payment of $860,000 of the related obligation. The common shares were considered issued at $1.25 per share. However, if on the measurement date of April 1, 2005, the average closing price of the ATSI common stock for the ten (10) trading days immediately preceding the measurement date is below $1.15, ATSI will be required to issue an additional 59,791 common shares. If, however, the average closing price of the ATSI common stock for the ten (10) trading days immediately preceding the measurement date is at or above $1.15, no other consideration will be given and the 687,600 shares issued will be considered as the final consideration. Additionally as part of the settlement, ATSI issued a promissory note for the remaining balance of $500,000. The note accrues interest at the rate of 6% per annum and has a maturity date of October 1, 2007, with no monthly payments. ATSI recognized a gain of $235,000 on the settlement of this debt.

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

On March 28, 2005, ATSI entered into a Settlement Agreement (at mediation) with James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas. The Settlement Agreement was subject to board approval. The Board of Directors met on April 28, 2005 and approved the Settlement Agreement, subsequently; ATSI issued 169,280 shares of its common stock for the settlement of all unpaid wages in the amount of $90,000. This claim was originally filed in December 2003 by ATSI as a cause of action in the 407th Judicial District of Bexar County, Texas against James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas whereby ATSI was seeking judicial review on the decision issued by the Texas Workforce Commission were it awarded a claim for unpaid wages against ATSI.

NOTE 9 - ACQUISITION OF A LOCAL EXCHANGE CARRIER COMPANY

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

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

SPECIAL NOTE: This Quarterly Report on Form 10-QSB/A contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities and Exchange Act of 1934, as amended. "Forward looking statements" are those statements that describe management's beliefs and expectations about the future. We have identified forward-looking statements by using words such as "anticipate," "believe," "could," "estimate," "may," "expect," and "intend." Although we believe these expectations are reasonable, our operations involve a number of risks and uncertainties, including those described in the Additional Risk Factors section of the Annual Report Form 10-K and other documents filed with the Securities and Exchange Commission. Therefore, these types of statements may prove to be incorrect.

The following is a discussion of the consolidated financial condition and results of operations of ATSI for the three and nine months ended April 30, 2005 and 2004. As used in this section, the term "fiscal 2005" means the year ending July 31, 2005 and "fiscal 2004" means the year ended July 31, 2004.

General

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

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

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

On August 1, 2004, we acquired a Local Exchange Carrier ("CLEC") based in South Texas. This acquisition served as a gateway to reach out to the Hispanic communities residing along the US and Mexico border. Our strategy is to provide reliable and affordable local and long distance services to the underserved Hispanic community through Texas. Our entry to the retail services under our TeleFamilia brand and subsidiary will allow us to leverage our existing international VoIP network with additional services that have the potential to deliver higher margins than our wholesale international VoIP services. We have deployed various postpaid and prepaid retail services and generated approximately $72,500 in retail services revenue during the nine months ended April 30, 2005.

We have incurred operating losses and deficiencies in operating cash flows in each year since our inception in 1994 and expect our losses to continue through July 31, 2005. We had an operating loss of $1,463,000, for the nine months ended April 30, 2005 and a working capital deficit of $5,228,000 at April 30, 2005. Due to such recurring losses, as well as the negative cash flows generated from our operations and our substantial working capital deficit, the auditor's opinion on our financial statements as of July 31, 2004 calls attention to substantial doubts about our ability to continue as a going concern. This means that there is substantial doubt that we will be able to continue in business through July 31, 2005.

We have experienced difficulty in paying our vendors and lenders on time in the past. As a result, during the nine months ended April 30, 2005 management continued to pursue different avenues for funding and we entered into various short-term convertible promissory notes in the aggregate amount of $414,000. These funds have allowed the Company to pay those operating and corporate expenses that were not covered by our current cash inflows from operations. We will continue to require additional funding until the cash inflows from operations are sufficient to cover the monthly operating expenses. There is no assurance that we will be successful in securing additionally funding over the next twelve months.

Results of Operations

The following table sets forth certain items included in the Company's results of operations in dollar mounts and as a percentage of total revenues for the three and nine month period ended April 30, 2005 and 2004.

