JOHN HANCOCK FINANCIAL OPPORTUNITIES FUND
Form N-CSRS
August 23, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED

MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811- 8568

John Hancock Financial Opportunities Fund
(Exact name of registrant as specified in charter)

601 Congress Street, Boston, Massachusetts 02210
(Address of principal executive offices) (Zip code)

Salvatore Schiavone

Treasurer

601 Congress Street

Boston, Massachusetts 02210
(Name and address of agent for service)

Registrant's telephone number, including area code: 617-663-4497

Date of fiscal year end: December 31

Date of reporting period: June 30, 2017

ITEM 1. REPORTS TO STOCKHOLDERS.

John Hancock

Financial Opportunities Fund

Ticker: BTO
Semiannual report 6/30/17

A message to shareholders

Dear shareholder,

Global financial markets extended their run of positive performance in recent months, with particular strength coming from outside the United States. Overseas markets generally have been attracting investors with their lower valuations and improving corporate fundamentals, while monetary policy remains extremely accommodative. U.S. stocks also generated positive returns so far this year and have benefited from stronger-than-expected corporate earnings. Fixed-income results were more muted, although standout returns came from convertible securities and emerging-market bonds. Interest-rate sensitive bonds in the United States remain most vulnerable, as the U.S. Federal Reserve withdraws economic stimulus and follows through with interest rate increases as is expected.

Advancing the interests of fund shareholders

One of our primary goals is to advance the interests of our fund shareholders wherever possible. To that end, we recently announced our third round of expense reductions this year, targeting six mutual funds and two closed-end funds that together represent more than $6.9 billion in assets under management. Details can be found at jhinvestments.com.

Recently, we learned that fund researcher Morningstar, Inc. formally recognized our shareholder friendly initiatives by upgrading our parent pillar rating a key component of the Morningstar Analyst Rating system to positive, the highest possible rating. The firm evaluates select funds and their parent firms based on intensive research, including on-site due diligence. They focused on such factors as whether our portfolio managers invest meaningfully in the funds they manage, the quality of our risk management, our corporate culture, and our commitment to recognizing shareholder interests in other words, how good we are as stewards of investor capital. We're pleased to be recognized by Morningstar in this way and to continue our work of furthering the interests of our fund shareholders.

On behalf of everyone at John Hancock Investments, I'd like to take this opportunity to welcome new shareholders and to thank existing shareholders for the continued trust you've placed in us.

Sincerely,

Andrew G. Arnott
President and Chief Executive Officer
John Hancock Investments

This commentary reflects the CEO's views, which are subject to change at any time. Investing involves risks, including the potential loss of principal. Diversification does not guarantee a profit or eliminate the risk of a loss. For more up-to-date information, please visit our website at jhinvestments.com.

John Hancock
Financial Opportunities Fund

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Your fund at a glance

INVESTMENT OBJECTIVE

The fund seeks to provide a high level of total return consisting of long-term capital appreciation and current income.

AVERAGE ANNUAL TOTAL RETURNS AS OF 6/30/17 (%)

The S&P Composite 1500 Banks Index is an unmanaged index of banking sector stocks in the S&P 1500 Index.

It is not possible to invest directly in an index. Index figures do not reflect expenses and sales charges, which would result in lower returns.

The fund's most recent performance and current annualized distribution rate can be found at jhinvestments.com.

The fund's performance at net asset value (NAV) is different from the fund's performance at closing market price because the closing market price is subject to the dynamics of secondary market trading. If a shareholder purchases shares at a time when the market price is at a premium to the NAV or sells shares at a time when the market price is at a discount to the NAV, the shareholder may sustain losses.

The performance data contained within this material represents past performance, which does not guarantee future results.

PERFORMANCE HIGHLIGHTS OVER THE LAST SIX MONTHS

Rising interest rates supported financials

Although financial stocks were lifted by two interest rate increases by the U.S. Federal Reserve, the perceived lack of progress on tax reform and deregulation caused the sector to lag the overall market.

A regional bank focus hurt results

The fund had a positive absolute return but underperformed a comparative index, the S&P Composite 1500 Banks Index, due to an overweight in regional and small-cap banks.

Positive stress tests lifted large banks

Money center banks and other large-cap financial stocks benefited from better-than-expected stress test results and capital return plans.

PORTFOLIO COMPOSITION AS OF 6/30/17 (%)

A note about risks

As is the case with all closed-end funds, shares of this fund may trade at a discount or a premium to the fund's net asset value (NAV). An investment in the fund is subject to investment and market risks, including the possible loss of the entire principal invested. There is no guarantee prior distribution levels will be maintained and distributions may include a substantial return of capital. Fixed-income investments are subject to interest-rate and credit risk; their value will normally decline as interest rates rise or if a creditor, grantor, or counterparty is unable or unwilling to make principal, interest, or settlement payments. Investments in higher-yielding, lower-rated securities are subject to a higher risk of default. An issuer of securities held by the fund may default, have its credit rating downgraded, or otherwise perform poorly, which may affect fund performance. Liquidity the extent to which a security may be sold or a derivative position closed without negatively affecting its market value may be impaired by reduced trading volume, heightened volatility, rising interest rates, and other market conditions. The fund's use of leverage creates additional risks, including greater volatility of the fund's NAV, market price, and returns. There is no assurance that the fund's leverage strategy will be successful. Focusing on a particular industry or sector may increase the fund's volatility and make it more susceptible to market, economic, and regulatory risks as well as other factors affecting those industries or sectors. Derivatives transactions, including hedging and other strategic transactions, may increase a fund's volatility and could produce disproportionate losses, potentially more than the fund's principal investment.

Discussion of fund performance

An interview with Portfolio Manager Lisa A. Welch, John Hancock Asset Management a division of Manulife Asset Management (US) LLC

Lisa A. Welch
Portfolio Manager
John Hancock Asset Management

What were the main factors driving market performance and financial stocks during the six months ended June 30, 2017?

Financial stocks delivered positive returns; however, the momentum tied to potential tax reform and deregulation that started post the November election faded in the period, causing financials to lag the broad U.S. equity market. The U.S. Federal Reserve (Fed) increased the federal funds rate by 0.25% each time at two separate policy meetings during the period, the third and fourth interest-rate hikes of the current tightening cycle. The rising interest-rate environment was generally positive for the financial group, particularly banks, brokers, and insurance companies, which can invest deposits and excess cash at higher rates.

The U.S. economy continues to expand at a modest pace with low inflation, despite limited progress on the Trump administration's policy agenda. We expect the Fed to hike rates at least once more in 2017, which should help most financial companies. The benefits of rising short-term rates were partially offset by a flattening of the yield curve; however, after declining since mid-March, the 10-year U.S. Treasury bond yield started to increase by the end of June.

Economic data continued to be mixed, with positive employment data offset by weakness in other areas. The Fed released the results of its annual stress test reviews near the end of the period, and banks exceeded the market's already high expectations in terms of capital return. Dividend increases and share buyback announcements were higher than projected, with some banks expected to return over 100% of their 2017 earnings to shareholders. A comparative index, the S&P Composite 1500 Banks Index, gained 4.90% for the reporting period, which was below the return of 8.87% for the broad-based S&P 1500 Composite Index.

"The fund had a positive absolute return at NAV, but underperformed the comparative index, primarily due to stock selection among regional banks."

The fund underperformed for the period. What trends affected its performance?

The fund had a positive absolute return at NAV, but underperformed the comparative index, primarily due to the overweight in mid- and small-cap banks and the underweight in money center banks, which comprise over 60% of the benchmark. The smaller banks delivered very strong performance following the election, but stalled with the new administration's lack of progress on accelerating economic growth, and tax and regulatory reform.

Which holdings had the biggest negative impact for the period?

Among the leading detractors were several regional banks with very strong returns in late 2016 that gave back some of those gains in the first half of the year, including FNB Corp. and Chemical Financial Corp.

The fund's lower exposure to JPMorgan Chase & Co., Bank of America Corp., and Citigroup, Inc., which delivered better-than-expected stress test results and outperformed the overall bank industry, was also a detractor from relative performance.

INDUSTRY COMPOSITION AS OF 6/30/17 (%)

"Rising interest rates should benefit much of the sector and we believe loan growth, which had been sluggish to start the year, should accelerate in the second half of 2017."

What stocks had the greatest positive impact on relative performance?

The leading contributors included Mississippi-based Hancock Holding Company, which saw its stock outperform following branch purchases from a competitor and an FDIC-assisted transaction. Cullen/Frost Bankers, Inc., which specializes in lending to oil and gas companies, was also a strong performer as U.S. shale production increased during the quarter, and the company exceeded earnings expectations. Georgia-based Ameris Bancorp outperformed after reporting strong earnings with core net interest margin expansion, solid fee income growth, and contained expenses.

Meanwhile, alternative asset manager The Blackstone Group LP's stock price surged after announcing the successful launch of a large, new fund, while rival KKR & Company LP also performed well.

How was the fund positioned at the end of the period?

We added two small-cap banks to the portfolio through the companies' additional share offerings: Civista Bancshares, Inc. of Ohio and MidWestOne Financial Group, Inc. which is headquartered in Iowa.

TOP 10 HOLDINGS AS OF 6/30/17 (%)

M&T Bank Corp.	2.5
JPMorgan Chase & Co.	2.5
The PNC Financial Services Group, Inc.	2.4
Citizens Financial Group, Inc.	2.3
Cullen/Frost Bankers, Inc.	2.2
U.S. Bancorp	2.1
SunTrust Banks, Inc.	2.1
BB&T Corp.	2.1
Wells Fargo & Company	2.0
Ameris Bancorp	1.8
Total	**22.0**

As a percentage of total investments.

Cash and cash equivalents are not included.

We exited the fund's position in business development company Fifth Street Finance Corp., as we continued to have concerns about the company's credit quality. We also sold out of Seattle-based HomeStreet, Inc., as we believed that the slowdown in mortgage refinancing activity would continue to negatively affect the bank's earnings.

We remain bullish on the prospects for financial stocks. Rising interest rates should benefit much of the sector and we believe loan growth, which had been sluggish to start the year, should accelerate in the second half of 2017. Merger-and-acquisition activity remains strong in the sector, particularly among the smaller banks. Further, we believe valuations remain attractive compared to historic levels. Corporate tax reform, if it is successfully implemented, could also be an added benefit for the industry.

MANAGED BY

Susan A. Curry
On the fund since 2006
Investing since 1993
Lisa A. Welch
On the fund since 1998
Investing since 1986
Ryan P. Lentell, CFA
On the fund since 2015
Investing since 1999

The views expressed in this report are exclusively those of Lisa A. Welch, John Hancock Asset Management, and are subject to change. They are not meant as investment advice. Please note that the holdings discussed in this report may not have been held by the fund for the entire period. Portfolio composition is subject to review in accordance with the fund's investment strategy and may vary in the future. Current and future portfolio holdings are subject to risk.

Fund's investments

AS OF 6-30-17 (unaudited)

	Shares	Value
Common stocks 103.8% (89.0% of Total investments)		$670,747,753
(Cost $356,901,673)		
Financials 103.8%		670,747,753
Banks 94.2%		
1st Source Corp.	121,706	5,834,586
Access National Corp.	64,963	1,722,819
Ameris Bancorp	274,471	13,229,502
Atlantic Capital Bancshares, Inc. (A)(B)(C)	192,378	3,655,182
Avidbank Holdings, Inc. (C)	200,000	3,932,000
Bank of America Corp.	432,436	10,490,897
Bank of Commerce Holdings (B)	40,374	446,133
Bank of Marin Bancorp	58,731	3,614,893
Bankwell Financial Group, Inc.	20,715	646,929
Bar Harbor Bankshares	129,698	3,997,292
BB&T Corp.	346,799	15,748,143
Berkshire Hills Bancorp, Inc.	338,903	11,912,440
Bryn Mawr Bank Corp.	80,000	3,400,000
Cambridge Bancorp (B)	5,257	353,533
Camden National Corp.	55,164	2,367,087
Capstar Financial Holdings, Inc. (A)(B)(C)	14,226	252,369
Carolina Financial Corp.	70,982	2,294,138
Chemical Financial Corp. (A)(B)	217,502	10,529,272
Citigroup, Inc.	49,519	3,311,831
Citizens Financial Group, Inc.	476,395	16,997,774
City Holding Company	39,363	2,592,841
Civista Bancshares, Inc.	43,240	902,851
Comerica, Inc.	167,706	12,282,787
Commerce Bancshares, Inc. (A)(B)	110,463	6,277,612
Communities First Financial Corp. (C)	115,523	1,732,845
Community Bank Systems, Inc. (A)(B)	38,226	2,131,864
County Bancorp, Inc.	62,184	1,492,416
CU Bancorp (B)(C)	91,813	3,319,040
Cullen/Frost Bankers, Inc. (A)(B)	178,964	16,806,509
DNB Financial Corp. (B)	78,515	2,693,065
Eagle Bancorp Montana, Inc.	75,106	1,359,419
Equity Bancshares, Inc. (C)	36,055	1,104,725
Equity Bancshares, Inc., Class A (C)	94,860	2,906,510
Evans Bancorp, Inc.	69,760	2,786,912
FCB Financial Holdings, Inc., Class A (C)	188,399	8,996,052
Fifth Third Bancorp	452,067	11,735,659
First Bancorp, Inc.	266,499	7,211,463
First Business Financial Services, Inc.	60,700	1,400,956

First Citizens BancShares, Inc., Class A	15,038	5,604,663
First Colebrook Bancorp, Inc. (D)	48,750	1,101,750

