ZOOM TECHNOLOGIES INC
Form 10-Q
November 14, 2007

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

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2007

or

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 0-18672

ZOOM TECHNOLOGIES, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	**51-0448969**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
207 South Street, Boston, Massachusetts	**02111**
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s Telephone Number, Including Area Code: **(617) 423-1072**

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

The number of shares outstanding of the registrant's Common Stock, $.01 par value, as of October 1, 2007, was 9,346,966 shares.

ZOOM TECHNOLOGIES, INC. AND SUBSIDIARY
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PART I - FINANCIAL INFORMATION

ZOOM TECHNOLOGIES, INC.
Condensed Consolidated Balance Sheets
(unaudited)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,656,283	$ 7,833,046
Accounts receivable, net of allowances of $1,237,309 at September 30, 2007 and $915,969 at December 31, 2006	3,664,072	3,385,280
Inventories	4,294,186	4,511,814
Prepaid expenses and other current assets	207,940	269,301
Total current assets	11,822,481	15,999,441
Equipment, net	178,854	249,221
Investment in Unity Business Networks, LLC	1,178,709	—
Total assets	$ 13,180,044	$ 16,248,662
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 2,420,459	$ 2,639,935
Accrued expenses	470,921	562,349
Deferred gain on sale of real estate	367,245	367,245
Total current liabilities	3,258,625	3,569,529
Deferred gain on sale of real estate	69,594	357,373
Total liabilities	3,328,219	3,926,902
Stockholders' equity		
Common stock, $0.01 par value:		
Authorized - 25,000,000 shares; issued – 9,355,366 shares, including shares held in treasury	93,554	93,554
Additional paid-in capital	31,468,147	31,275,169
Accumulated deficit	(22,298,902)	(19,597,296)
Accumulated other comprehensive income -currency translation adjustment	596,348	557,655
Treasury stock (8,400 shares), at cost	(7,322)	(7,322)
Total stockholders' equity	9,851,825	12,321,760
Total liabilities and stockholders' equity	$ 13,180,044	$ 16,248,662

See accompanying notes.

ZOOM TECHNOLOGIES, INC.
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Net sales	$ 5,580,131	$ 3,579,317	$ 14,676,439	$ 13,378,260
Cost of goods sold	4,287,082	3,338,349	11,792,877	11,948,971
Gross profit	1,293,049	240,968	2,883,562	1,429,289
Operating expenses:				
Selling	979,252	781,955	2,750,978	2,563,921
General and administrative	617,086	689,599	1,862,627	2,236,287
Research and development	433,823	520,767	1,416,036	1,709,640
Total operating expenses	2,030,161	1,992,321	6,029,641	6,509,848
Operating profit (loss) before gain on sale of real estate	(737,112)	(1,751,353)	(3,146,079)	(5,080,559)
Gain on sale of real estate	95,926	—	287,478	—
Operating profit (loss)	(641,186)	(1,751,353)	(2,858,601)	(5,080,559)
Other income(expense):				
Gain on sale of investment in Intermute, Inc.	-	869,750	-	869,750
Interest income	47,568	51,138	196,808	189,327
Interest (expense)	-	(76,140)	-	(221,845)
Other, net	(19,251)	74,364	(39,814)	178,744
Total other income (expense), net	28,317	919,112	156,994	1,015,976
Income (loss) before income taxes	(612,869)	(832,241)	(2,701,607)	(4,064,583)
Income taxes	—	—	—	—
Net income (loss)	$ (612,869)	$ (832,241)	$ (2,701,607)	$ (4,064,583)
Basic and diluted net income (loss) per share	$ (0.07)	$ (0.09)	$ (0.29)	$ (0.43)
Weighted average common and common equivalent shares				
Basic and diluted	9,346,966	9,346,966	9,346,966	9,346,966

See accompanying notes.