	Three months ended April 30,				Nine months ended April 30,			
	2005		2004		2005		2004	
	(Unaudited)							
	$	%	$	%	$	%	$	%
Operating revenues								
Services								
Carrier services	$ 1,727	96%	$ 484	86%	$ 3,943	95%	$ 726	82%
Network services	70	4%	77	14%	217	5%	161	18%
Total operating revenues	1,797	100%	561	100%	4,160	100%	887	100%
Cost of services (Exclusive of depreciation and amortization, shown below)	1,660	92%	501	89%	3,854	93%	768	87%
Gross Margin	137	8%	60	11%	306	7%	119	13%
Selling, general and administrative expense (exclusive of legal and professional fees, non cash stock compensation to employees and warrants for services, shown below)	139	8%	164	29%	314	8%	413	47%
Legal and professional fees	60	3%	52	9%	365	9%	201	23%
Non-cash issuance of common stock and warrants for services	-	0%	-	0%	533	13%	30	3%
Non-cash stock-based compensation, employees	-	0%	-	0%	474	11%	-	0%
Bad debt expense	-	0%	-	0%	4	0%	4	0%
Depreciation and amortization	32	2%	6	1%	79	2%	6	1%
Operating income (loss)	(94)	-5%	(162)	-29%	(1,463)	-35%	(535)	-60%

Debt forgiveness income	-	0%	-	0%	460	11%	-	0%
Gain on disposal of investment	12,104	674%	-	0%	12,104	291%	-	0%
Gain (loss) on derivative instrument liabilities	135	8%	-	0%	(317)	-8%	-	0%
Other income (expense)	20	1%	(32)	-6%	(55)	-1%	(149)	-17%
Net income (loss)	12,165	677%	(194)	-35%	10,729	258%	(684)	-77%
Less: preferred stock dividends	(38)	-2%	(82)	-15%	(114)	-3%	(268)	-30%
Net income (loss) to applicable to common shareholders	$ 12,127	675%	($276)	-49%	$ 10,615	255%	($952)	-107%

Three Months ended April 30, 2005 Compared to Three Months ended April 30, 2004

Operating Revenues. Consolidated operating revenues increased by 220% between periods from $561,000 for the quarter ended April 30, 2004 to $1,797,000 for the quarter ended April 30, 2005.

Carrier services revenues increased approximately by $1,243,000, or 257% from the quarter ended April 2004 to the quarter ended April 2005. Our carrier traffic increased from approximately 19.7 million minutes in the quarter ended April 30, 2004 to approximately 47.6 million minutes during the quarter ended April 30, 2005. The increase in revenue and carrier traffic can mainly be attributed to the growth in VoIP carrier services since the implementation of the NexTone VoIP soft-switch during the last quarter of fiscal 2004.

Network services revenues decreased by approximately 9% or $7,000 from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The decrease in network services revenue is primarily due to termination of the network service agreement with one of our customers. As a result, ATSI will loss about $22,000 of monthly revenue.

Cost of Services (Exclusive of depreciation and amortization). The consolidated cost of services increased by approximately $1,159,000 from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The increase in cost of services is a direct result of the increase in carrier services revenue and network services revenue. As mentioned above, our carrier traffic increased from approximately 19.7 million minutes during the quarter ended April 30, 2004 to approximately 47.6 million minutes in the quarter ended April 30, 2005, thus increasing our cost of services between quarters.

Selling, General and Administrative (SG&A) Expenses. (exclusive of legal and professional fees, non-cash stock compensation to employees and common stock and warrants for services). SG&A expenses decreased by approximately $25,000, or 15% from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The decrease is attributable to an adjustment of $16,408 in salaries and wages and a reversal of an over-accrual for services previously recognized.

Legal and professional Fees. Legal and professional fees increased by approximately $8,000, or 15% from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. During the quarter ended April 30, 2005, the company incurred approximately $20,000 in legal and professional services associated with various litigations and settlements. These legal and professional expenses were not incurred during the quarter ended April 30, 2004.

Depreciation and Amortization. Depreciation and amortization increased by $26,000 from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The increase is attributed to the recognition of depreciation expense and amortization on the NexTone VoIP soft-switch that was acquired during the last quarter of fiscal 2004.

