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Telecalc Incorporated 1986 Annual Report

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PROVIDING MANAGEMENT TOOLS
AND TECHNOLOGY
FOR AMERICA'S
TELEPHONE-INTENSIVE
ENVIRONMENTS

FORMED LESS THAN THREE YEARS AGO AND located in Bellevue, Washington, Telecalc, Inc., is already changing the way high volume telephone rooms are managed across America.

Prior to founding Telecalc, Michael S. Bledsoe spent 17 years in the telecommunications industry working with some of America's larger corporations. Based upon knowledge gained from this experience he recognized the opportunity for developing an add-on microcomputer-based information system to more effectively manage these high-volume telephone operations.

Since 1983, Telecalc has made excellent headway, progressing from an initial concept to a proven and reliable solution. The result is a system that currently manages over 100 million phone calls per year. Installed in some of America's most progressive businesses, Telecalc's principal product, the MIS-1, is leading the way for greater efficiency in telecommunications.

FINANCIAL HIGHLIGHTS

Statement of Operations Data:

Year Ended January 31	1986	1985
Net sales	\$5,669,808	\$2,437,088
Net income (loss)	\$ 185,685	\$ (489,797)
Net income (loss) per share	\$.08	\$ (.32)
Average shares outstanding, including common stock equivalents	2,294,423	1,540,671

Balance Sheet Data

As of January 31	1986	1985
Current assets	\$3,088,592	\$1,226,384
Total assets	\$3,546,588	\$1,436,345
Current liabilities	\$ 647,160	\$1,139,913
Long-term debt	—	\$ 6,512
Shareholders' equity	\$2,899,428 ¹	\$ 289,920

¹Reflects sale of 488,750 shares and net proceeds of \$2,364,000 from the Company's Initial Public Offering of August 7, 1985.

STOCK PRICE AND INVESTOR INFORMATION

Traded: Over-The-Counter

NASDAQ Symbol: TLCC

The Common Stock of Telecalc, Inc. began trading with the Company's Initial Public Offering August 7, 1985.

High and Low Bid Range Since Issue:

The table below lists the high and low bid quotations since issue as reported on NASDAQ. Prices represent quotations between dealers, do not include retail markups, markdowns, or commissions, and do not necessarily represent actual transactions.

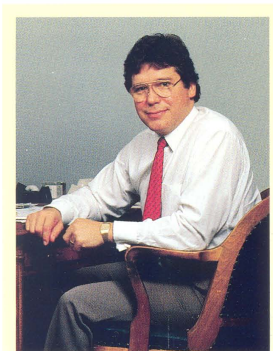
1986 Fiscal Quarter	High	Low
Third Quarter (from August 7)	8¾	6
Fourth Quarter (ended January 31)	10	7¼

Shareholders:

As of March 31 there were approximately 128 shareholders of record. The Company estimates another 250 holdings in broker depositories, or in "street" names.

Dividend Policy:

The Company has paid no dividends on its Common Stock and retains earnings to support its continuing growth. It does not anticipate paying any cash dividend in the foreseeable future.



TO OUR SHAREHOLDERS:

IN THIS FIRST ANNUAL REPORT SINCE BECOMING A PUBLIC COMPANY, I AM PLEASED to report that the past year has been the most successful year in the Company's short history. While gains in both sales and earnings were significant, they do not adequately reflect the full extent of the year's accomplishments.

Fiscal year 1986 was a year of foundation building. A number of key blocks were put into place which could allow Telecalc to emerge very quickly as the dominant company in the development of systems for the effective management of high volume inbound telephone centers. To support this longer term focus, the Company committed major resources in terms of capital and manpower during the year in an effort to refine and upgrade the performance and reliability of its existing products, while also adding three exciting new products to its product line. In mid-year, the Company also increased expenditures for the development of its next-generation management information system, scheduled for release during this next fiscal year.

Financial Results

Sales for the year ended January 31, 1986 increased 133%, to \$5.6 million vs. \$2.4 million recorded one year ago. Net income was \$186,000, or \$.08 per share, compared to a loss of \$490,000 or \$.32 per share last year.