	Shares	Value
Financials (continued)		
Banks (continued)		
First Community Corp.	136,228	$2,860,788
First Connecticut Bancorp, Inc.	202,450	5,192,843
First Financial Bancorp	146,045	4,045,447
First Hawaiian, Inc.	160,968	4,928,840
First Merchants Corp.	118,683	4,763,936
First Security Group, Inc. (C)	83,942	2,056,579
Flushing Financial Corp. (B)	139,050	3,919,820
FNB Corp. (A)(B)	913,889	12,940,668
German American Bancorp, Inc. (A)(B)	60,090	2,048,468
Glacier Bancorp, Inc. (A)(B)	223,556	8,184,385
Great Southern Bancorp, Inc. (B)	40,257	2,153,750
Great Western Bancorp, Inc.	159,455	6,507,359
Hamilton State Bancshares, Inc.	500,000	3,971,690
Hancock Holding Company	245,752	12,041,848
HCSB Financial Corp. (C)(D)	22,238,470	2,782,033
Heritage Commerce Corp.	506,922	6,985,385
Heritage Financial Corp. (B)	194,590	5,156,635
HomeTown Bankshares Corp. (C)	174,720	1,878,240
Horizon Bancorp (A)(B)	269,724	7,107,227
Howard Bancorp, Inc. (C)	136,118	2,620,272
Independent Bank Corp. (MA)	173,570	11,568,441
Independent Bank Corp. (MI)	125,407	2,727,602
JPMorgan Chase & Co.	203,805	18,627,777
KeyCorp	667,659	12,511,930
M&T Bank Corp.	117,579	19,041,919
Mackinac Financial Corp.	40,000	560,000
MainSource Financial Group, Inc.	185,504	6,216,239
MB Financial, Inc.	183,150	8,065,926
MidWestOne Financial Group, Inc. (B)	31,763	1,076,448
MutualFirst Financial, Inc. (B)	100,539	3,589,242
National Commerce Corp. (B)(C)	71,147	2,813,864
Nicolet Bankshares, Inc. (B)(C)	24,767	1,355,003
Northrim BanCorp, Inc.	99,739	3,032,066
Oak Valley Bancorp (B)	1,970	27,383
Old National Bancorp (A)(B)	464,937	8,020,163
Old Second Bancorp, Inc.	202,363	2,337,293
Pacific Continental Corp. (B)	185,636	4,743,000
Pacific Premier Bancorp, Inc. (A)(B)(C)	169,865	6,268,019
PacWest Bancorp	71,112	3,320,930
Park National Corp. (A)(B)	42,113	4,367,960
Park Sterling Corp.	585,931	6,960,860
Peoples Bancorp, Inc.	122,945	3,950,223

Pinnacle Financial Partners, Inc. (A)(B)	108,000	6,782,400
Prime Meridian Holding Company	83,010	1,441,884

	Shares	Value
Financials (continued)		
Banks (continued)		
QCR Holdings, Inc. (B)	48,822	$2,314,163
Regions Financial Corp.	651,413	9,536,686
Renasant Corp.	159,629	6,982,172
Sandy Spring Bancorp, Inc. (B)	68,417	2,781,835
SBT Bancorp, Inc. (B)	37,879	943,187
Shore Bancshares, Inc.	183,579	3,019,875
Sierra Bancorp (B)	1,496	36,727
South Atlantic Bancshares (C)	241,595	2,721,664
Southern First Bancshares, Inc. (C)	131,586	4,875,261
Southern National Bancorp of Virginia, Inc.	125,139	2,202,454
Southwest Bancorp, Inc. (B)	79,929	2,042,186
State Bank Financial Corp.	53,182	1,442,296
Stock Yards Bancorp, Inc.	66,324	2,580,004
Sun Bancorp, Inc. (B)	126,066	3,107,527
SunTrust Banks, Inc.	278,451	15,793,741
The Community Financial Corp. (B)	62,497	2,406,135
The First Bancshares, Inc. (B)	210,000	5,796,000
The First of Long Island Corp.	57,322	1,639,409
The PNC Financial Services Group, Inc.	146,047	18,236,889
Towne Bank (A)(B)	157,856	4,861,965
TriCo Bancshares (B)	202,536	7,119,140
U.S. Bancorp	310,100	16,100,392
Union Bankshares Corp.	161,410	5,471,799
United Bankshares, Inc. (A)(B)	74,856	2,934,355
Washington Trust Bancorp, Inc.	123,905	6,387,303
Wells Fargo & Company	269,099	14,910,776
Xenith Bankshares, Inc. (B)(C)	2,905	90,229
Zions Bancorporation (A)(B)	265,769	11,669,917
Capital markets 1.8%		
Intermediate Capital Group PLC	336,897	3,653,438
KKR & Company LP	233,755	4,347,843
The Blackstone Group LP	109,070	3,637,485
Consumer finance 0.6%		
Capital One Financial Corp.	47,914	3,958,655
Insurance 0.4%		
Gjensidige Forsikring ASA	165,452	2,824,242
Thrifts and mortgage finance 6.8%		
Bank Mutual Corp.	161,841	1,480,845
BSB Bancorp, Inc. (B)(C)	177,195	5,182,954
First Defiance Financial Corp. (B)	110,515	5,821,930
Provident Financial Holdings, Inc. (B)	97,339	1,873,776
Provident Financial Services, Inc.	155,989	3,959,001

Southern Missouri Bancorp, Inc.	112,188	3,619,185
United Community Financial Corp.	634,588	5,273,426

SEE NOTES TO FINANCIAL STATEMENTS

	Shares	Value
Financials (continued)		
Thrifts and mortgage finance (continued)		
United Financial Bancorp, Inc.	268,885	$4,487,691
Westbury Bancorp, Inc. (B)(C)	88,349	1,798,786
WSFS Financial Corp.	222,599	10,094,865
Preferred securities 5.2% (4.4% of Total investments)		**$33,079,456**
(Cost $30,675,626)		
Financials 3.2%		**20,172,801**
Banks 0.9%		
OFG Bancorp, Series C, 8.750%	1,671	1,594,515
SB Financial Group, Inc., 6.500%	250,000	4,092,550
Capital markets 1.9%		
JMP Group LLC, 7.250%	80,000	2,019,200
JMP Group LLC, 8.000%	82,428	2,097,793
THL Credit, Inc., 6.750% (A)(B)	136,266	3,556,543
TriplePoint Venture Growth BDC Corp., 6.750%	168,000	4,267,200
Mortgage real estate investment trusts 0.4%		
Arbor Realty Trust, Inc., 7.375%	100,000	2,545,000
Real estate 2.0%		**12,906,655**
Equity real estate investment trusts 2.0%		
American Homes 4 Rent (5.500% to 3-31-21, then 10.000% thereafter) (A)(B)	100,000	2,800,000
Bluerock Residential Growth REIT, Inc., 8.250%	84,140	2,229,710
Invesco Mortgage Capital, Inc. (7.750% to 12-27-24, then 3 month LIBOR + 5.180%)	150,000	3,796,500
Sotherly Hotels LP, 7.000%	99,475	2,568,445
Sotherly Hotels, Inc., 8.000%	60,000	1,512,000

	Rate (%)	Maturity date	Par value^	Value
Corporate bonds 7.1% (6.1% of Total investments)				**$45,877,520**
(Cost $44,061,108)				
Financials 7.1%				**45,877,520**
Banks 5.2%				
Avidbank Holdings, Inc. (6.875% to 11-15-20, then 3 month LIBOR + 5.367%) (E)	6.875	11-15-25	3,000,000	3,048,750
Cadence Financial Corp. (E)	4.875	06-28-19	1,500,000	1,471,875
Cadence Financial Corp. (6.500% to 3-11-20, then 3 month LIBOR + 4.663%) (E)	6.500	03-11-25	5,000,000	5,050,000
First Business Financial Services, Inc.	6.500	09-01-24	5,000,000	5,077,885
Northeast Bancorp (6.750% to 7-1-21, then 3				

month LIBOR + 5.570%)	6.750	07-01-26	5,000,000	5,012,500
Old Second Bancorp, Inc. (5.750% to 12-31-21, then 3 month LIBOR + 3.850%)	5.750	12-31-26	1,725,000	1,783,219
Popular, Inc.	7.000	07-01-19	6,000,000	6,300,000
VantageSouth Bancshares, Inc.	7.625	08-12-23	5,000,000	5,663,015

	Rate (%)	Maturity date	Par value^	Value
Financials (continued)				
Diversified financial services 1.9%				
Flagstar Bancorp, Inc.	6.125	07-15-21	6,000,000	$6,394,320
NewStar Financial, Inc.	7.250	05-01-20	5,935,000	6,075,956
Certificate of deposit 0.0% (0.0% of Total investments)				**$78,864**
(Cost $78,864)				
Country Bank for Savings	1.000	08-27-18	2,016	2,016
First Bank Richmond	0.990	12-05-19	21,010	21,010
First Bank System, Inc.	0.600	04-03-19	5,015	5,015
First Federal Savings Bank of Louisiana	0.100	01-05-18	3,042	3,042
Home Banks	1.739	11-04-21	18,927	18,927
Hudson Savings	0.800	04-23-19	2,188	2,188
Machias Savings Bank	0.500	05-29-18	1,975	1,975
Midstate Federal Savings and Loan	0.500	05-30-18	2,019	2,019
Milford Federal Savings and Loan Bank	0.250	06-10-19	1,913	1,913
Milford Federal Savings and Loan Bank	0.300	10-24-17	2,037	2,037
Mount McKinley Savings Bank	0.500	12-03-18	1,700	1,700
Mt. Washington Bank	0.650	10-31-17	1,899	1,899
MutualOne Bank	0.900	09-08-17	4,011	4,011
Newburyport Five Cent Savings Bank	0.700	10-19-18	2,093	2,093
Newton Savings Bank	0.450	05-30-18	1,955	1,955
OBA Federal Savings and Loan	0.390	12-15-17	1,338	1,338
Plymouth Savings Bank	0.200	04-22-19	1,946	1,946
Salem Five Cents Savings Bank	0.250	12-15-17	1,735	1,735
Sunshine Federal Savings and Loan Association	0.500	05-10-19	2,045	2,045

	Yield* (%)	Maturity date	Par value^	Value
Short-term investments 0.6% (0.5% of Total investments)				**$4,007,000**
(Cost $4,006,876)				
U.S. Government Agency 0.5%				**3,440,000**
Federal Home Loan Bank Discount Note	0.650	07-03-17	3,440,000	3,440,000

	Par value^	Value
Repurchase agreement 0.1%		**567,000**
Repurchase Agreement with State Street Corp. dated 6-30-17 at 0.340% to be repurchased at $567,016 on 7-3-17, collateralized by $590,000 U.S. Treasury Notes, 1.125% due 2-28-21 (valued at $580,775, including interest)	567,000	567,000

Total investments (Cost $435,724,147)† 116.7%	**$753,790,593**
Other assets and liabilities, net (16.7%)	**(107,711,492)**

Total net assets 100.0%	**$646,079,101**

The percentage shown for each investment category is the total value of the category as a percentage of the net assets of the fund.

^All par values are denominated in U.S. dollars unless otherwise indicated.

Security Abbreviations and Legend

LIBOR London Interbank Offered Rate

%

Selling, general and administrative expense (exclusive of legal and professional fees, non cash stock compensation to employees and warrants for services, shown below)

517

9

%

585

47

%

Legal and professional fees

417

7

%

303

24

%

Non-cash issuance of common stock and warrants for services

618

10

%

6,570

524

%

Non-cash stock-based compensation, employees

474

8

%

-

0

%

Impairment expense

-

0

%

702

300

%

Bad debt expense

4

0

%

4

0

%

Depreciation and amortization

112

2
%

20

2
%

Operating loss

(1,795
)

-30
%

(8,001
)

-638
%

Debt forgiveness income

460

8
%

257

0
%
Gain on disposal of investment

12,104

201
%

-

0
%
Gain (loss) on derivative instrument liabilities

(287
)

-5
%

4,439

354

%

Other income (expense)

(75

)

-1

%

(252

)

-20

%

Net income (loss)

10,407

173

%

(3,557

)

-284

%

Less: preferred stock dividends

(709

)

-12

%

(306

)

-24

%

Net income (loss) to applicable to common shareholders

$

9,698

161
%

($3,863
)

-308
%

19

Year Ended July 31, 2005 Compared to Year ended July 31, 2004

Operating revenues. Consolidated operating revenues increased by 379% between periods from $1.25 million for the year ended July 31, 2004 to $6.0 million for the year ended July 31, 2005.

Carrier services revenues increased by approximately $4.7 million, or 466% from the year ended July 31, 2004 to the year ended July 31, 2005. Our VoIP carrier traffic increased from approximately 25.8 million minutes during the year ended July 31, 2004 to approximately 149 million minutes during the year ended July 31, 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 approximately 2% or $5,000 from the year ended July 31, 2004 to the year ended July 31, 2005. The decrease in network services revenue is primarily due to termination of the network service agreement with our major customer for this service. As a result we expect a reduction of network service revenue by $22,000 per month.

Communication services revenues increased by 1% or $94,500 from the year ended July 31, 2004 to the year ended July 31, 2005. The increase in local and long distance retail services is primarily due to the acquisition in August 1, 2004, of a Competitive Local Exchange Carrier ("CLEC") based in South Texas. This acquisition has served as a gateway to reach out to the Hispanic communities residing along the US and Mexico border and allowed our local and long distance retail services to grow from $0 during fiscal 2004 to $94,500 for the year ended July 31, 2005.