Operating Income (Loss). The Company's operating income (loss) improved by approximately $68,000 or 42% from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The improvement in operating income (loss) is attributed to increase in gross profit margin of $77,000 and decrease in SG&A of $25,000 from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The increase in gross profit margin and decrease in SG&A was slightly offset by the increase in depreciation of $26,000 between periods.

Gain on disposal of investment. During the quarter ending April 30, 2005 ATSI recognized a gain on disposal of investment of approximately $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries have ceased operations.

Gain (loss) on derivative instruments liabilities, net. The Company recognized a gain on derivative instruments of $135,000 during the quarter ended April 30, 2005 compared to a gain of $0 during the quarter ended April 30, 2004, an increase of $135,000. The increase is as a result of the net unrealized (non-cash) change in the fair value of our derivative instrument liabilities related to certain, warrants, and embedded derivatives in our debt instruments that have been bifurcated and accounted for separately.

Other income (expense). Other (expense) decreased by approximately $52,000 or 163% from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The decrease in other income (expense) is attributed to the decrease in loss in investment in ATSICOM of approximately $25,000 recognized during the quarter ended April 30, 2004 associated with our portion of the losses on our investment in ATSICOM. During the quarter ended April 30, 2005 the Company did not recognized any loss associated to ATSICOM.

Preferred Stock Dividends. Preferred Stock Dividends expense decreased by approximately $44,000 between periods, from $82,000 for the quarter ended April 30, 2004 to $38,000 during the quarter ended April 30, 2005. During fiscal 2004 we converted all Redeemable Preferred Series F and Series G shares to common. As a result of these conversions, no dividends were incurred during the quarter ended April 2005 related to these securities.

Net income (loss) to Common Stockholders. The net income (loss) for the quarter ended April 30, 2005 decrease to $12,127,000 net income from $276,000 net (loss) for the quarter ended April 30, 2004. The improvement in net income (loss) to common stockholders is mainly attributed to the recognition of a gain on disposal of investment of $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under

Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries have ceased operations. Additionally, the improvement in net income (loss) is attributed to increase in gross profit margin of $77,000 and decrease in SG&A of $25,000 from the quarter ended April 30, 2004 to the quarter ended April 30, 2005. The increase in gross profit margin and decrease in SG&A was slightly offset by the increase in depreciation of $26,000 between periods.

Nine months ended April 30, 2005 Compared to nine months ended April 30, 2004

Operating Revenues. Consolidated operating revenues increased by 369% between periods from $887,000 for the nine months ended April 30, 2004 to $4.2 million for the nine months ended April 30, 2005.

Carrier services revenues increased by approximately $3.2 million, or 443% from the nine months ended April 2004 to the nine months ended April 2005. Our VoIP carrier traffic increased from approximately 19.1 million minutes during the nine months ended April 30, 2004 to approximately 113 million minutes during the nine months ended April 30, 2005. The increase in revenue and carrier traffic can mainly be attributed to the growth in VoIP carrier services since the implementation of the NexTone VoIP soft-switch during the last quarter of fiscal 2004.

Network services revenues increased approximately 35% or $56,000 from the nine month period ended April 30, 2004 to the nine month period ended April 30, 2005. The increase in network services revenue is primarily due to the purchase and assignment of a network services contract from American TeleSource International de Mexico S.A de C.V. (ASTIMEX). Under the assignment and purchase agreement with ATSIMEX, we acquired the remaining term of the contract, which extended from February 2004 through June 2004 and generated monthly revenues of approximately $22,000. The agreement was terminated during the quarter ended April 30, 2005 and as a result we expect a reduction of network service revenue by $22,000 per month.

Cost of Services (Exclusive of depreciation and amortization). The consolidated cost of services increased by approximately $3.1 million, or 402% from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The increase in cost of services is a direct result of the increase in carrier services revenue and network services revenue. As mentioned above, our carrier traffic increased from approximately 19.1 million minutes during the nine months ended April 30, 2004 to approximately 113 million minutes in the nine months ended April 30, 2005, thus increasing our cost of services between periods.