It is important to note that these results were achieved while Telecalc was spending \$737,000, or \$.32 per share, in research and development activities which will benefit future periods. In addition, another \$1 million in commissions was expensed under an exclusive marketing arrangement which requires commissions of 25% of the first \$5 million and 20% of the second \$5 million in sales from certain Regional Bell Operating Companies. Under this arrangement, once cumulative sales reach \$10 million, the agreement terminates and for the next 12 months the Company is then obligated to pay a commission rate of only 7½%-15% of sales under contract. While this arrangement was quite expensive on the front end, it did allow Telecalc to make much faster progress in penetrating the Bell Operating Companies than otherwise would have been possible. As of year end, cumulative sales under this arrangement totalled nearly \$6.4 million, and as a result, profit margins are expected to improve significantly after the next \$3.6 million in commissionable sales.

Undoubtedly, the single most significant financial achievement for the year was Telecalc's initial public offering, which provided the Company with nearly \$2.3 million in additional equity. This strategic move substantially strengthened its capital structure. It also allowed for increased expenditures for the development of its next-generation system and for more aggressive market penetration efforts — both critical elements of Telecalc's strategy of market dominance.

A Year of Significant Achievements

Overall, I am very pleased with the progress the company has made during the past year. Some of the more significant accomplishments were:

■ In April, 1985, Telecalc secured a major contract with U.S. West, the second Regional Bell Operating Company to utilize the Telecalc MIS system for its own internal high-volume telephone room operations.

■ On May 21, 1985, Telecalc received a patent from the U.S. Patent Office for its proprietary line scanning technology.

■ In mid-year, Telecalc finalized its internally developed, automated board testing equipment, which greatly improved the Company's ability to deliver high-quality electronic components for its systems.

■ Throughout the year, Telecalc capitalized on the feedback from its growing customer base to make further refinements and significant enhancements to its MIS-1 system software.

■ During the year, Telecalc released three new products that have significantly strengthened its product line. "MultiView" was released in the second quarter; "Scheduling" began field trial and testing during the third quarter; and "MIS Interpreter" was introduced at the end of the fourth quarter. Each of these products incorporates much of the unique market knowledge which Telecalc has gained in working with the Regional Bell Operating Companies and other high-volume telephone room applications over the past three years.

The primary goal of the Company at the beginning of the year was for Telecalc MIS-1 to become the standard high-volume telephone room management system in all seven of the Regional Bell Operating Companies. While this represented a rather ambitious task for a company that three years ago did not even exist, I believe the goal speaks well of the confidence the management team at Telecalc has in its product.

While I would have preferred faster progress toward achievement of this goal, I am proud of the progress that was made. The business climate during this post-divestiture period has been challenging for all suppliers attempting to do business with the Regional Bell Companies.

We believe that four Regional Bell Companies will be making major decisions concerning the upgrading of their high volume telephone management systems during our second and third fiscal quarters this year. I am extremely confident that once the "action" decision is made, Telecalc will be ideally positioned to land the majority of that business.

Outlook

As previously stated, long-term financial prospects have been tied to both our timing and success in obtaining the major orders we have been working on over the past year. Subsequent to year end Telecalc landed its second major Regional Bell contract. On the negative side, negotiations for this and other pending contracts have taken longer than anticipated, which will adversely affect short-term results.

In the more competitive environment of the 1980s and 1990s, more and more business is being conducted over the telephone. Telecalc's highly sophisticated, high-volume telephone room management system is well positioned to benefit from the growing market for telecommunications products and communication services, particularly among medium and large-size businesses. Telecalc will continue to be a customer-focused enterprise, and strive to keep contact with its customers so its position of innovation and technological leadership is maintained in the marketplace.

Finally, we would like to convey our appreciation to our shareholders for their continued interest, support, and patience, and to our employees for their extraordinary efforts during this period in the Company's development.