Cost of Services (Exclusive of depreciation and amortization). The consolidated cost of services increased by approximately $4.6 million, or 429% from the year ended July 31, 2004 to the year ended July 31, 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 25.8 million minutes during the year ended July 31, 2004 to approximately 149 million minutes in the year ended July 31, 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, shown below) SG&A expenses decreased by approximately $68,000, or 11% from the year ended July 31, 2004 to the year ended July 31, 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 $114,000, or 38% from the year ended July 31, 2004 to the year ended July 31, 2005. The increase is attributable to the recognition of approximately $225,000 in professional fees associated with a marketing campaign that commenced during the first quarter of fiscal 2005.

Non-cash issuance of common stock and warrants for services. Non-cash issuance of common stock and warrants for services decreased by approximately $6 million from the year ended July 31, 2004 to the year ended July 31, 2005. This decrease is primarily due to recognition of approximately $6.6 million in non-cash compensation expense, this expense was recognized during the fourth quarter of fiscal 2004 and was 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 year ended July 31, 2004 to the year ended July 31, 2005. This increase is attributed to the 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.

Impairment Expense. Impairment expense decreased by 100% or $702,000 from the year ended July 31, 2004 to the year ended July 31, 2005. During the year ended July 31, 2004, in accordance with U.S. GAAP we determined that the estimated cash flows expected from the concession license was less than the recorded value. As a result we recorded an impairment loss of approximately $702,000 to reduce the recorded value of the concession license. During the year ended July 31, 2005 we did not recognized any impairment expense.

Bad debt expense. Bad debt expense remained consistent at $4,000 over the year ended July 31, 2004 and the year ended July 31, 2005. During the year ended July 31, 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 $92,000 from the year ended July 31, 2004 to the year ended July 31, 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) decreased by approximately $6.2 million or 78% from the year ended July 31, 2004 to the year ended July 31, 2005. This decrease is primarily due to recognition of approximately $6.6 million in non-cash compensation expense, this expense was recognized during the forth quarter of fiscal 2004 and was associated with the consulting agreements entered into with certain individual affiliates of Recap Marketing & Consulting, LLP. Additionally, during the year ended July 31, 2004, in accordance with U.S. GAAP we determined that the estimated cash flows expected from the concession license was less than the recorded value. As a result we recorded an impairment loss of approximately $702,000 to reduce the recorded value of the concession license. During the year ended July 31, 2005 we did not recognized any impairment expense.

Debt forgiveness income. Our debt forgiveness income increased by approximately $203,000 from the year ended July 31, 2004 to the year ended July 31, 2005. During the year ended July 31, 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 year ended July 31, 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 $287,000 for the year ended July 31, 2005 compared to a gain of $4,439,000 for the year ended July 31, 2004, a decrease of $4,726,000. The decrease 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 warrants and debt instruments that have been bifurcated and accounted for separately.

Other income (expense). Other income (expense) decreased by approximately $177,000 or 70% from the year ended July 31, 2004 to the year ended July 31, 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 year ended July 31, 2004 associated with our portion of the losses on our investment in ATSICOM. During the year ended July 31, 2005 the Company did not incurr any loss in ATSICOM.

Preferred Stock Dividends. Preferred Stock Dividends expense increased by approximately $403,000 between periods, from $306,000 for the year ended July 31, 2004 to $709,000 during the year ended July 31, 2005. The increase in preferred stock dividend expense can be attributed to the recognition of $557,000 of dividend expense associated with the Redeemable Preferred Series H Stock, as per the certificate of designation the Redeemable Preferred Series H stockholders earns a 20% premium after is been held under the shareholders name for 1 year from the reincorporation in May 2004.

Net income (loss) to Common Stockholders. The net (loss) for the year ended July 31, 2005 decreased to $9,698,000 net income or $1.36 per share from $3,863,000 net (loss) or $3.22 (loss) per share for the year ended July 31, 2004. The decrease in net (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 by the decrease of $4,726,000 in gain (loss) on derivative instrument liabilities between periods and the recognition in 2005 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. Also, there was an increase in preferred stock dividends of approximately $403,000 from the year ended July 31, 2004 to the year ended July 31, 2005.

Liquidity and Capital Resources

The Company's financials statements for the year ended July 31, 2005 have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. For the year ended July 31, 2005, the Company reported a net income of $9,698,000 and has a stockholders' deficit as of July 31, 2005 of approximately $6.2 million. In addition, the Company has a working capital deficiency of $5.8 million as of July 31, 2005.

Cash used in operating activities:

During the year ended July 31, 2005, operations consumed approximately $561,000 in cash, although, the Company recognized a net income of $10.4 million for 2005. The net income for fiscal 2005 is attributed to the recognition of $12,104,000 associated with a gain on disposal of investment and the recognition of $460,000 of debt forgiveness income associated with the settlement of various debts. Additionally, the Company recognized $474,000 in non-cash compensation expense associated with the stock grants and stock options awarded to the employees and board of directors and we recognized $638,000 in non-cash warrant expense associated with the consulting services agreement entered into during fiscal 2005. We also recognized an increase in accounts payable and accrued liabilities of approximately $79,000 and $165,000, respectively. These increases are related to the recognition of various invoices associated with the carrier services cost of goods. Also, we recognized an increase in accounts receivables of $145,000 associated with the billing to our customers during the last week of fiscal 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 year ended July 31, 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 purchased 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 year ended July 31, 2005 we made principal payments on our capital lease obligation for approximately $2,000 and we received $918,000 from the exercise of warrants and $514,000 from proceeds from various notes payable. In addition, as result of the exercise of warrants we also recognized payments of $918,000 on our notes payable. Overall, our net operating, investing and financing activities during the year ended July 31, 2005 provided a decrease of approximately $65,000 in cash balances. We had a cash balance of $29,000 as of July 31, 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 2006. 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 $740,000 in cash flow savings during the fiscal year ended July 31, 2005.

Our working capital deficit at July 31, 2005 was approximately $5.8 million. This represents a decrease of approximately $14,839,000 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. These bankrupt subsidiaries ceased all 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.

· $1,182,000 associated with the Series D Cumulative preferred stock. Of this balance, $942,000 is associated with the full redemption of this security and $240,000 is related to the accrued dividends as of July 31, 2005.

· $1,749,000 associated with the Series E Cumulative preferred stock. Of this balance, $1,463,000 is associated with the full redemption of this security and $286,000 is related to the accrued dividends as of July 31, 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 for the redemption of Series D and Series E preferred stock combined for a total of approximately $2,931,000. 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 July 31, 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.

We have incurred amounts of debt to finance our working capital requirements. During the year ended July 31, 2005, we borrowed a total of $984,000 from Recap Marketing & Consulting, LLP to fund our operating expenses and other corporate expenses. This debt was 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 7. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
ATSI Communications, Inc.
San Antonio, Texas

We have audited the consolidated balance sheet of ATSI Communications, Inc. and subsidiaries ("ATSI") as of July 31, 2005 and the related consolidated statements of operations, comprehensive loss, stockholders' deficit and cash flows for the years ended July 31, 2005 and 2004. These consolidated financial statements are the responsibility of ATSI's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ATSI as of July 31, 2005 and the consolidated results of their operations and their cash flows for the years ended July 31, 2005 and 2004 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that ATSI will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, ATSI has a working capital deficit, has suffered recurring losses and has a stockholders' deficit. These conditions raise substantial doubt about ATSI's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As described in Note 12, the financial statements for 2004 and 2005 have been restated.

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

September 9, 2005
(April 13, 2006 as to Note 12 and the effects of the restatement)

PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

		July 31,2005 (Restated)
ASSETS:		
CURRENT ASSETS:		
Cash and cash equivalents	$	29
Accounts receivable		170
Prepaid & other current assets		44
Total current assets		243
PROPERTY AND EQUIPMENT		228
Less - accumulated depreciation		(90)
Net property and equipment		138
Total assets	$	381
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES:		
Accounts payable	$	606
Accrued liabilities		1,033
Current portion of obligation under capital leases		3
Notes payable		16
Notes payable, Franklin Cardwell & Jones		77
Convertible debentures		234
Series D Cumulative Preferred Stock, 3,000 shares authorized, 742 shares issued and outstanding		1,182
Series E Cumulative Preferred Stock, 10,000 shares authorized, 1,170 shares issued and outstanding		1,749
Derivative financial instrument liabilities (footnote 12)		24
Liabilities from discontinued operations, net of assets		1,152
Total current liabilities		6,076
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, 13,912,372 issued and outstanding		14

Common stock, $0.001, 150,000,000 shares authorized, 10,397,222 issued and outstanding		10
Additional paid in capital		66,458
Accumulated deficit		(73,196)
Other comprehensive income		502
Total stockholders' deficit		(6,212)
Total liabilities and stockholders' deficit	$	381

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

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

	Years ended July 31, 2005	2004
OPERATING REVENUES:		
Services		
Carrier services	$ 5,782	$ 1,020
Network services	229	234
Total operating revenues	6,011	1,254
OPERATING EXPENSES:		
Cost of services (exclusive of depreciation and amortization, shown below)	5,664	1,071
Selling, general and administrative expense (exclusive of legal and professional fees, non cash stock compensation to employees and warrants for services, shown below)	517	585
Legal and professional fees	417	303
Non-cash issuance of common stock and warrants for services	618	6,570
Non-cash stock-based compensation, employees	474	-
Impairment expense	-	702
Bad debt expense	4	4
Depreciation and amortization	112	20
Total operating expenses	7,806	9,255
OPERATING LOSS	(1,795)	(8,001)
OTHER INCOME (EXPENSE):		
Other income	27	7
Debt forgiveness income	460	257
Gain on disposal of investment	12,104	0
Gain from sale of assets	-	25
Gain (loss) on derivative instrument liabilities	(287)	4,439
Loss on an unconsolidated affiliate	-	(107)
Interest expense	(102)	(177)
Total other income	12,202	4,444
NET INCOME (LOSS)	10,407	(3,557)
LESS: PREFERRED DIVIDENDS	(709)	(306)
NET INCOME (LOSS) TO COMMON STOCKHOLDERS	$ 9,698	($3,863)
BASIC INCOME (LOSS) PER SHARE	$ 1.36	($3.22)

DILUTED INCOME (LOSS) PER SHARE	$	0.42	($3.22)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING		7,128,847	1,199,892

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

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

	Twelve months ended July 31, 2005	2004
Net income (loss) to common stockholders	$ 9,698	($3,863)
Foreign currency translation adjustment	-	-
Comprehensive income (loss) to common stockholders	$ 9,698	($3,863)

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

ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' (DEFICIT) (RESTATED)
(in thousands)

	Preferred Stock (A)		Preferred Stock (H)		Common Stock						
	Shares	Amount	Shares	Amount	Shares	Amount	Additional Paid In Capital	Accumulated Deficit	Notes receivable from officers	Cumulative Translation Adjustment	Total Stockholders' (DEFICIT)
BALANCE, JULY 31, 2003	4	0	-	-	1,036	$ 1	$ 60,720	($80,046)	$ 0	$ 502	(18,819)
Shares issued for services					929	1	861				862
Shares issued for cash					567	1	5				6
Conversion of redeemable preferred stock					401	0	314				314
Reincorporation to Nevada			14,385	14	(14)	(0)	128				142
Dividends declared							(306)				(306)
Derivative instrument (income) expense							(5,784)				(5,784)
Warrant expense							6,569				6,569
Net loss								(3,557)			(3,557)
BALANCE, JULY 31, 2004	4	0	14,385	14	2,919	$ 3	$ 62,510	($83,602)	$ 0	$ 502	(20,573)
Shares issued for services					1,417	1	606				607
Shares issued to Purchase Assets					121	0	69				69
Shares issued for P/S Conversion			(473)		473	0	0				1
Shares issued for Debt Conversion					1,188	1	944				945
Exercise of Warrants					4,280	4	914				918
Warrant expense							443				443
Derivative instrument (income) expense							1,638				1,638
Dividends declared							(709)				(709)
Option Expense							42				42
Net income								10,407			10,407
BALANCE, JULY 31, 2005	4	0	13,911	14	10,397	$ 10	$ 66,458	($73,196)	$ 0	$ 502	(6,212)

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

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

	Years ended July 31, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	$ 10,407	($3,557)
Adjustments to net income (loss):		
Gain on disposal of investment	(12,104)	
Debt forgiveness income	(460)	(257)
Adjustments to reconcile net loss to cash used in operating activities:		
Impairment loss	-	702
Depreciation and amortization	112	19
Loss on an unconsolidated affiliate	-	107
Non-cash issuance of stock grants and options, employees	474	-
Non-cash issuance of common stock and warrants for services	618	6,570
Provision for losses on accounts receivable	4	4
Loss (gain) on derivative instrument liabilities	287	(4,439)
Changes in operating assets and liabilities:		
Increase in		
Accounts receivable	(125)	(21)
Prepaid expenses and other	(18)	(31)
Increase / (decrease) in		
Accounts payable	79	284
Accrued liabilities	165	162
Net cash used in operating activities	(561)	(457)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property & equipment	(8)	(130)
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)	10
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from notes payable	918	410
Payments on notes payable	(918)	(9)
Proceeds from the exercise of warrants	514	-
Principal payments on capital lease obligation	(2)	-
Net cash provided by financing activities	512	401
DECREASE IN CASH	(65)	(46)
CASH AND CASH EQUIVALENTS, beginning of period	94	140
CASH AND CASH EQUIVALENTS, end of period	$ 29	$ 94
NON-CASH TRANSACTIONS		
Issuance of common stock for conversion of debt	$ 944	-
Issuance of common stock for purchase of fixed & Intangible assets	82	-
Fair value of the derivative instrument	26	6,569

Change in derivative liabilities on warrants exercised	1,638	1,638

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

ATSI COMMUNICATIONS, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business: ATSI Communications, Inc. ("ATSI") was incorporated in Nevada on May 24, 2004. ATSI is an international telecommunications carrier that utilizes the Internet to provide economical international telecommunications services to carriers and telephony resellers around the world. ATSI's continuing operations consist of VoIP wholesale business and network services. ATSI provides transmission and termination services to U.S. and foreign telecommunications companies who lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America.