Selling, General and Administrative (SG&A) Expenses. (exclusive of legal and professional fees, non-cash stock compensation to employees and common stock and warrants for services). SG&A expenses decreased by approximately $99,000, or 24% from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The decrease is attributable to an adjustment of $108,648 in salaries and wages and a reversal of an over-accrual for services previously recognized.

Legal and professional Fees. Legal and professional fees increased by approximately $164,000, or 82% from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The increase is attributable to the recognition of approximately $150,000 in professional fees associated with a marketing campaign that commenced during the first quarter of fiscal 2005. Additionally, during the nine month period we recognized approximately $90,000 in legal fees associated to the lawsuit for stock fraud and manipulation by various institutions.

Non-cash issuance of common stock and warrants for services. Non-cash issuance of common stock and warrants for services increased by $503,000 from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. This increase is primarily due to recognition of approximately $533,000 in non-cash compensation expense associated with the consulting agreements entered into with certain individual affiliates of Recap Marketing & Consulting, LLP.

Non-cash stock-based compensation, employees. Non-cash compensation expense to employees increased by $474,000 from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. This increase is attributed to recognition of approximately $474,000 in non-cash compensation expense associated with the grant of stock options and stock grants to our employees and board of directors.

Bad debt expense. Bad debt expense remained consistent at $4,000 over the nine months ended April 30, 2004 and the nine months ended April 30, 2005. During the nine months ended April 30, 2005 we recognized $4,000 in bad debt expense associated with the write-off of a carriers services customer that ceased operations.

Depreciation and Amortization. Depreciation and amortization increased by $73,000 from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The increase is attributed to the recognition of depreciation expense and amortization on the NexTone VoIP soft-switch that was acquired during the last quarter of fiscal 2004.

Operating income (loss). The Company's operating income (loss) increased by approximately $928,000 or 173% from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The increase in operating loss is attributed to the recognition of $533,000 in non-cash warrant expense associated with the consulting agreements entered into with certain individual affiliates of Recap Marketing & Consulting, LLP and the recognition of $474,000 in non-cash stock based compensation expense associated with the stock options and stock grants awarded to the company employees and board of directors. The increase in non-cash warrant and compensation expense was offset slightly by the increase in gross margin of approximately $187,000.

Debt forgiveness income. Our debt forgiveness income increased by approximately $460,000 from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. During the nine month period ended April 30, 2005, we negotiated and exchanged various liabilities for equity. These settlements were related to the settlement of the $859,500 liability with Alfonso Torres Roqueni, the former owner of the concession license acquired in July 2000, and the settlement of a $250,000 note payable with Infraestructura Espacial, S.A de C.V. and Tomas Revesz, a former ATSI director. The debt forgiveness income was based on the difference between the market price of ATSI equity at the time of issuance and the market price calculated at the time of the settlement of the debt.

Gain on disposal of investment. During the nine month period ended April 30, 2005 ATSI recognized a gain on disposal of investment of approximately $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries have ceased operations.

Gain (loss) on derivative instruments liabilities, net. The Company recognized a loss on derivative instruments of $317,000 during the quarter ended April 30, 2005 compared to a gain of $0 during the quarter ended April 30, 2004, an increase of $317,000. The increase is as a result of the net unrealized (non-cash) change in the fair value of our derivative instrument liabilities related to certain, warrants, and embedded derivatives in our debt instruments that have been bifurcated and accounted for separately.

Other income (expense). Other income (expense) decreased by approximately $94,000 or 63% from the nine months ended April 30, 2004 to the nine months ended April 30, 2005. The decrease in other income (expense) is attributed to the decrease in loss in investment in ATSICOM of approximately $85,000 recognized during the nine months ended April 30, 2004 associated with our portion of the losses on our investment in ATSICOM. During the nine months ended April 30, 2005 the Company did not incurred any loss in ATSICOM.

Preferred Stock Dividends. Preferred Stock Dividends expense decreased by approximately $154,000 between periods, from $268,000 for the nine months ended April 30, 2004 to $114,000 during the nine months ended April 30, 2005. During fiscal 2004 we converted all Redeemable Preferred Series F and Series G shares to common. As a result of these conversions, no dividends were incurred during the nine months ended April 2005 related to these securities.