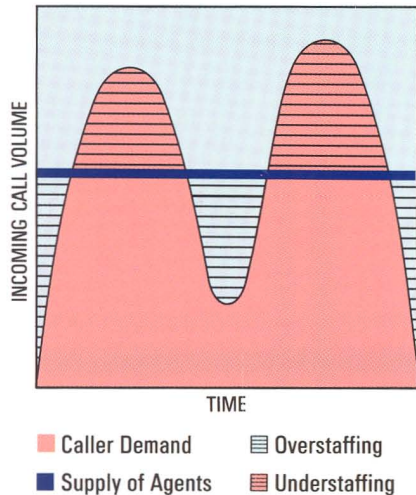
Warm regards,

Michael S. Bledsoe

Michael S. Bledsoe
Chairman

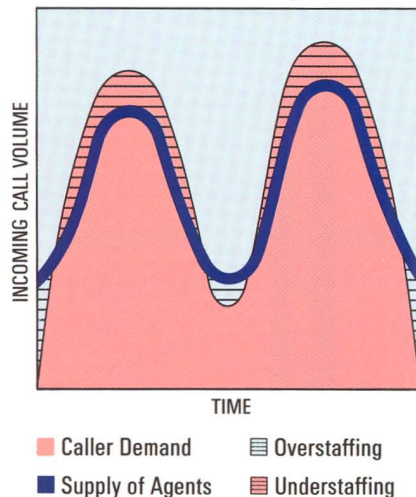
HIGH VOLUME TELEPHONE ROOM MANAGEMENT: A COMPLEX PROCESS

Prior to Telecalc Scheduling



With uniform staffing levels, shifting incoming call volumes can result in poor service quality (lost calls; lost customers) during peak-volume hours, and idle phone agents (an unnecessary labor cost) when call volumes recede.

With Telecalc Scheduling



Telecalc MIS seeks to maximize service quality and minimize costs by matching supply of agents to the shifting demand of incoming call volumes. Powerful Telecalc software first identifies cycles in the incoming call volumes, then recommends optimum staffing levels to match throughout the day.

IN THE MORE COMPETITIVE ENVIRONMENT OF THE 1980'S, MANY OF AMERICA'S most successful corporations are placing greater reliance on the telephone to conduct their business. In doing so, these businesses are becoming aware that better management of their high volume telephone rooms can greatly improve their corporate profitability, as well as enhance customer goodwill through an improved quality of service as perceived by the customer.

Over the past ten to fifteen years, much more of the direct contact between businesses and customers has been occurring over the telephone. Concurrently, research indicates that consumers of today are better educated and exhibit less brand loyalty. They also expect greater quality in the goods and services they purchase. As a result, businesses are realizing that much of their long-term business prospects depend on how well they learn to manage their high volume telephone operations.

Effective management of high volume telephone rooms is a complex process which is most difficult when the business is focused upon handling large numbers of incoming calls. Whereas outgoing calls can be tightly scheduled and controlled, incoming calls occur randomly, at volumes that shift constantly, affected by time of day, day of week, month, season, or year.

When call volumes peak, many incoming callers receive busy signals, or abandon the call before being helped which can result in revenues being lost to a competitor. When call volumes recede, business phones and agents are left idle, an excessive labor cost. This pattern of lost revenues and excessive labor costs usually repeats on a daily cycle, a tremendous cost overall that is rarely identified, and seldom corrected.

The optimum solution is to adjust staffing levels throughout the day to match call volume as it changes, maximizing revenues and service quality, minimizing labor costs.

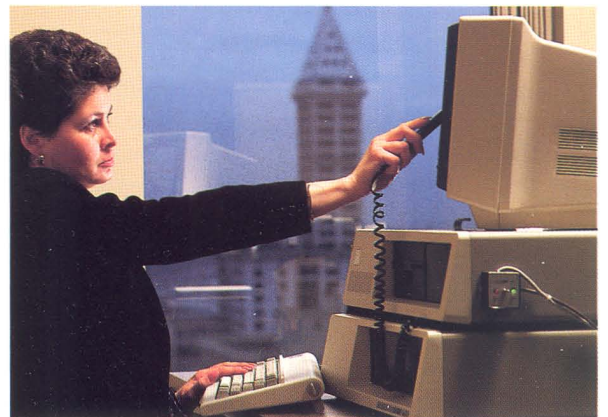
While most businesses realize that mismatches in staffing affect profitability, in the majority of cases accurate and reliable information is not readily available to analyze and improve staffing decisions. As a result, the full financial impact of optimum staffing is understood by only a small minority of businesses.

In a typical high volume phone room atmosphere it is often possible to reduce labor costs 10%-20%, while increasing revenues and/or the number of calls answered by 2.5%-5% through improved telephone room management techniques. In a hypothetical telephone room of forty agents, that translates to a monthly savings of \$6,600 to \$13,200 in labor costs, plus an increase in marginal profit contributions of between \$43,300 and \$86,600 per month, presuming each agent answers only ten calls per hour at a \$25 profit contribution per call.