ZOOM TECHNOLOGIES, INC.
Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Operating activities:		
Net income (loss)	$ (2,701,607)	$ (4,064,583)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on sale of Investment in InterMute, Inc	-	(869,750)
Amortization of deferred gain on sale of real estate	(287,478)	-
Depreciation	65,847	172,006
Stock based compensation	192,978	180,977
Changes in operating assets and liabilities:		
Accounts receivable, net	(246,042)	921,914
Inventories	220,026	784,753
Prepaid expenses and other assets	62,489	22,406
Accounts payable and accrued expenses	(306,384)	(1,573,819)
Net cash provided by (used in) operating activities	(3,000,171)	(4,426,096)
Investing activities:		
Investment in Unity Business Networks, LLC	(1,178,709)	-
Proceeds from sale of Investment in InterMute, Inc.	-	869,750
Additions to property, plant and equipment	4,892	(84,572)
Net cash provided by (used in) investing activities	(1,178,817)	785,178
Financing activities:		
Principal payments on long-term debt	-	(1,275,258)
Net cash provided by (used in) financing activities	-	(1,275,258)
Effect of exchange rate changes on cash	(2,775)	(6,251)
Net change in cash	(4,176,763)	(4,922,427)
Cash and cash equivalents at beginning of period	7,833,046	9,081,122
Cash and cash equivalents at end of period	$ 3,656,283	$ 4,158,695
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ —	$ 221,845
Income taxes	$ —	$ —

See accompanying notes.

ZOOM TECHNOLOGIES, INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation and Principles of Consolidation

The condensed consolidated financial statements of Zoom Technologies, Inc. (the "Company") presented herein have been prepared pursuant to the rules of the Securities and Exchange Commission for quarterly reports on Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. These statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2006 included in the Company's 2006 Annual Report on Form 10-K.

The accompanying financial statements are unaudited. However, the condensed balance sheet as of December 31, 2006 was derived from audited financial statements. In the opinion of management, the accompanying financial statements include all adjustments (consisting of normal, recurring adjustments) necessary for a fair presentation of results for these interim periods.

The accompanying financial statements include the accounts of the Company and its wholly-owned subsidiary, Zoom Telephonics, Inc. All intercompany accounts and transactions have been eliminated in consolidation.

The results of operations for the periods presented are not necessarily indicative of the results to be expected for the entire year.

(b) *Recently Issued or Proposed Accounting Pronouncements*

In July 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109” (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure.

Effective January 1, 2007, the Company adopted FIN 48. As of that date and as of September 30, 2007 the Company had no material unrecognized income tax benefits. Further, no significant changes in the unrecognized income tax benefits are expected to occur over the next twelve months.

Historically the Company has not accrued or paid significant interest and penalties for underpayments of income taxes. Interest and penalties related to such underpayments would be classified as a component of income tax expense. No material amounts of interest or penalties for underpayments of income taxes were required to be accrued as of September 30, 2007.

The Company files income tax returns in the United States and the United Kingdom. Currently, open tax years in the US for federal and state income tax purposes are 2003 through 2006. Open tax years in the UK are 2005 through 2006.

The Company accounts for point-of-sale taxes on a net basis under Emerging Issues Tax Force No. 06-3, “How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income

Statement (That Is, Gross Versus Net Presentation).”

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115.* Under SFAS 159, a company may elect to use fair value to measure certain financial assets and financial liabilities. The fair value election is irrevocable and generally made on an instrument-by-instrument basis even if a company has similar instruments that it elects not to measure at fair value. At the adoption date, unrealized gains and losses on existing items for which the fair value option had been elected are reported as a cumulative effect adjustment to retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in operations. SFAS is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company on January 1, 2008. The Company is currently determining if fair value accounting is appropriate for any eligible items and cannot currently estimate the effect, if any, that SFAS 159 will have on its financial statements.

(2) Liquidity

On September 30, 2007 the Company had working capital of $8.6 million, including $3.7 million in cash and cash equivalents.

To conserve cash and manage liquidity, the Company has implemented cost cutting initiatives including the reduction of employee headcount and overhead costs. The employee headcount was 79 at September 30, 2006 and 65 at September 30, 2007. The Company plans to continue to assess its cost structure as it relates to revenues and cash position. The Company may make further reductions if the actions are deemed necessary.