Net income (loss) to Common Stockholders. The net income (loss) for the nine months ended April 30, 2005 improved to $10,615,000 net income from $952,000 net (loss) for the nine months ended April 30, 2004. The improvement in net income (loss) to common stockholders is mainly attributed to the recognition of a gain on disposal of investment of $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI's subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries have ceased operations. The gain on disposal of investment was offset slightly by the recognition of $533,000 in non-cash warrant expense and $474,000 in non-cash stock based compensation expense associated with the stock options and stock grants awarded to the company employees and board of directors. Also, there was an increase in depreciation and amortization of approximately $73,000 from the nine months ended April 30, 2004 to the nine months ended April 30, 2005.

Liquidity and Capital Resources

Cash used in operating activities: During the nine months ended April 30, 2005, operations consumed approximately $427,000 in cash. This cash consumed by operations is primarily due to the recognition of $474,000 in non-cash compensation expense associated with the stock grants and stock options awarded to the employees and board of directors. Additionally, we recognized $533,000 in non-cash warrant expense associated with the consulting services agreement entered into during the second quarter of fiscal 2005. Furthermore, we recognized $317,000 as a loss on derivative instrument liabilities. We also recognized an increase in accounts payable of approximately $62,000 and an increase in accrued liabilities of approximately $77,000. The increase in accrued liabilities and accounts payable is primarily due to the company recognizing approximately $56,000 in interest expense associated with various notes and the accrual of preferred stock dividends of $114,000. Also, we recognized an increase in accounts receivables of $120,000 associated with the billing to our customers during the quarter ending April 30, 2005. We also recognized an increase in prepaid expenses for $18,000 related to the prepayments/retainers to our attorneys for legal services.

Cash provided used in investing activities: During the nine months ended April 30, 2005, the Company made various payments for $8,000 related to the acquisition of some telecommunications equipment acquired during fiscal 2005. Additionally, during the quarter ended October 31, 2004, ATSI entered into an Asset Purchase Agreement with Hinotel, Inc., a Hispanic owned Competitive Local Exchange Carrier ("CLEC") based in South Texas. The assets purchase under the agreement included Hinotel's customer base, a customer management and billing system, and supplier contracts. The transaction also included the assignment and transfer of the CLEC license in the State of Texas. The purchase price of the assets was $31,500, paid in 40,000 shares of ATSI common stock and $7,500 in cash.

Cash provided by financing activities: During the nine months ended April 30, 2005 we made principal payments on our capital lease obligation for approximately $2,000 and we received $810,000 from the exercise of warrants and $414,000 from proceeds from various notes payables. In addition, a result of the exercise of warrants we also recognized payments of $810,000 on our notes payable.

Overall, our net operating, investing and financing activities during the nine months ended April 30, 2005 provided a decrease of approximately $31,000 in cash balances. We had a cash balance of $63,000 as of April 30, 2005.

Our current operating expenses are expected to be approximately $70,000 per month, including wages, rent, utilities, litigation fees and corporate professional fees. We will require approximately $30,000 per month to cover the deficiencies in cash from operations during Fiscal 2005. We intend to cover our initial monthly operating expenses with our available cash and the factoring of our receivables. We expect to continue conserving cash resources by paying executive compensation, fees for certain consultants and professional services with shares of our common stock. In addition, outstanding indebtedness payable to a law firm is being paid through conversions to common stock. Furthermore, we will continue to pursue additional debt and equity financings to cover our deficiencies in cash reserves. However, we presently do not have a definitive agreement in place to obtain such financing. Any additional debt or equity financing may not be available in sufficient amounts or on acceptable terms. If such financing is not available in sufficient amounts or on acceptable terms, the Company's results of operations and financial condition may be adversely affected.

Additionally, in an effort to continue to conserve cash, we are not presently paying quarterly interest and dividends on our outstanding convertible debentures and Redeemable Preferred stock. However, we have continued to accrue dividends and interest on such debentures and Redeemable Preferred stock. The increase in accrued liabilities related to the dividends and interest in arrears contributed approximately $160,000 in cash flow savings during the nine months ended April 30, 2005.