Recognizing the problem and desiring to solve it are only the first steps. Finding a reliable, proven, and satisfactory solution is another matter. Prior to forming Telecalc, founder Michael S. Bledsoe spent 17 years helping some of America's largest corporations solve their high volume telephone room problems. Most large businesses, utilities, and government agencies have at least one high volume telephone environment. Typical applications include order entry, customer services, inquiries and information, appointments and reservations, credit authorization, sales and shipping.



Improved management of a high volume telephone center (above) can greatly enhance corporate profitability and corporate image. Right: Accurate, to-the-minute Telecalc MIS reporting lets Managers know at a touch how all factors in the telephone operation are performing: agents, callers, equipment.



Bledsoe recognized that the mandatory AT&T divestiture of the twenty-three Regional Bell Operating Companies presented an opportunity unlike any other in the history of telecommunications. In addition to an increased need to better manage telephone operations, the Bell Companies faced a regulatory ruling that eliminated support of their existing, last-generation management system by 1988.

A UNIQUE TIME IN HISTORY

AS BLEDSON'S CLIENTS WERE BECOMING INCREASINGLY AWARE OF THE NEED TO improve the productivity and effectiveness of their high volume telephone rooms, he was becoming increasingly frustrated because an automated solution did not exist. Based on his years of experience and unique industry knowledge, he was able to solve even the most complex telephone traffic management problems rather routinely. But because the problem (matching the supply of answering to the demand of calling) continued to change, he found that his clients required constantly changing solutions. It became clear that what the client really needed was the expertise Bledsoe possessed, packaged in a computer that would always be available to constantly analyze the problem and recommend the solution.

Bledsoe also recognized that the mandatory AT&T divestiture of the twenty-three Regional Bell Operating Companies presented an opportunity unlike any other in the history of telecommunications.

After divestiture, the Regional Bell Companies would be under increased pressure from the market to be better managed. This pressure would emphasize reduced costs, increased revenues, and improved customer satisfaction. This presented an ideal climate for the Telecalc system because the telephone sales departments of these companies represented large quantities of labor costs, large sources of revenue, and provided the majority of customer contacts. In addition to this increased need to better manage telephone operations, the Bell Companies faced a regulatory ruling that eliminated support of their existing, last-generation management system by 1988.

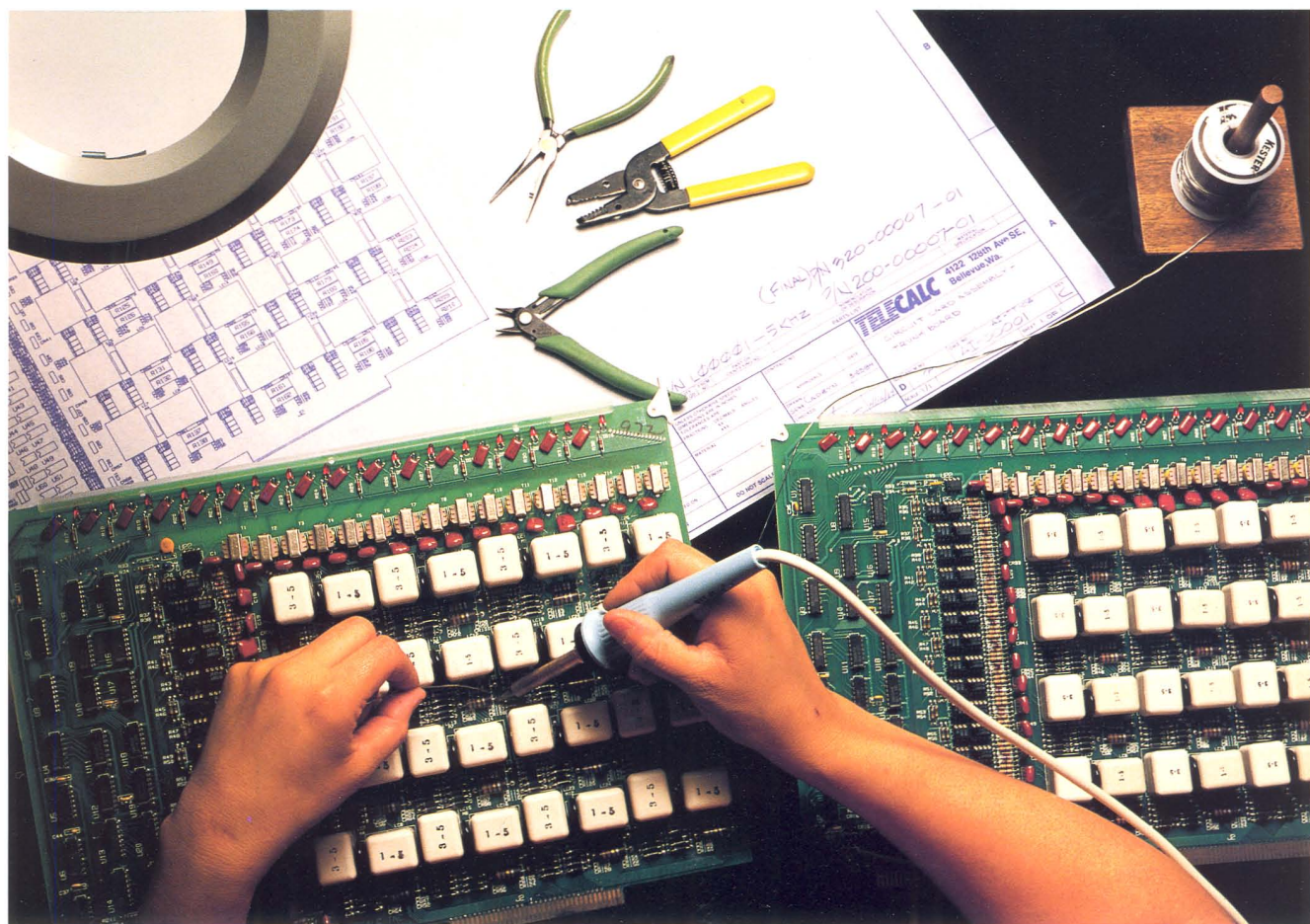
Bledsoe's industry sources indicated that the Regional Bell Companies' internal needs for high volume call management systems could exceed 1,000 systems (over \$50 million) during the first two or three years after divestiture. With the advent of microcomputer technology, for the first time in history it was now possible to track and store the essential telephone call data needed for analysis at a reasonable cost.