Reclassifications. Certain prior year amounts have been reclassified to conform with the current year presentation.

Principles of Consolidation. The consolidated financial statements have been prepared on the accrual basis of accounting under accounting principles generally accepted in the United States (GAAP). All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates. In preparing financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities in the balance sheet and revenue and expenses in the statement of expenses. Actual results could differ from those estimates.
Derivative financial instruments. ATSI 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.

Cash and Cash Equivalents. For purposes of the statement of cash flows, ATSI considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

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

Carrier Service: ATSI provides transmission and termination services to U.S. and Foreign telecommunications companies who lack transmission facilities, require additional capacity or do not have the regulatory licenses to terminate traffic in Mexico, Asia, the Middle East and Latin America. Typically these telecommunications companies offer their services to the public for local and international long distance services. Carrier service revenue is derived through transporting and terminating minutes of telecommunications traffic over ATSI's owned or leased VoIP network (Voice over Internet Protocol). ATSI recognizes revenue in the period the service is provided, net of revenue reserves for potential billing credits. Such disputes can result from disagreements with customers regarding the duration, destination or rates charged for each call.

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

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Communication Services: ATSI provides retail local phone service and international VoIP long distance service to the U.S. Hispanic market throughout Texas, mainly in the Rio Grande Valley. Our local phone service includes access to a landline and value-added services such a caller ID and call waiting. These services are offered to our customers in both prepaid and postpaid basis. Additionally, ATSI provides prepaid domestic and long-distance services; under these services ATSI allows our customers to access our prepaid VoIP network platform. The customer will access this platform and be able to complete the call by using their local phone number as their "PIN" or personal identification number. The revenues derived from prepaid local telephone and long-distance are billed monthly in advance and are recognized the following month when services are provided. Additionally, revenues derived from postpaid local telephone and long-distance services are recognized monthly as services are provided.

Allowance for Doubtful Accounts. Bad debt expense is recognized based on management's estimate of likely losses per year, based on past experience and an estimate of current year uncollectible amounts. There was no allowance for doubtful accounts as of July 31, 2005.

Note receivable. ATSI has fully reserved and recognized an allowance for a note receivable from Telemarketing de Mexico S.A de C.V. associated with the sale of 51% of ATSI Comunicaciones S.A de C.V. Originally, under the terms of the Share Purchase Agreement dated May 24, 2003, ATSI was scheduled to receive from Telemarketing $20,750 per month for 24 months beginning in May 2004, contingent on ATSI generating 20,750,000 minutes of monthly traffic through ATSICOM's network, until Telemarketing paid the total remaining purchase price of $498,000. In the event ATSI was not able to reach the above-mentioned volume of monthly minutes, the monthly payments were to be adjusted based on the percentage of the shortfall in minutes. ATSI has 10% of ATSICOM's stock as collateral on this note.

During fiscal 2004 ATSI experienced difficulties with DialMex's network, due primarily to deficiencies in DialMex's network capacity, call interruptions and limited traffic routing selections. Additionally, ATSI Comunicaciones S.A de C.V. has not been able to complete the required interconnections with other Mexican carriers, to process domestic and international VoIP traffic. As result, ATSI has not generated the monthly minutes required under the Telemarketing agreement. Consequently, ATSI has not received any payments from Telemarketing since May 2004. Since there is no assurance from Telemarketing and its principal owners of payment, we recognized an allowance for the total amount and reflected the balance, net of the allowance, as zero in the accompanying financial statements as of July 31, 2005.

Direct Cost of Revenue:

Carrier Services: Under carrier services ATSI incurs termination charges. These charges are related to the fees that ATSI is charged by carriers / vendors for the termination of phone calls into their infrastructure and network to terminate traffic in Mexico, Asia, the Middle East and Latin America. The cost is based on a per minute rate and volume. ATSI also incurs installation charges from various carriers; this cost is passed on to customers for the connection to the VoIP network from ATSI's carriers.

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

Communication Services: ATSI incurs charges for local telephone service and related features from the dominant local exchange carrier. Additionally, ATSI incurs a cost per minute and platform fees from two suppliers for long distance services and platform access.

Property and equipment is valued at cost. Additions are capitalized and maintenance and repairs are charged to expense as incurred. Gains and losses on dispositions of equipment are reflected in operations. Depreciation is provided using the straight-line method over the estimated useful lives of the assets, which are one to five years.

Impairment of Long-Lived Assets. ATSI reviews the carrying value of its long-lived assets annually or whenever events or changes in circumstances indicate that the historical cost-carrying value of an asset may no longer be appropriate. ATSI assesses recoverability of the carrying value of the asset by estimating the future net cash flows expected to result from the asset, including eventual disposition. If the future net cash flows are less than the carrying value of the asset, an impairment loss is recorded equal to the difference between the asset's carrying value and fair value.

During the year ended July 31, 2004, in accordance with U.S. GAAP, ATSI determined that the estimated cash flows expected from the concession license would be less than the recorded value. As a result, ATSI recorded an impairment loss of approximately $702,000 to reduce the recorded value of the concession license.

Investment in unconsolidated subsidiary. On May 22, 2003 ATSI sold 51% of its interest in ATSI Comunicaciones S.A de C.V., (ATSI COM) As of July 31, 2003, ATSI has a 49% interest in the profits and equity of ATSICOM, a Mexican Corporation, engaged in providing telecommunications services. During fiscal 2003 ATSI recorded the investment in the unconsolidated subsidiary in conformity with the equity method of accounting. During the year ended July 31, 2004, ATSI has taken a conservative approach and determined that the estimated future cash flows expected from the concession license will be less than its carrying value. As a result ATSI recorded an impairment loss of approximately $702,000 to reduce the recorded value of the concession license. Although there is no assurance of future value appreciation, ATSI will conduct a valuation of its investment in the concession license annually and record the determined value, if any, in its financial statements.

Income taxes. ATSI recognizes deferred tax assets and liabilities based on differences between the financial reporting and tax bases of assets and liabilities using the enacted tax rates and laws that are expected to be in effect when the differences are expected to be recovered. ATSI provides a valuation allowance for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

Basic and diluted net loss per share. The basic net loss per common share is computed by dividing the net loss by the weighted average number of common shares outstanding. Diluted net loss per common share is computed by dividing the net loss adjusted on an "as if converted" basis, by the weighted average number of common shares outstanding plus potential dilutive securities. For the year ended July 31, 2004, potential dilutive securities had an anti-dilutive effect and were not included in the calculation of diluted net loss per common share.

Stock based compensation. ATSI adopted the disclosure requirements of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (FAS No. 123) and FAS No. 148 with respect to pro forma disclosure of compensation expense for options issued. For purposes of the pro forma disclosures, the fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model.

ATSI applies APB No. 25 in accounting for its stock option plans and, accordingly, no compensation cost has been recognized in ATSI financial statements for stock options under any of the stock plans which on the date of grant the exercise price per share was equal to or exceeded the fair value per share. However, compensation cost has been recognized for warrants and options granted to non-employees for services provided. 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.

		Twelve months ended July 31, 2005	2004 (Restated)
Net income (loss) to common shareholders, as reported	$	9,698,000	($3,863,000)
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)	$	8,739,587	($3,863,000)
Basic and diluted net income (loss) per share			
As reported	$	1.36	($3.22)
Pro forma	$	1.23	($3.22)

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:

For the Years Ended July 31,	2005	2004
Expected dividends yield	0.00%	0.00%
Expected stock price volatility	297%	248%
Risk-free interest rate	3.5%	2%
Expected life of options	3 years	1-3 years

ATSI granted 2,104,001 options to purchase common stock to employees during fiscal 2005. Sixty percent of these options vested immediately and the remaining balance vest over three years. ATSI recorded compensation expense of $42,000 under the intrinsic value method during the year ended July 31, 2005. The weighted average fair value of options granted during 2005 is $0.46. There were no options granted to employees during fiscal 2004.

Concentration of Credit Risk. Financial instruments that potentially subject ATSI to concentration of credit risk consist primarily of trade receivables. In the normal course of business, ATSI provides credit terms to its customers. Accordingly, ATSI performs ongoing credit evaluations of its customers and maintains allowances for possible losses, which, when realized, have been within the range of management's expectations. ATSI maintains cash in bank deposits accounts, which, at times, may exceed federally insured limits. ATSI has not experienced any losses in such accounts and ATSI does not believe ATSI is exposed to any significant credit risk on cash and cash equivalents.

Recently issued accounting pronouncements. In December 2004, the FASB issued SFAS No.123R, "Accounting for Stock-Based Compensation". SFAS No.123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No.123R requires that the fair value of such equity instruments be recognized as expense in the historical financial statements as services are performed. Prior to SFAS No.123R, only certain pro forma disclosures of fair value were required. SFAS No.123R shall be effective for small business issuers as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The adoption of this new accounting pronouncement is not expected to have a material impact on the financial statements of ATSI during fiscal year 2006.

ATSI does not expect the adoption of any other recently issued accounting pronouncements to have a significant impact on ATSI's results of operations, financial position or cash flow.

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NOTE 2 - GOING CONCERN

As shown in the accompanying financial statements, ATSI incurred net income (loss) from operations of $10,407,000 and ($3,557,000) in fiscal 2005 and 2004, respectively, has an accumulated deficit of $73 million and a working capital deficit of $5.8 million as of July 31, 2005. These conditions create substantial doubt as to ATSI's ability to continue as a going concern. Management will continue to pursue financings that may include raising additional capital through sale of common stock, preferred stock, or warrants. The financial statements do not include any adjustments that might be necessary if ATSI is unable to continue as a going concern.

NOTE 3 - PROPERTY AND EQUIPMENT

Following is a summary of ATSI's property and equipment at July 31, 2005 (in thousands):

	Depreciable lives	July 31, 2005	
Telecom equipment & Software	1-5 years	$	228
Less: accumulated depreciation			(90)
Net-property and equipment		$	138

For the years ended July 31, 2005 and 2004, depreciation and amortization totaled approximately $112,000 and $20,000, respectively.

NOTE 4 - NOTES PAYABLE

On November 1, 2004, ATSI entered into a note payable with Franklin Cardwell and 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%. 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. This 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 July 31, 2005, is $18,851 and is included in Derivative Financial Instrument Liabilities on the balance sheet. A corresponding gain of $0 and $7,430 is reflected in the statement of operations for the years ended July 31, 2004 and 2005, respectively, as a gain on derivative instrument liabilities. (See Note 12).

NOTE 5 - CONVERTIBLE SUBORDINATED DEBENTURES

During fiscal 2002 ATSI received $275,000 of advances without specific terms of repayment or interest. In January 2003 ATSI issued 275 9% Convertible Subordinated Debentures with a face value of $1,000 each, due December 2005 and warrants to purchase 137,500 shares of common stock in exchange for the $275,000 previously advanced. Each debenture accrues interest at the rate of 9% per annum payable quarterly. The debentures convert into common stock at a conversion price of $13.50 and the warrants are priced at $11.20. At July 31, 2005, ATSI was in default of the terms of the debentures for non-payment of quarterly interest. As of July 31, 2005, ATSI had approximately $80,070 in accrued interest related to these debentures.

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 and the warrants issued. The embedded derivative value is $0 at July 31, 2005 and is included in Derivative Financial Instrument Liabilities on the balance sheet. A corresponding gain of $0 and $10,487 is reflected in the statement of operations for the years ended July 31, 2004 and 2005, respectively, as gain on derivative instrument liabilities. (See Note 12)

NOTE 6 - GAIN ON DISPOSAL OF INVESTMENT

During the year ended July 31, 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 represented 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

NOTE 7 - 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. Additionally, on the measurement date of April 1, 2005, the average closing price of ATSI common stock for the ten (10) trading days immediately preceding the measurement date was below $1.15, as a result ATSI issued an additional 59,791 common shares. As well 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. As of July 31, 2005, ATSI had approximately $25,000 in accrued interest related to this note.

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 8 - 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.

NOTE 9 COMMITMENTS AND CONTINGENCIES

Leases:

ATSI leases its office space with monthly payments of $3,547; the lease expires in March 2006. The rent expense under the operating lease was $38,760 and $41,420 for 2004 and 2005, respectively. The future minimum lease payment under the operating lease is $42,564 for FY2006.

Litigation:

On October 31, 2002, ATSI 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. ATSI plans to appeal that decision once a final judgment has been entered. On July 9, 2004, ATSI 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, ATSI appealed the dismissal of the second action to the United States Court of Appeals for the Second Circuit. On September 9, 2005, ATSI appealed the dismissal of the first 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 ATSI 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. On August 29, 2005 the U.S. Bankruptcy Court for the Western District of Texas dismissed this proceeding against ATSI Communications, Inc., a Nevada Corporation for lack of merit.

On March 28, 2005, ATSI 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 Board of Directors met on April 28, 2005 and approved the Settlement Agreement. As part of the settlement, ATSI subsequently issued 169,280 shares of our common stock.

In January 2004, ATSI filed a petition in the 150th Judicial District of Bexar County, Texas against Inter-tel.net, Inc. and Vianet Communications, Inc. d/b/a Inter-tel.net seeking declaratory relief that ATSI Communications, Inc. is not bound by the Carrier Services Agreement between Vianet Communications, Inc. and ATSI-Texas. On February 27, 2004 the Bankruptcy Court in the ATSI-Texas Bankruptcy case allowed Vianet Communications, Inc. to amend its claim against ATSI-Texas that was pending in the Bankruptcy of ATSI-Texas and assert its claim for breach of contract against ATSI. The Bankruptcy Court then ordered the lawsuit to be remanded back to state court for hearing.