The Company's total current assets at September 30, 2007 were $11.8 million and current liabilities were $3.3 million. The Company did not have any long-term debt at September 30, 2007. Management believes it has sufficient resources to fund its planned operations through at least September 30, 2008. However, if the Company is unable to increase its revenues, reduce its expense, or raise capital the Company's longer-term ability to continue as a going concern and achieve its intended business objectives could be adversely affected.

(3) Earnings Per Share

Options to purchase 1,388,750 shares of common stock at September 30, 2007 and 1,228,200 shares at September 30, 2006 were outstanding but not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2007 and 2006 because their effect would be antidilutive.

(4) Inventories

Inventories consist of :	September 30, 2007	December 31, 2006
Raw materials	$ 2,566,677	$ 2,969,375
Work in process	485,021	522,307
Finished goods	1,242,488	1,020,132
Total Inventories	$ 4,294,186	$ 4,511,814

(5) Comprehensive Income (Loss)

Comprehensive income (loss) follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income (loss)	$ (612,869)	$ (832,241)	$ (2,701,607)	$ (4,064,583)
Foreign currency translation adjustment	14,136	44,696	38,693	110,220

Comprehensive income (loss)	$	(598,733)	$	(876,937)	$	(2,662,914)	$	(3,954,363)

(6) Contingencies

The Company is party to various lawsuits and administrative proceedings arising in the ordinary course of business. The Company evaluates such lawsuits and proceedings on a case-by-case basis, and its policy is to vigorously contest any such claims that it believes are without merit. The Company's management believes that the ultimate resolution of such pending matters will not materially and adversely affect the Company's business, financial position, results of operations or cash flows.

(7) Segment and Geographic Information

The Company’s operations are classified as one reportable segment. The Company’s net sales follow:

		Three Months Ended September 30, 2007	% of Total		Three Months Ended September 30, 2006	% of Total		Nine Months Ended September 30, 2007	% of Total		Nine Months Ended September 30, 2006	% of Total
North America	$	3,259,696	58%	$	2,280,425	64%	$	9,374,066	64%	$	7,711,063	58%
Turkey		44,575	1%		49,630	1%		62,511	0%		1,101,894	8%
UK		1,452,551	26%		679,357	19%		3,183,286	22%		2,474,063	18%
All Other		823,309	15%		569,905	16%		2,055,576	14%		2,091,240	16%
Total	$	5,580,131	100%	$	3,579,217	100%	$	14,676,439	100%	$	13,378,260	100%

(8) Customer Concentrations

Relatively few customers account for a substantial portion of the Company's net sales. In the third quarter of 2007 the Company's net sales to its top three customers accounted for 50% of its total net sales. In the third quarter of 2006 the Company's net sales to its top three customers accounted for 37% of its total net sales. In the nine months ended September 30, 2007 the Company's net sales to its top three customers accounted for 44% of its total net sales. In the nine months ended September 30, 2006 the Company's net sales to its top three customers accounted for 28% of its total net sales. The Company's customers generally do not enter into long-term agreements obligating them to purchase the Company’s products. The Company may not continue to receive significant revenues from any of these or from other large customers. A reduction or delay in orders from any of the Company's significant customers, or a delay or default in payment by any significant customer could materially harm the Company's business and prospects. Because of the Company's significant customer concentration, its net sales and operating income could fluctuate significantly due to changes in political or economic conditions, or the loss, reduction of business, or less favorable terms for any of our significant customers.