Convinced the product was technologically viable, that the timing was right, and that substantial need for the product did indeed exist, Bledsoe closed his very successful consulting practice in March, 1983, to devote his full industry knowledge and energy toward development of the Telecalc product.

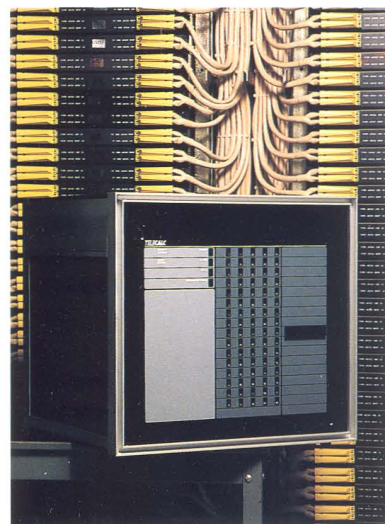
From the start, the product was designed to be an independent add-on rather than an integral part of the telephone switching system, an important aspect meaning that phone service would not be interrupted or affected if the system broke down for any reason. Bledsoe knew from industry experience that a service-affecting product would require support of a local service facility network before it could be marketed successfully. The passive add-on design allowed Telecalc to bypass this major capital and logistical difficulty which could limit the Company's ability to grow and dominate a market niche.

The first and most critical component for the new product was the Line Scanner Unit (LSU), a device that would gather the crucial data directly from the telephone lines with the required accuracy. Once designed, this device would have to pass rigid FCC certification requirements.

For the next year and a half the company would spend considerable research and manufacturing effort refining and perfecting the technology in order to obtain the FCC certification. After several phases of testing, FCC Certification was obtained in the summer of 1984. In May, 1985, the Company received patent approval from the U.S. Patent Office for its line scanner technology.



Above: The Company designs, assembles and tests its own products, an important commitment to quality assurance and cost control. Right: A patented, FCC-approved Line Scanner Unit (LSU), draws essential call data directly from the telephone switching system.



Knowing that phone room supervisors were far more comfortable dealing with people than with computers, the Company designed the system to be non-threatening, easy to learn, and easy to use. Information was designed to be either shown on the color video monitor, employing state-of-the-art graphics and abundant use of color, or to print out conveniently on paper at any time for reference.