On August 10, 2005 a settlement was reached with Vianet Communications. As part of the settlement, ATSI issued 200,000 warrants to purchase ATSI stock, the exercise price on the warrants range from $0.12 to $0.23. Additionally, ATSI issued 200,000 shares of Series H preferred Stock that can be converted into 1.2 shares of common stock after it's been held for (1) one year and into 1.5 shares of common stock if held for (2) two years.

On June 17, 2005, ATSI filed an arbitration claim against Ntera Holdings, Inc. for $100,000 and attorneys fees. The claim is associated with a dispute over supposed debt incurred under a Reciprocal Network Carrier Service Agreement between the parties. On July 7, 2005 Ntera Holdings, Inc. filed a counterclaim. Under the arbitration claim, ATSI is not disputing all of the alleged indebtedness but ATSI is alleging the offset of services and that the payment should be in the form of exchange of services, as implied in the Reciprocal Network Carrier Service Agreement with Ntera Holdings, Inc. Currently ATSI can not predict the result of the arbitration or the financial impact on our ongoing operations.

We may become a party to future claims and legal proceedings arising in the ordinary course of business. Due to the inherent uncertainty of litigation, the range of possible loss, if any, cannot be estimated with a reasonable degree of precision and there can be no assurance that the resolution of any particular claim or proceeding would not have an adverse effect on our results of operations in the period in which it occurred.

NOTE 10 - EQUITY

Common stock

During the year ended July 31, 2005, ATSI issued 4,280,290 shares of common stock related to the exercise of warrants. (See note 11). Additionally, during the year ended July 31, 2005, ATSI issued 472,630 common shares associated with the redemption of 472,630 shares of Series H Convertible Preferred Stock.

During fiscal 2005, ATSI issued 516,780 shares of common stock valued at $175,202 for legal and consulting services rendered during the year by various individuals.

On August 1, 2004, ATSI issued 40,000 shares of common stock valued at $24,000 for the acquisition of Hinotel, Inc., a Hispanic owned Competitive Local Exchange Carrier ("CLEC") based in South Texas. (See note 8)

On October 1, 2004, ATSI issued 747,391 shares of common stock associated with the Settlement Agreement and Mutual release entered with Alfonso Torres Roqueni, the former owner of the concession license purchased by ATSICOM in July 2000. The Settlement was for the amounts owed of approximately $860,000.

On October 26, 2004, ATSI issued 30,000 shares of common stock associated with the Settlement Agreement and Mutual release with Infraestructura Espacial, S.A de C.V. and Tomas Revesz, a former ATSI director. The settlement included all principal and interest owed under a note payable in the amount of $250,000.

On October 31, 2004, ATSI issued 131,000 shares of common stock valued at $95,050 for the settlement of debt associated with legal services previously rendered.

On March 11, 2005, ATSI issued 80,625 shares of common stock valued at $45,150 for the maintenance of equipment and consulting services rendered during the year.

On March 28, 2005, ATSI issued 169,280 shares of common stock associated with the Settlement Agreement (at mediation) with James C. Cuevas, Raymond G. Romero and Texas Workforce Commission. The Settlement was for all unpaid wages in the amount of $90,000.

No dividends were paid on ATSI's common stock during fiscal 2005 and 2004.

Preferred Stock

The terms of ATSI's Series A, Series D, Series E and Series H preferred stock restrict ATSI from declaring and paying dividends on ATSI's common stock until such time as all outstanding dividends have been fulfilled related to the preferred stock. The outstanding Series A, Series D, Series E and Series H preferred stock have liquidation preference prior to common stock and ratably with each other.

Series A Preferred Stock

During Fiscal 2005 there were no conversions of the Series A Preferred stock and 3,750 shares of Series A Preferred Stock remain outstanding. As of July 31, 2005, ATSI has accrued approximately $212,500 for dividends associated with the Series A Preferred Stock.

The Series A Preferred Stock and any accumulated, unpaid dividends may be converted into Common Stock for up to one year at the average closing price of the Common Stock for twenty (20) trading days preceding the Date of Closing (the "Initial Conversion Price"). On each Anniversary Date up to and including the fifth Anniversary Date, the Conversion price on any unconverted Preferred Stock, will be reset to be equal to 75% of the average closing price of the stock for the then twenty (20) preceding days provided that the Conversion price can not be reset any lower than 75% of the Initial Conversion Price. As these conversion features are considered a "beneficial conversion feature" to the holder, ATSI allocated approximately $3.6 million of the approximate $5.0 million in proceeds to additional paid-in capital as a discount to be amortized over various periods ranging from ninety days to a twelve-month period. During fiscal year 2001 the remaining beneficial conversion feature was fully amortized. The Series A Preferred Stock is callable and redeemable by ATSI at 100% of its face value, plus any accumulated, unpaid dividends at ATSI's option any time after the Common Stock of ATSI has traded at 200% or more of the conversion price in effect for at least twenty (20) consecutive trading days, so long as ATSI does not call the Preferred Stock prior to the first anniversary date of the Date of Closing.

Series D Preferred Stock

The Series D Preferred Stock accrues cumulative dividends at the rate of 6% per annum payable quarterly. As of July 31, 2005, 742 shares of Series D Preferred Stock remain outstanding, for which ATSI accrued approximately $240,000 for dividends. Additionally, on January 24, 2003 ATSI received a demand redemption letter from the Series D Preferred holders. ATSI has not issued these shares; it is the position of ATSI that the investor's shares are not owed. Further ATSI has filed a lawsuit against one or more parties to whom the investors share are allegedly owed. ATSI is seeking damages from the parties involved for stock manipulation and fraud.

The Series D Preferred Stock and any accumulated, unpaid dividends may be converted into Common Stock for up to two years at the lesser of a) the market price on the day prior to closing or b) 83% of the five lowest closing bid prices on the ten days preceding conversion.

The terms of ATSI's Series D Preferred Stock allow for mandatory redemption by the holder upon certain conditions. The Series D Preferred Stock allows the holder to elect redemption upon the change of control of ATSI at 120% of the sum of $1,300 per share and accrued and unpaid dividends. Additionally, the holder may elect redemption at $1,270 per share plus accrued and unpaid dividends if ATSI refuses to honor conversion notice or if a third party challenges conversion. As mentioned earlier on January 24, 2003, ATSI received a redemption letter. As a result ATSI adjusted Series D Preferred Stock to the full redemption amount of approximately $942,000 by recording an additional amount of dividend expense of approximately $284,000.

Series E Preferred Stock

As of July 31, 2005, 1,170 shares of Series E Preferred Stock remain outstanding and accrued dividends of approximately $284,000.

The Series E Preferred Stock may be converted into Common Stock for up to three years at the lesser of a) the market price - defined as the average of the closing bid price for the five lowest of the ten trading days prior to conversion or b) the fixed conversion price - defined as 120% of the lesser of the average closing bid price for the ten days prior to closing or the October 12, 2000 closing bid price. Of the approximate $1.5 million of proceeds assigned to the first issuance of Series E Preferred Stock approximately $802,000 was allocated to additional paid-in capital as a discount to be amortized over the lesser of the period most beneficial to the holder or upon exercise of the conversion feature. In accordance with the agreement, the conversion price was reset on February 11, 2001 to the then defined “market price”. The reset of the conversion price resulted in additional “beneficial conversion feature” of approximately $188,000, which was allocated to additional paid-in capital as a discount and recognized during fiscal 2001. No beneficial conversion expense was required to be recognized related to the second and third issuance of Series E Preferred Stock.

The terms of ATSI’s Series E Preferred Stock allow for mandatory redemption by the holder upon certain conditions. The Series E Preferred Stock allows the holder to elect redemption at $1,250 per share plus 6% per annum if: 1) ATSI refuses conversion notice, 2) an effective registration statement was not obtained by prior to March 11, 2001, 3) bankruptcy proceedings are initiated against ATSI, 4) The Secretaría de Comunicaciones y Transportes of the SCT limits or terminates the scope of the concession or, 5) if ATSI fails to maintain a listing on NASDAQ, NYSE or AMEX.

Series H Preferred Stock

During fiscal 2005 472,628 shares of Series H Convertible Preferred Stock were redeemed for 472,628 shares of common stock. As of July 31, 2005 13,912,372 shares of Series H Convertible Preferred Stock remained outstanding and accrued dividends of $556,000.

On May 6, 2004 ATSI’s stockholders approved the reincorporation of ATSI into a wholly owned subsidiary, ATSI Merger Corporation in Nevada. As a result of the merger, ATSI’s Stockholders of record as of May 24, 2004 received one (1) share of New ATSI Common Stock and ten (10) shares of New ATSI Series H Convertible Preferred Stock for each 100 shares of Old ATSI Common Stock surrendered. During fiscal 2004, 14,385,000 shares of the New ATSI Series H Convertible Preferred Stock were issued.

Pursuant to ATSI’s Certificate of Incorporation, ATSI’s board of directors may issue, in series, 16,000,000 of the New ATSI Series H Convertible Preferred shares, with a par value of $0.001.

NOTE 11 - WARRANTS AND STOCK OPTIONS

On October 13, 2003, ATSI entered into consulting agreements for twelve months with certain individual affiliates of Recap Marketing and Consulting LLC. (Recap) 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

During the year ended July 31, 2005, individual affiliates of Recap elected to exercise 4,280,290 warrants and Recap forgave notes in the amount of $918,000 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 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 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.

On June 1, 2005, ATSI entered into mutual release and termination agreement with certain individuals' affiliates of Recap. The mutual release and termination agreement allows for the repricing of 783,500 compensation warrants at a new exercise price's ranging from $0.17 per share to $0.25 per share. At signing of the mutual release and termination agreement, ATSI recognized $17,629 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 $5,353 at July 31, 2005 and is included in Derivative Financial Instrument Liabilities on the balance sheet. A corresponding gain (loss) of $4,409,000 and ($305,135) is reflected in the statement of operations for the years ended July 31, 2004 and 2005, respectively, as gain (loss) on derivative instrument liabilities. See Note 12.

Modification of Non-Employee Awards Accounted for Under FAS 123

ATSI granted 1,250,000 warrants to outsiders in March 2005 and the amendment to the agreement allowed for the repricing of the warrants, as a result of the modification of these warrants ATSI recognized $220,000 of non-cash compensation expense. Additionally, on June 1, 2005, ATSI entered into a mutual release and termination agreement with certain individuals' affiliates of Recap. The mutual release and termination agreement allows for the repricing of 783,500 compensation warrants. At signing of the mutual release and termination agreement, ATSI recognized $61,375 of non-cash compensation expense associated with the issuance of these warrants. The repricing of these warrants in March 2005 and June 2005 triggered a modification of the original awarded warrants. A modification of the terms of an award that makes it more valuable shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater value, incurring additional compensation cost for that incremental value. The incremental value shall be measured by the difference between (a) the fair value of the modified option determined in accordance with the provisions of this section and (b) the value of the old option immediately before its terms are modified, determined based on the shorter of (1) its remaining expected life or (2) the expected life of the modified option.

Following is a summary of warrant activity for the years ended July 31, 2005 and 2004 (Excluding warrants issued under the 2004 Stock Compensation plan):

	Year Ending July 31,	
	2005	**2004**
Warrants outstanding, beginning	19,874	45,088
Warrants issued	-	-
Warrants expired	(19,874)	(25,214)
Warrants exercised	-	-

Warrants outstanding, ending	-	19,874

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During fiscal 2005 no options were granted or exercised under the 2003, 2002, 1998 and 1997 Stock Option Plans adopted during those years. Additionally, all options previously granted under these plans were forfeited during fiscal 2005.

In May 2004, ATSI's board of directors adopted the 2004 Stock Compensation Plan. The 2004 Stock Compensation Plan authorizes the grant of up to 7.5 million of warrants, stock options, restricted common stock, non-restricted common stock and other awards, or a combination, to employees, directors, consultants and certain other persons. The 2004 Stock Compensation Plan is intended to permit ATSI to retain and attract qualified individuals who will contribute to ATSI's overall success of ATSI. The exercise price of all of the warrants, stock options, restricted common stock, non-restricted common stock and other awards will vary based on the market price of the shares of common stock as of the date of grant. The warrants, stock options, restricted common stock, non-restricted common stock and other awards vest pursuant based in the individual security granted.

In January 2005, the Board of directors granted the issuance of 2,104,000 stock options to ATSI's employees and Board of Directors. The exercise price of the stock options granted was set at $0.46 per option. In addition, 60% of the options vested immediately and the remaining options will vest over the next three years. Additionally, the Board of Directors granted 900,000 stock grants to ATSI's employees and Board of Directors. Furthermore, during the year ended July 31, 2005, the Board of Directors granted the issuance and repricing of 3,033,500 warrants to consultants for services rendered, the warrants exercise price range from $0.17 to $0.50. As of July 31, 2005 4,280,286 warrants have been exercised at an average exercised price of $0.21 and 303,140 warrants remained outstanding at an average exercise price of $0.25

Additionally, during fiscal 2005 the Board of Directors granted the issuance of 516,780 common shares for legal services and consulting services performed during the year. The average exercise price of the common stock issued was set at $0.34.

During fiscal 2004, the Board of directors granted the issuance of 3,900,000 warrants to consultants for services rendered, the warrants exercise price range from $0.01 to $0.75. During fiscal 2004 566,574 warrants were exercised at an average exercised price of $0.01.