(9) Investment in Unity Business Networks, LLC

During the quarter ended September 30, 2007 the Company purchased all the Series A Preferred Shares (the Series A Shares) of Unity Business Networks, LLC (Unity) for cash of $1.2 million, including transaction costs. The Series A Shares are convertible at any time at the Company’s option into 15% of Unity’s common stock on a fully-diluted basis. The Series A Shares convert automatically if Unity consummates a public offering with gross proceeds in excess of $25 million or 30 days after Unity delivers its 2009 audited financial statements to the Company. In addition, the Company has an option to purchase all the outstanding common stock of Unity based on a specified multiple of Unity’s revenues, as defined, for 2008. The option is exercisable for 30 days following the receipt of Unity’s 2008 audited financial statements. The Company’s CEO is a member of Unity’s five member board of directors. Further, the Company is entitled to vote Series A Shares on an as-converted basis with Unity’s common stock. The Company is unable to exercise significant influence over Unity’s policies or operations. The Company accounts for its investment in Unity at cost. The investment will be reviewed periodically for potential impairment.

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

The following discussion and analysis should be read in conjunction with the safe harbor statement and the risk factors contained in Item IA of Part II of this Quarterly Report on Form 10-Q set forth in our Annual Report on Form

10-K for the year ended December 31, 2006 and our other filings with the SEC. Readers should also be cautioned that results of any reported period are often not indicative of results for any future period.

Overview

We derive our net sales primarily from sales of Internet-related communication products to retailers, distributors, Internet Service Providers and Original Equipment Manufacturers. Our products include broadband and dial-up modems and other communication products. We sell our products through a direct sales force and through independent sales agents. As of September 30, 2007 our employees were primarily located at our headquarters in Boston, Massachusetts and our sales office in the United Kingdom. During July and August 2007 we closed our support office in Boca Raton, Florida and transferred its support activities to our headquarters in Boston. We typically design our hardware products; but we do sometimes use another company's design if it meets our requirements. Electronic assembling and testing of our products in accordance with our specifications is typically done in China or Taiwan.

For many years we performed most of the final assembling, testing, packaging, warehousing and distribution at a production and warehouse facility at Summer Street in Boston, Massachusetts. That location also engaged in firmware programming for some products. We moved these operations to a dedicated facility in Tijuana, Mexico in August and September of 2006.

Since 1983 our headquarters has been in two adjacent buildings near South Station in downtown Boston. These buildings connect on most floors and house our entire Boston staff. In December 2006 we sold these buildings to a third party, with a two-year lease-back of approximately 25,000 square feet of the 62,000 square foot facility. Our net sale proceeds were approximately $7.7 million, of which approximately $3.6 million was repaid to our mortgage holder, eliminating the mortgage debt from our balance sheet.

For many years we derived a majority of our net sales from the retail after-market sale of dial-up modems to customers seeking to add or upgrade a modem for their personal computers. In recent years the size of this market and our sales to this market have declined, as personal computer manufacturers have incorporated a modem as a built-in component in most consumer personal computers and as increasing numbers of consumers worldwide have switched to broadband Internet access. The consensus of communications industry analysts is that sales of dial-up modems will probably continue to decline. There is also consensus among industry analysts that the installed base for broadband Internet connection devices, such as cable modems and DSL modems, will grow rapidly. In response to increased and forecasted worldwide demand for faster connection speeds and increased modem functionality, we have invested and continue to invest resources to advance our product line of broadband modems, both DSL modems and cable modems.

We continually seek to improve our product designs and manufacturing approach to improve product performance and reduce our costs. We pursue a strategy of outsourcing rather than internally developing our modem chipsets, which are application-specific integrated circuits that form the technology base for our modems. By outsourcing the chipset technology, we are able to concentrate our research and development resources on modem system design, leverage the extensive research and development capabilities of our chipset suppliers, and reduce our development time and associated costs and risks. As a result of this approach, we are able to quickly develop new products while maintaining a relatively low level of research and development expense as a percentage of net sales. We also outsource aspects of our manufacturing to contract manufacturers as a means of reducing our costs of production, and to provide us with greater flexibility in our production capacity.

Over the past several years our net sales have declined. In response to declining sales volume, we have cut costs by reducing staffing and some overhead. Our total headcount of full-time employees, including temporary workers, went from 79 on September 30, 2006 to 65 on September 30, 2007. Of the 65 employees on September 30, 2007, 14 were engaged in research and development, 18 were involved in purchasing, assembly, packaging, shipping and quality control, 21 were engaged in sales, marketing and technical support, and the remaining 12 performed accounting, administrative, management information systems, and executive functions.