TELECALC: BECOMING HIGHLY PROFICIENT IN A VARIETY OF DISCIPLINES

SOFTWARE, THE SECOND CRITICAL COMPONENT OF THE DESIGN, IS THE HIGHLY complex coding within the microcomputer, which links to the Line Scanner Unit, then sorts and presents information to the user. Knowing that phone room supervisors were far more comfortable dealing with people than with computers, the Company designed the system to be non-threatening, easy to learn, and easy to use. The software was designed so the user could operate the system easily, by applying a light pen to the color video monitor. Information was designed to be either shown on the color video monitor, employing state-of-the-art graphics and abundant use of color, and printed out conveniently on paper at any time for reference. Wherever possible, information would be shown in picture form, rather than by rows and columns of numbers.

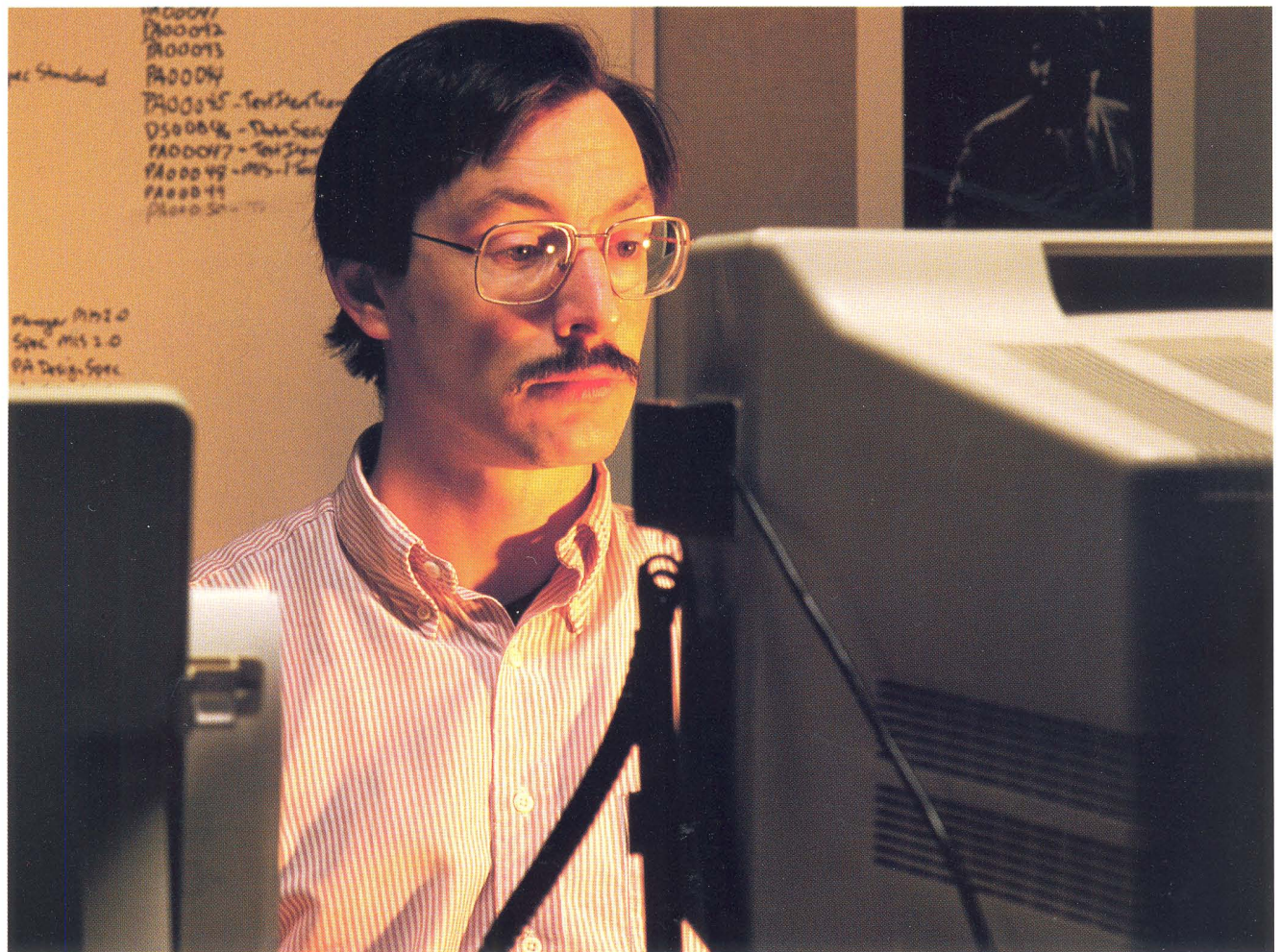
A third critical component, the ability to allow the microcomputer to perform multiple tasks at the same time, presented a major software obstacle. This operating system was essential to the entire system design, yet industry giants IBM and Microsoft reported this capability as still under development.