Our working capital deficit at April 30, 2005 was approximately $5,228,000. This represents a decrease of approximately $15,448,000 from our working capital deficit at July 31, 2004. The decrease can primarily be attributed to the recognition of a gain on disposal of investment of $12,104,000. The gain on disposal of investment was associated with the disposal of ATSI’s subsidiaries, American TeleSource International, Inc. (ATSI Texas) and TeleSpan, Inc. (TeleSpan). These entities filed for protection under Chapter 11 of the U.S. Bankruptcy Code on February 4, 2003 and February 18, 2003 respectively. The court ordered joint administration of both cases on April 9, 2003 and on May 14, 2003 the court converted the cases to Chapter 7. The two bankrupt subsidiaries have ceased operations. Additionally, the decrease in working capital deficit is also attributed to the settlement of various liabilities through the issuance of common stock. These settlements were associated with the settlement of $859,500 liability with Alfonso Torres Roqueni, the former owner of the concession license acquired in July 2000 and the settlement of a $250,000 note payable with Infraestructura Espacial, S.A de C.V. and Tomas Revesz, a former ATSI director.

Our current liabilities include:

- $103,454 owed to Attorneys for legal services rendered during fiscal 2004.

- $1,171,000 associated with the Series D Cumulative preferred stock. Of this balance, $942,000 is associated with the full redemption of this security and $229,000 is related to the accrued dividends as of April 30, 2005.

- $1,732,000 associated with the Series E Cumulative preferred stock. Of this balance, $1,463,000 is associated with the full redemption of this security and $269,000 is related to the accrued dividends as of April 30, 2005. During the fiscal year ended July 31, 2003, the Company was de-listed from AMEX and according to the terms of the Series E Cumulative preferred stock Certificate of Designation, if the Company fails to maintain a listing on NASDAQ, NYSE or AMEX the Series E preferred stockholder could request a mandatory redemption of the total outstanding preferred stock. As of the date of this filing we have not received such redemption notice. On October 31, 2002, we filed a lawsuit in the United States District Court for the Southern District Court of New York against several individuals and financial institutions, including Rose Glen Capital and Shaar Fund, the holders of our Series D and E Redeemable Preferred Stock, for, among other things, stock fraud and manipulation. On February 25, 2005, Judge Lewis A. Kaplan issued a memorandum opinion and order dismissing the complaint as to defendants that included the holders of our Series D and E Redeemable Preferred Stock. We plan to appeal that decision once a final judgment has been entered. These liabilities combined for a total of approximately $2,903,000. Accounting rules dictate that these liabilities must remain on our books under Current Liabilities until the lawsuit is resolved in the judicial system or otherwise. At this time we cannot predict the outcome or the time frame for this to occur.

We also have approximately $1,152,000 of current liabilities (net of assets) associated to the discontinued operations of the retail services unit. This balance is composed primarily of approximately $453,000 owed to the Mexican taxing authorities related to a note assumed through the acquisition of Computel and approximately $699,000 related to income taxes owed as of April 30, 2005.

Ongoing operations

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

As outlined in Note 4 to the financial statements, we have incurred amounts of debt to finance our working capital requirements. During the nine months ended April 30, 2005, we borrowed a total of $414,000 from Recap Marketing & Consulting, LLP; to fund our operating expenses and other corporate expenses. This debt will be applied to the payment of warrants issued to certain individual affiliates of Recap Marketing & Consulting, LLP.

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

ITEM 3. CONTROLS AND PROCEDURES

The Company has adopted and implemented disclosure controls and procedures designed to provide reasonable assurance that all reportable information will be recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer and the Company's Controller and Principal Financial Officer, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e) as of the end of the fiscal quarter covered by this report. Based on the evaluation of the President and Chief Executive Officer and the Controller and Principal Financial Officer have identified weaknesses in the accounting for convertible instruments and disclosure of embedded derivatives.