Generally our gross margin for a given product depends on a number of factors including the type of customer to whom we are selling. The gross margin for retailers tends to be higher than for some of our other customers; but the sales, marketing, support, and overhead costs associated with retailers also tend to be higher. Our sales to certain countries, including Turkey, Vietnam, and Saudi Arabia, are currently handled in each country by a single in-country master distributor who handles the support, sales, and most marketing cost within that country. Gross margin for sales to these master distributors tends to be low, since lower pricing to these distributors helps them to cover the support, sales and marketing costs for their country. Our gross margin for broadband modems tends to be lower than for dial-up modems for a number of reasons, including that retailers are currently a more significant channel for our dial-up modems than for our broadband modems, that a higher percentage of our DSL sales come from low-margin countries, and that there is stronger competition in the broadband market than in the dial-up market.

In the third quarter of 2007 our net sales were up 56% compared to the third quarter of 2006. The main reason for the sales increase was increased shelf space for our products in major retailers including Best Buy in the U.S. and DSG in the U.K. We are also seeing growth in some areas, including DSL sales to U.S. Internet Service Providers and to U.S. and U.K. retailers. We are continuing our efforts to expand our DSL customer base and product line. Because of our significant customer concentration, however, our net sales and operating results have fluctuated and in the future could continue to fluctuate significantly due to changes in political or economic conditions or the loss, reduction of business, or less favorable terms for any of our significant customers.

On July 26, 2007 the Company purchased all the Series A Preferred Shares (the Series A Shares) of Unity Business Networks, LLC (Unity) for cash of $1.2 million, including transaction costs. The Series A Shares are convertible at any time at the Company’s option into 15% of Unity’s common stock on a fully-diluted basis. The Series A Shares convert automatically if Unity consummates a public offering with gross proceeds in excess of $25 million or 30 days after Unity delivers its 2009 audited financial statements to the Company. In addition, the Company has an option to purchase all the outstanding common stock of Unity based on a specified multiple of Unity’s revenues, as defined, for 2008. The option is exercisable for 30 days following the receipt of Unity’s 2008 audited financial statements. The Company’s CEO is a member of Unity’s five member board of directors. Further, the Company is entitled to vote Series A Shares on an as-converted basis with Unity’s common stock. The Company is unable to exercise significant influence over Unity’s policies or operations. The Company accounts for its investment in Unity at cost. The investment will be reviewed periodically for potential impairment.

Our cash and cash equivalents balance at September 30, 2007 was $3.7 million, down from $7.8 million at December 31, 2006. This reduction was due primarily to our $2.7 million loss and our $1.2 million investment, including $0.1 million of transaction costs, in Unity Business Systems.

Critical Accounting Policies and Estimates

Following is a discussion of our more significant accounting policies and estimates. As described below, management judgments and estimates must be made and used in connection with the preparation of our consolidated financial statements. Material differences could result in the amount and timing of our net sales, costs, and expenses for any period if we made different judgments or used different estimates.

Revenue (Net Sales) Recognition. We primarily sell hardware products to our customers. The hardware products include dial-up modems, DSL modems, cable modems, voice over IP products, embedded modems, ISDN modems, telephone dialers, and wireless and wired networking equipment. We earn a small amount of royalty revenue that is included in our net sales, primarily from internet service providers. We generally do not sell software. We began selling services in 2004. We introduced our Global Village VoIP service in late 2004, but sales of those services to date have not been material.

We derive our net sales primarily from the sales of hardware products to four types of customers:

- computer peripherals retailers,
- computer product distributors,
- Internet service providers, and
- original equipment manufacturers (OEMs)

We recognize hardware net sales to our customers at the point when the customers take legal ownership of the delivered products. Legal ownership passes from us to the customer based on the contractual FOB point specified in signed contracts and purchase orders, which are both used extensively. Many of our customer contracts or purchase orders specify FOB destination. We verify the delivery date on all significant FOB destination shipments made during the last 10 business days of each quarter.