A summary of the status of ATSI's 1997, 1998, 2000 and 2004 Stock Option Plans for the fiscal 2005, and 2004 changes during the periods are presented below:

	Years Ended July 31,					
1997 Stock Option Plan	2005			2004		
	Options		Weighted Average Exercise Price	Options		Weighted Average Exercise Price
Outstanding,						
Beginning of year	-	$	-	20	$	58
Granted	-		-	-		-
Exercised	-		-	-		-
Forfeited	-		-	(20)		58
Outstanding, end of year	-	$	-	-	$	58
Options exercisable at end of year	-		-	(20)	$	58
Weighted average fair value of options granted during the year		$	N/A			N/A

1998 Stock Option Plan	2005			2004		
	Options		Weighted Average Exercise Price	Options		Weighted Average Exercise Price
Outstanding,						
Beginning of year	3,559	$	56	3,559	$	56
Granted	-		-	-		-
Exercised	-		-	-		-
Forfeited	(3,559)		56	-		-
Outstanding, end of year	-	$	-	3,559	$	56
Options exercisable at end of year	-		-	3,559	$	56
Weighted average fair value of options granted during the year		$	N/A			N/A

2000 Stock Option Plan	2005			2004		
	Options		Weighted Average Exercise Price	Options		Weighted Average Exercise Price
Outstanding,						
Beginning of year	28,767	$	48	38,100	$	45
Granted	-		-	-		-
Exercised	-		-	-		-
Forfeited	(28,767)		48	(9,333)		48
Outstanding, end of year	-	$	-	28,767	$	48
Options exercisable at end of year	-		-	22,466	$	47
Weighted average fair value of options granted during the year		$	N/A			N/A

2004 Stock Option Plan	2005			2004		
	Options		Weighted Average Exercise Price	Options		Weighted Average Exercise Price
Outstanding,						
Beginning of year	-	$	-	-	$	-
Granted	3,004,000		0.46	57,786		0.95
Exercised	(900,000)		0.46	(57,786)		0.95
Forfeited	-		-	-		-
Outstanding, end of year	2,104,000	$	-	-	$	-
Options exercisable at end of year	1,328,000	$	0.46	-	$	-
Weighted average fair value of options granted during the year		$	0.46		$	0.95

2004 Stock Compensation Plan (WARRANTS)	2005		2004	
	Warrants	Weighted Average Exercise Price	Warrants	Weighted Average Exercise Price

Outstanding,						
Beginning of year	3,333,426	$	0.25	-	$	-
Granted	2,183,500		0.32	3,900,000		0.21
Exercised	(4,280,286)		0.21	(566,574)		0.21
Forfeited	(933,500)		0.56	-		-
Outstanding, end of year	303,140	$	0.25	3,333,426	$	0.25
Warrants exercisable at end of year	303,140	$	0.25	-	$	-
Weighted average fair value of warrants granted during the year		$	0.32		$	0.21

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During the year ending July 31, 2005 all options granted but not exercised under the 1997, 1998 and 2000 Stock Option Plan were forfeited. The weighted average remaining contractual life of the stock options outstanding at July 31, 2005 is approximately 9 years and for warrants granted under the 2004 Stock Option Plan is 1 year.

The following table summarizes information about stock options and warrants outstanding for all plans at July 31, 2005:

	Options and Warrants Outstanding			Options and Warrants Exercisable	
Range of Exercise Price	Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Number Exercisable	Weighted Average Exercise Price
Options					
$0.46	2,140,000	$ 0.46	9.50	1,328,000	$ 0.46
Warrants					
$0.25	303,140	$ 0.25	0.80	303,140	$ 0.25

NOTE 12 - 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, ATSI concluded that 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 and warrants issued to consultants as embedded derivatives.

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

In addition, ATSI bifurcated and separately accounted for 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.

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, 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. As a result, ATSI reflected these changes in the accompanying restated financial statements under the amended Form 10-KSB for the year ended July 31, 2005.

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

	Embedded derivative liability balance		
	7/31/2005	7/31/2004	Cumulative Net change
Note Payable, Franklin Cardwell and Jones	$ 18,851	-	$ 18,851
9% Convertible Debenture & warrants	-	10,503	(10,503)
Consulting warrants	5,353	1,338,375	(1,333,022)
Total:	$ 24,204	$ 1,348,878	($1,324,674)

And the impact on the statements of operations as of July 31, 2005 and 2004 were as follows:

Gain (loss) on embedded derivative liabilities:	Twelve months ended July 31,	
	7/31/2005	7/31/2004
Note Payable, Franklin Cardwell and Jones	$ 7,430	-
9% Convertible Debenture & warrants	10,487	30,000
Consulting warrants	(305,135)	4,409,000.00
Total gain (loss) on embedded derivative liabilities:	($287,218)	$ 4,439,000

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, 2005, the Series D Preferred Stock, which is carried as a current liability, is recorded at its full 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 July 31, 2005 and 2004, the carrying amount of the Series D Preferred Stock was $1,182,000 and $1,138,000, respectively, including accrued dividends of $240,000 and $196,000, respectively.

Additionally, since 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, 2005, the Series E Preferred Stock, which is carried as a current liability, is recorded at its full stated redemption amount of $1,250 per share or approximately $1,465,000. 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 July 31, 2005 and 2004, the carrying amount of the Series E Preferred Stock was $1,749,000 and $1,679,000, respectively, including accrued dividends of $284,000 and $217,000, respectively.

NOTE 13 - INCOME TAXES

Deferred tax assets are comprised of the following as of July 31, 2005:

Net operating loss carry-forward	$ 11,491,000
Valuation allowance	(11,491,000)
Total deferred tax asset	$ -

ATSI conducts a periodic examination of its valuation allowance. Factors considered in the evaluation include recent and expected future earnings and ATSI's liquidity and equity positions. As of July 31, 2005, ATSI has determined that a valuation allowance is necessary for the entire amount of deferred tax assets.

At July 31, 2005, ATSI had net operating loss carry-forwards related to U.S. operations of approximately $35 million with expiration dates ranging from 2009 through 2024.

NOTE 14 - EARNINGS (LOSS) PER SHARE

In accordance with SFAS No. 128, "Earnings Per Share," basic earnings per share has been computed based upon the weighted average of common shares outstanding. Diluted earnings per share gives effect to outstanding convertible preferred shares, warrants and stock options, unless their effect is anti-dilutive. Earnings (loss) per common share has been computed as follows:

		Year ended July 31, 2005	2004
Net income (loss) to be used to compute income (loss) per share:			
Net income (loss)		10,406,771	(3,863,000)
Less preferred dividends		(709,000)	-
Net income (loss) attributable to common Shareholders - Basic		9,697,771	(3,863,000)
Add back preferred dividends		709,000	-
Net income (loss) attributable to common shareholders -Diluted		10,406,771	(3,863,000)
Weighted average number of shares:			
Weighted average common shares outstanding		7,128,847	1,199,892
Effect of conversion of preferred shares		-	-
Effect of warrants and options		-	-
Weighted average common shares outstanding assuming dilution		7,128,847	1,199,892
Basic income (loss) per common share	$	1.36	($3.22)
Diluted income (loss) per common share	$	0.42	($3.22)

NOTE 15 - RISKS AND UNCERTAINTIES AND CONCENTRATIONS

ATSI is subject to regulations by the United States and Mexican governments. According to ATSI's regulatory concession requirements, ATSI is required to maintain approximately $10 million in capital. As of July 31, 2005, ATSICOM has not met this requirement. Currently, Telemarketing, ATSI's equity partner in ATSICOM is in negotiations with the Mexican government on meeting this requirement. The default does not presently affect the business, operating results or financial condition of the Company. However, if such default is not cured or waived, the Government of Mexico could terminate or limit the concession. Any such termination or limitation would adversely affect the business, operating results and financial condition of the Company.

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ATSI's business is dependent upon key pieces of equipment, switching and transmission facilities capacity from ATSI's carriers. Should ATSI experience service interruptions from ATSI's underlying carriers or equipment failures, there would likely be a temporary interruption of ATSI's services, which could adversely and materially affect ATSI's operations. ATSI believes that suitable arrangements could be obtained with other carriers to provide transmission capacity, although there can be no assurance that such arrangement could be obtained or obtained without service interruption to our customers.

NOTE 16 - RELATED PARTY TRANSACTIONS

In December 2002, ATSI entered into a note payable with a related party, a director of ATSI, Mr. John R. Fleming, in the amount of $25,000. The note called for 12 monthly payments of $2,163.17 including interest, commencing on February 1, 2003. The note has an interest rate of 7% annually and a maturity date of January 1, 2004. During fiscal 2004 ATSI made payments towards this note in the amount of $9,000. As of July 31, 2005 the principal balance is $16,000 and the accrued interest is $3,700. Additionally, at July 31, 2005, ATSI had a payable of approximately $42,519 for board fees and related expenses.

NOTE 17 - SUBSEQUENT EVENTS

On August 29, 2005 the U.S. Bankruptcy Court for the Western District of Texas dismissed all claims from Helen G. Schwartz against ATSI Communications, Inc., a Nevada Corporation for lack of merit. As mentioned in note 9, 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.

On August 10, 2005 a settlement was reached between ATSI Communications, Inc. with Vianet Communications. As mentioned in note 9, in January 2004, ATSI filed a petition in the 150th Judicial District of Bexar County, Texas against Inter-tel.net, Inc. and Vianet Communications, Inc. d/b/a Inter-tel.net seeking declaratory relief that ATSI Communications, Inc. is not bound by the Carrier Services Agreement between Vianet Communications, Inc. and ATSI-Texas. On February 27, 2004 the Bankruptcy Court in the ATSI-Texas Bankruptcy case allowed Vianet Communications, Inc. to amend its claim against ATSI-Texas that was pending in the Bankruptcy of ATSI-Texas and assert its claim for breach of contract against ATSI. The Bankruptcy Court then ordered the lawsuit to be remanded back to state court for hearing. As part of the settlement, ATSI issued 200,000 warrants to purchase ATSI stock, the exercise price on the warrants range from $0.12 to $0.23. Additionally, ATSI issued 200,000 shares of Series H preferred Stock that can be converted into 1.2 shares of common stock after it's been held for (1) one year and into 1.5 shares of common stock if held for (2) two years. As part of the settlement during fiscal 2005, ATSI recognized approximately $53,000 in settlement expense associated with the value of the warrants and Series H preferred stock issued.

NOTE 18 - RESTATEMENT

ATSI has restated its 2005 and 2004 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 and 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 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. Note 12 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 fiscal year ended July 31, 2005, was a decrease in the net loss attributable to common shareholders of $110,048. Basic and diluted net income attributable to common shareholders per share for the fiscal year ended July 31, 2005 increased by $0.02. The effect on the consolidated balance sheet as of July 31, 2005 was a decrease in stockholders' equity of $409,000.

ATSI has also recorded an additional liability and a corresponding adjustment to additional paid in capital to present the Series E Convertible Preferred Stock at its full redemption value of $1,463,000.

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

	For the Year ended July 31, 2005			For the Year ended July 31, 2004		
	(in thousands, except share information)					
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Summary Balance Sheet						
Total assets	$ 381	-	$ 381	$ 270	-	$ 270
Pre-petition Liabilities of bankrupt subsidiaries, net of assets	-	-	-	12,351	-	12,351
Accounts payable	606	-	606	512	(4)	508
Accrued liabilities	983	50	1,033	1,621	17	1,638
Current portion of obligation under capital leases	3	-	3	-	-	-
Notes payable, related party	16	-	16	16	-	16
Notes payable	-	-	-	762	-	762
Notes payable, Franklin Cardwell & Jones	104	(27)	77	-	-	-
Convertible debentures	275	(41)	234	275	(41)	234
Series D Cumulative Preferred Stock	1,182	-	1,182	1,138	-	1,138
Series E Cumulative Preferred Stock	1,346	403	1,749	1,275	404	1,679
Derivative financial instrument liabilities	-	24	24	-	1,349	1,349
Liabilities from discontinued operations	1,152	-	1,152	1,152	-	1,152
Total current liabilities	5,667	409	6,076	19,102	1,725	20,827
Total long-term liabilities	517	-	517	20	-	20

Series A preferred stock	-	-	-	-	-	-
Series H preferred stock	14	-	14	14	-	14
Common stock	10	-	10	3	-	3
Additional paid in capital	71,920	(5,462)	66,458	69,174	(6,667)	62,507
Accumulated deficit	(78,249)	5,053	(73,196)	(88,545)	4,942	(83,603)
Other comprehensive income	502	-	502	502	-	502
Total Stockholder's deficit	(5,803)	(409)	(6,212)	(18,852)	(1,725)	(20,577)
Total liabilities and stockholder's deficit	381	-	381	270	-	270
Summary statements of operations						
Revenues	6,011	-	6,011	1,254	-	1,254
Operating expenses	8,235	(429)	7,806	9,739	(484)	9,255
Operating loss	(2,224)	429	(1,795)	(8,485)	484	(8,001)
Other Income	12,520	(318)	12,202	16	4,428	4,444
Net income (loss)	10,296	111	10,407	(8,469)	4,912	(3,557)
Preferred Dividends	(709)	-	(709)	(306)	-	(306)
Net income (loss) to common stockholders	9,587	111	9,698	(8,775)	4,912	(3,863)
Basic Earnings (loss) per share	$ 1.34	$ 0.02	$ 1.36	($7.31)	$ 4.09	($3.22)
Diluted Earnings (loss) per share	$ 0.40	$ 0.02	$ 0.42	($7.31)	$ 4.09	($3.22)

ITEM 8. **CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

NONE.