Specifically, we identified deficiencies in our internal controls and disclosure controls related to the accounting for convertible debt with conversion features contingent upon future prices of our stock and convertible debt with detachable warrants, primarily with respect to accounting for derivative liabilities in accordance with EITF 00-19 and SFAS 133. We restated our consolidated financial statements for the year ended July 31, 2005 and for each of the interim periods ending April 30, 2005, October 31, 2005 and January 31, 2006, in order to correct the accounting in such financial statements with respect to derivative liabilities in accordance with EITF 00-19 and SFAS 133. Since January 2006, we have undertaken improvements to our internal controls in an effort to remediate these deficiencies through the following efforts: 1) implementing a review of all convertible securities to identify any securities that are not conventional convertible securities and 2) improving supervision and training of our accounting staff to understand and implement the requirements of EITF 00-19 and SFAS 133.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On October 31, 2002, we filed a lawsuit in the United States District Court for the Southern District Court of New York against several individuals and financial institutions, including the holders of our Series D and E Redeemable Preferred Stock, for, among other things, stock fraud and manipulation. On February 25, 2005, Judge Lewis A. Kaplan issued a memorandum opinion and order dismissing the complaint as to all defendants with prejudice. We plan to appeal that decision once a final judgment has been entered. On July 9, 2004, we filed a separate but related lawsuit in the same court against Sam Levinson and Uri Wolfson. On April 27, 2005, the court entered a final judgment dismissing that action with prejudice based on the February 25, 2005 decision in the first action. On May 25, 2005, we appealed the dismissal of the second action to the United States Court of Appeals for the Second Circuit. Our attorneys are also in the process of investigating whether any other institutions participated in the manipulation of the company's stock and to advise us whether to pursue other legal proceedings. Currently we cannot predict the outcome of this litigation or the financial impact on our ongoing operations.

On February 3, 2005 Helen G. Schwartz, Trustee for ATSI Communications, Inc. (a Texas corporation) and TeleSpan, Inc. filed in the U.S. Bankruptcy Court for the Western District of Texas an Adversary Proceeding against ATSI Communications, Inc., a Nevada corporation alleging that ATSI-Nevada had received preferential payments as defined by the U.S. Bankruptcy Code in the amount of $510,836. On March 31, 2005 ATSI filed its response denying any such payments were received by ATSI Nevada, formerly ATSI Delaware. A hearing has been scheduled for September 7, 2005. Currently we cannot predict the outcome of this litigation or the financial impact on our ongoing operations.

On March 28, 2005, we entered into a Settlement Agreement, which resolved all claims in the case filed in the 407th Judicial District Court of Bexar County Texas by with James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas for unpaid wages. The Settlement Agreement was subject to board approval. The Board of Directors met on April 28,2005 and approved the Settlement Agreement. We subsequently issued 169,280 shares of our common stock.

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

On April 28, 2005, we issued 169,280 shares of our common stock in settlement of all claims made by James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas for unpaid wages. These shares were issued pursuant to an exemption from registration under Section 4(2) of the Securities Act because of the limited size of the group, the direct relationship between us and the individuals to whom they were issued, the absence of public solicitation or advertising, and restrictions on resale of the shares.

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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

As of April 30, 2005, the Company was in arrears with respect to the declaration of the following dividends payable on outstanding shares of its Preferred Stock:

Series A Cumulative Preferred Stock	$ 203,000
Series D Cumulative Preferred Stock	229,000
Series E Cumulative Preferred Stock	269,000
TOTAL	$ 701,000

ITEM 6. EXHIBITS

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

Exhibit Number	**Description**
4.1	Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. *
10.1	Extension of consulting agreements (Amendment No:1) with Hunter M. A. Carr and Donald W. Sapaugh. *
10.2	Settlement Agreement (at mediation) with James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas. *
31.1	Certification of our President and Chief Executive Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. *
31.2	Certification of our Corporate Controller and Principal Financial Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. *
32.1	Certification of our President and Chief Executive Officer, under Section 906 of the Sarbanes-Oxley Act of 2002. *
32.2	Certification of our Corporate Controller and Principal Financial Officer, under Section 906 of the Sarbanes-Oxley Act of 2002. *

SIGNATURE

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

ATSI COMMUNICATIONS, INC.
(Registrant)

Date: April 14, 2006 By: /s/ Arthur L. Smith
Name: Arthur L. Smith
Title: President and Chief Executive Officer

Date: April 14, 2006 By: /s/ Antonio Estrada
Name: Antonio Estrada
Title: Corporate Controller (Principal Accounting and Principal Financial Officer)