Our net sales of hardware include reductions resulting from certain events which are characteristic of the sales of hardware to retailers of computer peripherals. These events are product returns, certain sales and marketing incentives, price protection refunds, and consumer mail-in and in-store rebates. Each of these is accounted for as a reduction of net sales based on detailed management estimates, which are reconciled to actual customer or end-consumer credits on a monthly or quarterly basis.

Our 2007 VoIP service revenues are recorded as the end-user-customer consumes billable VoIP services. The end-user-customer becomes a service customer by electing to sign up for the Global Village billable service on the Internet. We record revenue as billable services are consumed or monthly when flat-fee services are billed.

Product Returns. Products are returned by retail stores and distributors for inventory balancing, contractual stock rotation privileges, and warranty repair or replacements. We estimate the sales and cost value of expected future product returns of previously sold products. Our estimates for product returns are based on recent historical trends plus estimates for returns prompted by, among other things, new product introductions, announced stock rotations and announced customer store closings, etc. Our management reviews historical returns, current economic trends, and changes in customer demand and acceptance of our products when estimating sales return allowances. The estimate for future returns is recorded as a reserve against accounts receivable, a reduction of net sales, and the corresponding change to inventory and cost of sales. The relationship of quarterly physical product returns to quarterly product sales remained relatively stable for many years, ranging from a high of 10.6% to a low of 5.4% in the past two years. Product returns as a percentage of total product sales were 10.1% in the first nine months of 2007.

Price Protection Refunds. We have a policy of offering price protection to certain of our retailer and distributor customers for some or all their inventory. Under the price protection policies, when we reduce our prices for a product, the customer receives a credit for the difference between the original purchase price and our reduced price for their unsold inventory of that product. Our estimates for price protection refunds are based on a detailed understanding and tracking by customer and by sales program. Estimated price protection refunds are recorded in the same period as the announcement of a pricing change. Information from customer inventory-on-hand reports or from direct communications with the customers is used to estimate the refund, which is recorded as a reduction of net sales and an allowance against accounts receivable. Reductions in our net sales due to price protection were $0.2 million in 2005 and $0.1 million in 2006. In the first nine months of 2007 the reduction in our net sales due to price protection was $0.08 million.

Sales and Marketing Incentives. Many of our retailer customers require sales and marketing support funding, usually set as a percentage of our sales in their stores. The incentives were reported as reductions in our net sales and were $1.1 million in 2005 and $1.1 million in 2006. In the first nine months of 2007, the reduction in our net sales due to sales and marketing incentives was $1.0 million compared to $0.7 million in the first nine months of 2006.

Consumer Mail-In and in Store Rebates. Our estimates for consumer mail-in and in-store rebates are based on a detailed understanding and tracking by customer and sales program, supported by actual rebate claims processed by the rebate redemption centers plus an accrual for an estimated lag in processing at the redemption centers. The estimate for mail-in and in-store rebates is recorded as a reserve against accounts receivable and a reduction of net sales in the same period that the rebate obligation was triggered. In the first nine months of 2007 the reduction in our net sales due to consumer rebates was $0.2 million compared to $0.6 million in the first nine months of 2006.

To ensure that the sales, discounts, and marketing incentives are recorded in the proper period, we perform extensive tracking and documenting by customer, by period, and by type of marketing event. This tracking includes reconciliation to the accounts receivable records for deductions taken by our customers for these discounts and incentives.

Accounts Receivable Valuation. We establish accounts receivable valuation allowances equal to the above-discussed net sales adjustments for estimates of product returns, price protection refunds, and consumer rebates. These allowances are reduced as actual credits are issued to the customers. Our bad-debt write-offs and expense were not significant in either the first nine months of 2006 or 2007.