ITEM 8A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure 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 period covered by this report. Based on that evaluation, 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.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the fourth fiscal quarter covered by this report that have had a material affect or are reasonably likely to have a material affect on internal control over financial reporting. The registered public accounting firm that audited the financial statements included in this report has issued an attestation report on management’s assessment of the Company’s internal control over financial reporting.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

Business Experience

The following table contains the name, age of our directors and executive officers.

Name	Age	Position Held
Arthur L. Smith	40	President, Chief Executive Officer and Director
Ruben Caraveo	37	Vice President, Sales and Operations
Antonio Estrada	31	Corporate Controller
John R. Fleming	51	Interim Executive Chairman of the Board
Murray R. Nye	52	Director

Arthur L. Smith has served as our Chief Executive Officer and Director since May 2003. Mr. Smith also served as the President of ATSI de Mexico S.A de C.V. from August 2002 to April 2003, as our Chief Executive Officer and a Director from June 1996 to July 2002 and as our President since our formation in June 1996 to July 1998. Mr. Smith also served as President, Chief Operating Officer and a director of ATSI-Canada since its formation in May 1994. From December 1993 until May 1994, Mr. Smith served in the same positions with Latcomm International Inc., which amalgamated with Willingdon Resources Ltd. to form ATSI-Canada in May 1994. Mr. Smith has also served as President and Chief Executive Officer of American TeleSource International, Inc., a Texas corporation (“ATSI-Texas”), one of our principal operating subsidiaries, since December 1993. From June 1989 to December 1993, Mr. Smith was employed as director of international sales by GeoComm Partners, a satellite-based telecommunications company located in San Antonio, providing telecommunications services to Latin America. Mr. Smith has over 15 years’ experience in the telecommunications industry.

Ruben R. Caraveo has served as our Vice President of Sales and Operations since May 2003. Mr. Caraveo is responsible for Carrier Sales and the delivery of Carrier Services for both the U.S. and Mexico. Mr. Caraveo served as our Vice President of Operations from May 2001 to January 2003. Prior to joining ATSI, Mr. Caraveo served as Vice President of Operations and Engineering at Vycera Communications where he was responsible for overseeing all daily operations, including network engineering, marketing, and the network trouble reporting and resolution departments. His prior experience also includes positions with Worldtel Interactive, Frontier, and WorldCom. Mr. Caraveo is armed with more than 15 years’ telecommunications industry experience, specializing in the areas of Network Engineering, Data and Systems Analysis, Product Marketing, and Systems Development. Mr. Caraveo attended California State University, Northridge, School of Engineering.

Antonio Estrada has served as our Corporate Controller since May 2003. From January 2002 through January 2003, Mr. Estrada served as our Director of International Accounting and Treasurer. From January 2001 to January 2002, Mr. Estrada served in various roles within ATSI, including International Accounting Manager and general Accountant. Prior to joining ATSI in 1999 he served as a Senior Accountant for the Epilepsy Association of San Antonio and South Texas. Mr. Estrada graduated from the University of Texas at San Antonio, with a Bachelors of Business Administration, with a concentration in Accounting.

John R. Fleming has served as our Interim Executive Chairman of the Board since August 2002 and as one of our Directors since January 2001. Mr. Fleming is the principal and founder of Vision Corporation, an early-stage investment company that focuses on communications technologies, service and hardware. Prior to forming Vision Corporation, Mr. Fleming served as President, International of IXC Communications, Inc. from April 1998 to December 1999. Immediately prior to that he served as IXC’s President of Emerging Markets from December 1997, as Executive Vice President of IXC from March 1996 through November 1997 and as Senior Vice President of IXC from October 1994 through March 1996. He served as Vice President of Sales and Marketing of IXC from its formation in July 1992 until October 1994. Prior to that, Mr. Fleming served as Director of Business Development and Director of Carrier Sales of CTI from 1986 to March 1990 and as Vice President of Marketing and Sales of CTI from March 1990 to July 1992. Mr. Fleming was a Branch Manager for Satellite Business Systems from 1983 to 1986.

Murray R. Nye has served as one of our Directors since its formation in June 1996. Mr. Nye also served as of the Chief Executive Officer and a director of ATSI-Canada from its formation in May 1994. From December 1993 until May 1994, Mr. Nye served in the same positions with Latcomm International Inc., which company amalgamated with Willingdon Resources Ltd. to form ATSI-Canada in May 1994. From 1992 to 1995, Mr. Nye served as President of Kirriemuir Oil & Gas Ltd. From 1989 until 1992, Mr. Nye was self-employed as a consultant and Mr. Nye is again currently self-employed as a consultant. Mr. Nye serves as a director of D.M.I. Technologies, Inc., an Alberta Stock Exchange-traded company.

Audit Committee and Audit Committee Financial Expert

The Company does not presently have an audit or compensation committee or other board committee performing equivalent functions. All functions of the audit committee and compensation committee are performed by the Company's Board of Directors. The Company does not have an audit committee financial expert because none of its current directors have the necessary training or experience to qualify as a financial expert.

Recent developments with ATSI Board of Directors

On October 20, 2005 the Board of Directors accepted the voluntary resignation of Michael G. Santry as a member of the board. Mr. Santry resigned to pursue other business interests. There were no disagreements with Mr. Santry. The vacancy caused by Mr. Santry's resignation will either be filled by a candidate receiving a vote of a majority of the Board or the seat could remain vacant until the next election of directors at the corporation's next annual stockholder meeting.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors and executive officers and persons who own more than 10% of a registered class of the Company's equity securities to file various reports with the Securities and Exchange Commission concerning their holdings of, and transactions in, securities of the Company. Copies of these filings must be furnished to the Company. Based on a review of the copies of such forms furnished to the Company and other information, the Company believes that, during the fiscal year ended July 31, 2005, the following individuals failed to report transactions in the Company's equity securities or reported transactions late:

Name and Position	Number of Transactions Not Reported	Number of Reports Filed Late	Number of Transactions Reported Late
Arthur L. Smith, President and Director	0	6	5
Ruben R. Caraveo, Vice President	0	7	6
Antonio Estrada, Controller	0	5	4
John R. Fleming	0	0	0
Murray R. Nye	0	0	0

Code of Ethics

ATSI Communications, Inc. adopted an Executive Code of Ethics that applies to the Chief Executive Officer, Chief Financial Officer, Controller and other members of our management team. The Board of Directors approved the code of Ethics on December 7, 2004. The Executive Code of Ethics may be viewed on our Website, www.atsi.net. Upon request, a copy of the Executive Code of Ethics will be provided without charge upon written request to ATSI Communications, Inc., 8600 Wurzbach Road, Suite 700W., San Antonio, TX 78240

ITEM 10. EXECUTIVE COMPENSATION.

Summary Compensation Table

The following table sets forth information concerning the compensation earned during the Company's last three fiscal years by the Company's Chief Executive Officer and each of the Company's four most highly compensated executive officers whose total cash compensation exceeded $100,000 for services rendered in all capacities for the fiscal year ended July 31, 2005 (collectively, the "Named Executive Officers").

		Annual Compensation			Long-Term Compensation			
					Awards		Payouts	
Name And Principal Position	Fiscal Year	Salary ($)	Stock Grant ($)	Other Annual Compensation ($)(1)	Restricted Stock Awards ($)	Securities Underlying Options/ SARs (#)	LTIP Payout($)	All Other Compens-ation ($)
Arthur L. Smith (2)	2005	$ 128,000	$ 31,500	-	-	$ 193,200(5)	-	-
CEO & President	2004	$ 128,000	-	-	-	-	-	-
Ruben Caraveo (3)	2005	$ 115,000	$ 26,250	-	-	$ 172,500(5)	-	-
Vice President, Operations	2004	$ 115,000	-	-	-	-	-	-
Antonio Estrada (4)	2005	$ 80,000	$ 26,250	-	-	$ 159,620(5)	-	-
Corporate Controller	2004	$ 65,000	-	-	-	-	-	-

(1) Certain of the Company's executive officers receive personal benefits in addition to salary. The Company has concluded that the aggregate amount of such personal benefits does not exceed the lesser of $5,000 or 10% of annual salary and bonus for any Named Executive Officer.

(2) Mr. Smith has served as CEO & President and Director of ATSI Nevada (Formerly a Delaware Corp.) since May 2003

(3) Mr. Caraveo has served as Vice President of Sales and Operations of ATSI Nevada since May 2003.

(4) Mr. Estrada has served as Corporate Controller of ATSI Nevada since May 2003.

(5) Stock options granted during Fiscal 2005 have an exercise price of $0.46

Aggregate options exercisable and unexercisable during Fiscal 2005

The following table reflects the Company's officer's shares covered by both exercisable and unexercisable stock options as of July 31, 2005.

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number of Securities Underlying Unexercised Options at FYE(#) Exercisable	Unexercisable	Value of Unexercised In-the-Money Options at FYE ($) Exercisable	Unexercisable
Arthur L. Smith	-	-	272,000	148,000	-	-
Ruben Caraveo	-	-	241,000	134,000	-	-

Antonio Estrada	-	-	213,000	134,000	-	-

COMPENSATION OF DIRECTORS

ATSI Directors are reimbursed their reasonable out-of-pocket expenses in connection with their travel to and attendance at meetings of the Board of Directors. In addition, each Director that is not an officer of the Company receives 1,500 shares of Common Stock for each meeting of the Board attended in person and $250 for each meeting attended by telephone. In January 2005, ATSI issued a total of 400,000 shares of our common stock as part of the stock grant, valued at $84,000, to outside directors.

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Aggregate options exercisable and unexercisable during Fiscal 2005

The following table reflects the Company's director's shares covered by both exercisable and unexercisable stock options as of July 31, 2005.

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number of Securities Underlying Unexercised Options at FYE(#) Exercisable	Unexercisable	Value of Unexercised In-the-Money Options at FYE ($) Exercisable	Unexercisable
John Fleming	-	-	175,000	100,000	-	-
Murray Nye	-	-	175,000	100,000	-	-

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT The following table lists the beneficial ownership of shares of our Common Stock and Series A Preferred Stock by (i) all persons and groups known by the Company to own beneficially more than 5% of the outstanding shares of our Common Stock or Series A Preferred Stock, (ii) each director and nominee, (iii) the Named Executive Officers, and (vi) all directors and officers as a group. Information with respect to officers, directors and their families is as of July 31, 2005 and is based on the books and records of the Company and information obtained from each individual. Information with respect to other stockholders is based upon the Schedule 13D or Schedule 13G filed by such stockholders with the Securities and Exchange Commission. Unless otherwise stated, the business address of each individual or group is the same as the address of the Company's principal executive office and solely the person indicated beneficially owns all shares.

NAME OF INDIVIDUAL OR GROUP	COMMON STOCK	% OF CLASS (1)	SERIES A PREFERRED STOCK	% OF CLASS (2)	TOTAL VOTING INTEREST	% OF CLASS (3)
5% STOCKHOLDERS						
Peter Blindt 30 E. Huron #5407 Chicago, IL 60611	0	*	500	13.3%	743	*
Edward Corcoran 6006 W. 159th Street Bldg. C 1-W Oak Forest, IL 60452	0	*	500	13.3%	743	*
Gerald Corcoran 11611 90th Avenue St. John, IN 46373	0	*	500	13.3%	743	*
Joseph Migilio 13014 Sandburg Ct. Palos Park, IL 60464	0	*	500	23.0%	743	*
Jeffrey Tessiatore 131 Settlers Dr. Naperville, IL 60565	0	*	500	13.3%	743	*

Albert Vivo 9830 Circle Parkway Palos Park, IL 60464	0	*	500	13.3%	743	*
Gary Wright 3404 Royal Fox Dr. St. Charles, IL 60174	0	*	750	20.0%	1,115	*

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INDIVIDUAL OFFICERS, DIRECTORS AND NOMINEES

Arthur L. Smith President, Chief Executive Officer Director	630,853(4)	5.4%	0	*	630,853(4)	5.4%
Antonio Estrada Corporate Controller	328,000(5)	2.83%		*	328,000(5)	2.8%
Ruben R. Caraveo Vice President, Sales and Operations	303,500(6)	2.62%	0	*	303,500(6)	2.6%
John R. Fleming Director	325,000(7)	2.80%	0	*	325,000(7)	2.8%
Murray R. Nye Director	325,000(8)	2.80%	0	*	325,000(8)	2.8%
ALL OFFICERS AND DIRECTORS AS A GROUP	1,912,353(9)	18.4%	0	*	1,912,353(9)	18.4%

* Less than 1%

(1) Based on 11,593,222 shares of Common Stock outstanding as of July 31, 2005. Any shares represented by options exercisable within 60 days
After July 31, 2005 are treated as being outstanding for the purpose of computing the percentage of class for such person but not for any other purpose
(2) Based on 3,750 shares of Series A Preferred Stock outstanding as of July 31, 2005.
(3) Based on 11,593,222 shares of Common Stock outstanding as of July 31, 2005. Any shares represented by options exercisable within 60 days
After July 31, 2005 are treated as being outstanding for the purpose of computing the percentage of class for such person but not for any other purpose
(4) Includes 272,000 shares subject to options exercisable at July 31, 2005.
(5) Includes 213,000 shares subject to options exercisable at July 31, 2005.
(6) Includes 241,000 shares subject to options exercisable at July 31, 2005.
(7) Includes 175,000 shares subject to options exercisable at July 31, 2005.
(8) Includes 175,000 shares subject to options exercisable at July 31, 2005.
(9) Includes 1,076,000 shares subject to options exercisable at July 31, 2005.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