Inventory Valuation and Cost of Goods Sold. Inventory is valued on a standard cost basis where the material standards are periodically updated for current material pricing. Allowances for obsolete inventory are established by our management based on usability reviews performed each quarter. Our allowances against the inventory of a particular product range from 0% to 100%, based on management's estimate of the probability that the material will not be consumed or that it will be sold below cost. Our valuation process is to compare our cost to the selling prices each quarter, and if the selling price of a product is less than the "if completed" cost of our inventory, we write-down the inventory on a "lower of cost or market" basis.

Valuation and Impairment of Deferred Tax Assets. As part of the process of preparing our consolidated financial statements we estimate our income tax provision. This process involves the estimation of our actual current tax together with deferred income taxes on temporary differences between the book and tax bases of assets and liabilities and on net operating loss and tax credit carryovers. We assess the likelihood that our net deferred income tax assets will be recovered. To the extent we believe that recovery is not likely, we establish a valuation allowance. Changes in the valuation allowance are reflected in the statement of operations.

Significant management judgment is required in determining our provision for income taxes and any valuation allowance recorded against our net deferred tax assets. We have recorded a 100% valuation allowance against our deferred tax assets. It is management's estimate that, after considering the entire available objective evidence, historical and prospective, with greater weight given to historical evidence, it is more likely than not that these assets will not be realized. If we establish a record of continuing profitability, at some point we will be required to reverse the valuation allowance and restore the deferred asset value to the balance sheet, recording an equal income tax benefit which will increase net income in that period(s).

On December 31, 2006 we had federal net operating loss carry forwards of approximately $31,854,000. These federal net operating losses are available to offset future taxable income, and are due to expire in years ranging from 2018 to 2025. On December 31, 2006 we had state net operating loss carry forwards of approximately $22,253,000. These state net operating losses are available to offset future taxable income, and are primarily due to expire in years ranging from 2007 to 2010.

Results of Operations

Summary. Net sales were $5.6 million for our third quarter ended September 30, 2007, up 56% from $3.6 million in the third quarter of 2006. From operations, we had a net loss of $0.6 million for the third quarter of 2007, compared to a net loss of $1.8 million in the third quarter of 2006. We had a total net loss of $0.6 million for the third quarter of 2007, compared to a total net loss of $0.8 million in the third quarter of 2006. Loss per diluted share improved from $0.09 for the third quarter of 2006 to $0.07 for the third quarter of 2007.

Net sales were $14.7 million for the nine months ended September 30, 2007, up 9.7% from $13.4 million in the first nine months of 2006. From operations, we had a net loss of $2.9 million for the third quarter of 2007, compared to a net loss of $5.1 million in the third quarter of 2006. We had a total net loss of $2.7 million for the first nine months of 2007, compared to a total net loss of $4.1 million in the first nine months of 2006. Loss per diluted share was $0.29 for the first nine months of 2007 compared to a loss per diluted share of $0.44 for the first nine months of 2006.

Net Sales. Our net sales for the third quarter of 2007 increased 56% from the third quarter of 2006, primarily due to a 130% increase in DSL modem sales, a 632% increase in cable modem sales, and a 3% decrease in dial-up modem sales. DSL modem net sales increased from $1.3 million in the third quarter of 2006 to $3.0 million in the third quarter of 2007. Cable modem sales increased from $0.1 million net sales in the third quarter of 2006 to $1.2 million net sales in the third quarter of 2007. Dial-up modem net sales declined from $2.0 million net sales in the third quarter of 2006 to $1.9 million in the third quarter of 2007. Our dial-up modem net sales decline was less than the overall market decline. A major reason was that in the third quarter of 2006 one of our large dial-up modem retailers converted to a consignment sales arrangement which resulted in a net sales reversal of $0.5 million. The increase in DSL and cable modem net sales was primarily a result of increased product placements and sales to our large retailer customers.

Our net sales for the first nine months of 2007 increased 9.7% from the first nine months of 2006, primarily due to a 26% increase in DSL modem sales, a 792% increase in cable modem sales, and a 12% decrease in dial-up modem sales. DSL modem net sales increased to $7.3 million in the first nine months of 2007 compared to $5.8 million in the first nine months of 2006. Cable modem sal