In December 2002, ATSI entered into a note payable with a related party, a director of ATSI, Mr. John R. Fleming, in the amount of $25,000. The note called for 12 monthly payments of $2,163.17 including interest, commencing on February 1, 2003. The note has an interest rate of 7% annually and a maturity date of January 1, 2004. During fiscal 2004 ATSI made payments towards this note in the amount of $9,000. As of July 31, 2005 the principal balance is $16,000 and the accrued interest is $3,700. Additionally, at July 31, 2005, ATSI had a payable of approximately $42,519 for board fees and related expenses.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

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

2.1	Plan and Agreement of Merger of ATSI Communications, Inc. with and into ATSI Merger Corporation, dated as of March 24, 2004. (Exhibit 2.1 to Form 8-K of ATSI filed on May 24, 2004)
3.1	Articles of Incorporation of ATSI Merger Corporation. (Exhibit 3.1 to Form 8-K of ATSI filed on May 24, 2004)

3.2 Bylaws of ATSI Merger Corporation. (Exhibit 3.2 to Form 8-K of ATSI filed on May 24, 2004)

3.3 Articles of Merger of ATSI Communications, Inc. with and into ATSI Merger Corporation. (Exhibit 3.3 to Form 8-K of ATSI filed on May 24, 2004)

4.1 Securities Purchase Agreement between The Shaar Fund Ltd. and ATSI dated July 2, 1999 (Exhibit 10.33 to Registration statement on Form S-3 (No. 333-84115) filed August 18, 1999)

4.2 Common Stock Purchase Warrant issued to The Shaar Fund Ltd. by ATSI dated July 2, 1999 (Exhibit 10.35 to Registration statement on Form S-3 (No. 333-84115) filed August 18, 1999)

4.3 Registration Rights Agreement between The Shaar Fund Ltd. and ATSI dated July 2, 1999 (Exhibit 10.36 to Registration statement on Form S-3 (No. 333-84115) filed August 18, 1999)

4.4 Securities Purchase Agreement between The Shaar Fund Ltd. and ATSI dated September 24, 1999 (Exhibit 10.39 to Registration statement on Form S-3 (No. 333-84115) filed October 26, 1999)

4.5 Common Stock Purchase Warrant issued to The Shaar Fund Ltd. by ATSI dated September 24, 1999 (Exhibit 10.41 to Registration statement on Form S-3 (No. 333-84115) filed October 26, 1999)

4.6 Registration Rights Agreement between The Shaar Fund Ltd. and ATSI dated September 24, 1999 (Exhibit 10.42 to Registration statement on Form S-3 (No. 333-84115) filed October 26, 1999)

4.7 Form of letter dated December 30, 1999 from H. Douglas Saathoff, Chief Financial Officer of American TeleSource International, Inc. to holders of Convertible Notes (Exhibit 4.1 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000

4.8 Form of letter dated January 24, 2000 from H. Douglas Saathoff, Chief Financial Officer of American TeleSource International, Inc. to holders of Convertible Notes (Exhibit 4.2 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000)

4.9 Registration Rights Agreement between American TeleSource International, Inc. and Kings Peak, LLC dated February 4, 2000 (Exhibit 4.4 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000)

4.10 Form of Convertible Note for $2.2 million principal issued March 17, 1997 (Exhibit 4.5 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000)

4.11 Form of Modification of Convertible Note (Exhibit 4.6 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000)

4.12	Promissory Note issued to Four Holdings, Ltd. dated October 17, 1997 (Exhibit 4.7 to Registration statement on Form S-3 (No. 333-35846) filed April 28, 2000)
4.13	Securities Purchase Agreement between The Shaar Fund Ltd. and ATSI dated February 22, 2000 (Exhibit 4.5 to Registration statement on Form S-3 (No. 333-89683) filed April 13, 2000)
4.14	Common Stock Purchase Warrant issued to The Shaar Fund Ltd. by ATSI dated February 22, 2000 (Exhibit 4.7 toRegistration statement on Form S-3 (No. 333-89683) filed April 13, 2000)
4.15	Common Stock Purchase Warrant issued to Corporate Capital Management LLC by ATSI dated February 22, 2000 (Exhibit 4.8 to Registration statement on Form S-3 (No. 333-89683) filed April 13, 2000)
4.16	Registration Rights Agreement between The Shaar Fund Ltd. and ATSI dated February 22, 2000 (Exhibit 4.9 to Registration statement on Form S-3 (No. 333-89683) filed April 13, 2000)

4.17 Securities Purchase Agreement between ATSI and RGC International Investors, LDC dated October 11, 2000 (Exhibit 10.1 to Form 8-K filed October 18, 2000)

4.18 Registration Rights Agreement between ATSI and RGC International Investors, LDC dated October 11, 2000 (Exhibit10.5 to Form 8-K filed October 18, 2000)

4.19 Stock Purchase Warrant between ATSI and RGC International Investors, LDC dated October 11, 2000 (Exhibit 10.6 to Form 8-K filed October 18, 2000)

4.20 Securities Purchase Agreement between ATSI and "Buyers" dated March 21, 2001(Exhibit 4.31 to Annual Report on Form 10-K for the year ended July 31, 2001 filed October 30, 2001)

4.21 Stock Purchase Warrant between ATSI and "Buyers" dated March 23, 2001 (Exhibit 4.32 to Annual Report on Form 10-K for the year ended July 31, 2001 filed October 30, 2001)

4.22 Securities Purchase Agreement between ATSI and "Buyers" dated March 21, 2001(Exhibit 4.34 to Annual Report on Form 10-K for the year ended July 31, 2001 filed October 30, 2001

4.23 Stock Purchase Warrant between ATSI and "Buyers" dated March 21, 2001 (Exhibit 4.35 to Annual Report on Form 10-K for the year ended July 31, 2001 filed October 30, 2001)

4.24 Convertible Debenture Agreement (Exhibit 4.37 to Annual Report on Form 10-K for the year ended July 31, 2003 filed November 12, 2003)

4.25 Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. (Exhibit 4.1 to Form 10-QSB for the period Ended October 31, 2004 filed December 15, 2004)

4.26 Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. (Exhibit 4.1 to form 10-QSB for the period Ended January 31, 2005 filed March 15, 2005)

4.27 Convertible Promissory Note issued to Franklin Cardwell and Jones, PC. dated November 1, 2004 (Exhibit 4.2 to form 10-QSB for the period Ended January 31, 2005 filed March 15, 2005)

4.28 Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. (Exhibit 4.1 to form 10-QSB for the period Ended April 30, 2005 filed June 14, 2005)

4.29 Convertible Promissory Notes issued to Recap Marketing & Consulting, LLP. (Exhibit 4.1 to form 10-QSB for the period Ended July 31, 2005 filed October 24, 2005)*

10.1 American TeleSource International, Inc. 1998 Stock Option Plan (Exhibit 4.7 to Registration statement on Form S-8 filed January 11, 2000)

10.2	2000 Option Plan (Exhibit 4.36 to annual Report on Form 10-K for the year ended July 31, 2003 filed November 12. 2000.)
10.3	Agreement with SATMEX (Agreement #095-1) (Exhibit 10.31 to Annual Report on Form 10-K for year ended July 31, 1998 (No. 000-23007))
10.4	Agreement with SATMEX (Agreement #094-1) (Exhibit 10.32 to Annual Report on Form 10-K for year ended July 31, 1998 (No. 000-23007))
10.5	Amendment to Agreement #094-1 with SATMEX (Exhibit 10.3 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed August 25, 2000)

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10.6	Amendment to Agreement #095-1 with SATMEX (Exhibit10.4 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed August 25, 2000)
10.7	Bestel Fiber Lease (Exhibit 10.5 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed April 14, 2000)
10.8	Addendum to Fiber Lease with Bestel, S.A. de C.V. (Exhibit 10.6 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed August 25, 2000)
10.9	Commercial Lease with BDRC, Inc (Exhibit 10.24 to Annual Report on Form 10-K for year ended July 31, 2003 filed November 12, 2003)
10.10	Stock Purchase Agreement with Telemarketing (Sale of ATSICOM) (Exhibit 10.1 to Form 8-K filed June 16, 2003)
10.11	Interconnection Agreement TELMEX and ATSICOM (English summary) (Exhibit 10.26 to Annual Report on Form 10-K for year ended July 31, 2003 filed November 12, 2003)
10.12	Interconnection Agreement TELMEX and ATSICOM (English Translation) (Exhibit 10.27 to Amended Annual Report on Form 10-K/A for the year ended July 31, 2003 filed March 2, 2004)
10.13	Carrier Service Agreement DialMex and ATSI (Exhibit 10.27 to Annual Report on Form 10-K for year ended July 31, 2003 filed November 12, 2003)
10.14	Confidential Settlement Agreement and Mutual Release, Note Payable and Lock out agreement between ATSI and Alfonso Torres Roqueni, dated October 1, 2004. (Exhibit 10.1 to Form 10-QSB for the quarter ended October 31, 2004 filed December 15, 2004)
10.15	Extension to consulting agreements with Hunter M. A. Carr and Donald W. Sapaugh dated November 1, 2004. (Exhibit 10.1 to Form 10-QSB for the quarter ended January 31, 2005 filed March 15, 2005)
10.16	Extension of consulting agreements (Amendment No: 1) with Hunter M. A. Carr and Donald W. Sapaugh dated March 1, 2005. (Exhibit 10.1 to Form 10-QSB for the quarter ended April 30, 2005 filed June 14, 2005)
10.17	Settlement Agreement (at mediation) with James C. Cuevas, Raymond G. Romero, Texas Workforce Commission and ATSI-Texas dated March 28, 2005. (Exhibit 10.2 to Form 10-QSB for the quarter ended April 30, 2005 filed June 14, 2005)
10.18	Order granting Joint Motion to dismiss all claims against ATSI Communications, Inc. (A Nevada Corp., formerly a Delaware Corp.) by Helen G. Schwartz, Chapter 7 Trustee for TeleSpan, Inc. dated August 29, 2005. (Exhibit 10.18 to annual report Form 10-KSB for the year ended July 31, 2005

	filed October 18, 2005)*
10.19	Agreement of compromise, settlement and release between ATSI Communications, Inc. and Vianet, Inc. dated August 10, 2005. (Exhibit 10.19 to annual report Form 10-KSB for the year ended July 31, 2005 filed October 18, 2005) *
10.20	Mutual release and Termination Agreement between Hunter M. A. Carr and Donald W. Sapaugh and ATSI Communciations, Inc. dated June 1, 2005. (Exhibit 10.20 to annual report Form 10-KSB for the year ended July 31, 2005 filed October 18, 2005)*

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21	Subsidiaries of ATSI (Exhibit 21 to Annual Report on Form 10-K for year ended July 31, 2004 filed November 9, 2004)
31.1	Certification of our President and Chief Executive Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. *
31.2	Certification of our Corporate Controller and Principal Financial Officer, under Section 302 of the Sarbanes-Oxley Act of 2002. *
32.1	Certification of our President and Chief Executive Officer, under Section 906 of the Sarbanes-Oxley Act of 2002. *
32.2	Certification of our Corporate Controller and Principal Financial Officer, under Section 906 of the Sarbanes-Oxley Act of 2002. *
99.1	FCC Radio Station Authorization - C Band (Exhibit 10.10 to Registration statement on Form S-4 (No. 333-05557) filed June 7, 1996)
99.2	FCC Radio Station Authorization - Ku Band (Exhibit 10.11 to Registration statement on Form 10 (No. 333-05557) filed June 7, 1996)
99.3	Section 214 Certification from FCC (Exhibit 10.12 to Registration statement on Form 10 (No. 333-05557) filed June 7, 1996)
99.4	Comercializadora License (Payphone License) issued to ATSI-Mexico (Exhibit 10.24 to Registration statement on Form 10 (No. 000-23007) filed August 22, 1997)
99.5	Network Resale License issued to ATSI-Mexico (Exhibit 10.25 to Registration statement on Form 10 (No. 000-23007) filed August 22, 1997)
99.6	Shared Teleport License issued to Sinfra (Exhibit 99.7 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed April 14, 2000)
99.7	Packet Switching Network License issued to SINFRA (Exhibit 10.26 to Registration statement on Form 10 (No. 000-23007) filed August 22, 1997)
99.8	Value-Added Service License issued to SINFRA (Exhibit 99.9 to Amended Annual Report on Form 10-K for year ended July 31, 1999 filed April 13, 2000)
99.9	Public Utility Commission of Texas ("PUC") approval of transfer of the Service Provider Certificate of Authority ("SPCOA") from Hinotel, Inc. to ATSI's subsidiary, Telefamilia Communications, Inc. Dated October 25, 2004. (Exhibit 99.1 on Form 10-QSB for the quarter ended October 31, 2004 filed December 15, 2004)
(b)	Reports on Form 8-K No reports on Form 8-K were filed during the last quarter of the period covered by this report

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

The Company paid the following fees to its principal independent accountants for services during the fiscal years ended July 31, 2005 and July 31, 2004.

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Description of Fees	Year Ended July 31, 2005	2004
Audit Fees	$ 29,000	$ 14,000
Audit Related Fees	-0-	-0-
Tax Fees	-0-	-0-
All Other Fees	-0-	-0-

The Audit Committee has instructed Malone and Bailey PC that any fees for non-audit services must be approved before being incurred.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ATSI COMMUNICATIONS, INC.

By: /s/ Arthur L. Smith

Arthur L. Smith
President and
Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Arthur L. Smith Arthur L. Smith	Principal Executive Officer and Director	April 13, 2006
/s/ Antonio Estrada Antonio Estrada	Principal Accounting Officer Principal Finance Officer	April 13, 2006
/s/ John R. Fleming John R. Fleming	Director	April 13, 2006
/s/ Murray R. Nye Murray R. Nye	Director	April 13, 2006