Telecalc therefore began to develop its own multi-tasking ability in order to bring its product to market in time to capitalize on the AT&T divestiture. In retrospect, this decision proved to be an excellent one inasmuch as Telecalc engineered, developed and released the product more than a year before it would have otherwise been available.

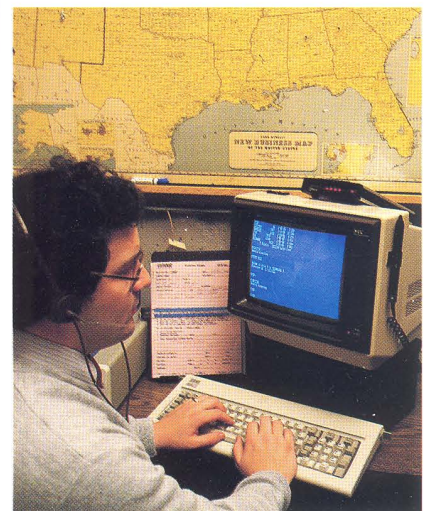
The multi-tasking software system allowed Telecalc's system to track, monitor, and display real-time telephone activity as it was occurring, even as the user was performing other functions — accessing information, making forecasts of future call demand, making an economic analysis, or projecting staffing requirements.

In order to ensure that Telecalc would be successful in the design, development, and introduction of a system of such complexity, the Company decided early to attract a number of proven and highly skilled individuals in such areas as hardware and software design and development, telecommunications equipment design and repair, plus full hardware and software manufacturing and testing capabilities. Also, in order to deliver and support a uniform, high-quality product, the Company determined that it would also attempt to become highly proficient in a wide variety of disciplines including on-site user training, remote diagnostics and repair, as well as telephone installation, and installation training.

Headquartered in Bellevue, Washington, Telecalc immediately found itself situated in an area rich in electronics, telecommunications, and high technology talent. Bellevue is also the home of Microsoft, one of the premier developers of software used in the microcomputer industry. To be able to compete for top people in the market and to become a respected employer in the region, Telecalc decided at an early stage to commit major resources to the development of a comprehensive human resource program and equitable benefit plans. The strategy has enabled the Company to develop a high-quality management team almost entirely from the local market, with a range of talents not often found in a company at such an early stage of development. Telecalc now finds itself in the enviable position of having a unique blend of highly talented individuals not only with considerable experience in telecommunications, but also with the experience that allows diversification into other areas such as electronics development and manufacture, or software development, should the need to diversify arise.



Above: A team of Sustaining Engineers monitors the success of existing products, improving reliability, and adding new features that are developed as a result of customer research. Right: Each Telecalc system in the field connects via telecommunications to the home office for regular software servicing, diagnostics or to receive the latest software update.



Throughout the past year, Telecalc committed a considerable amount of management attention, as well as major capital and manpower resources, to further solidify its position of technological leadership. During the year Telecalc invested and expended over \$737,000 (13% of sales) in product research and development. The majority of these expenditures represent a sharp increase in both the number and quality of in-house software engineers, many of whom were recruited from some of the area's premier micro-computer software firms.

CAPITALIZING ON ITS UNIQUE MARKET POSITION

THE COMPANY'S FULL SERVICE HARDWARE AND SOFTWARE DEVELOPMENT capabilities have not gone unnoticed by several of the Regional Bell Operating Companies who, as a result of divestiture, are no longer able to develop projects through reliance upon Western Electric, which served them well for so many years. The post-divestiture period has seen an unprecedented explosion of technological product advances brought about as the Regional Bell Operating Companies attempted to deal with the challenges of the unregulated environment. The majority of these products were developed for the first time in history outside of the Bell family.

It is encouraging to note that, during this post-divestiture period, Telecalc has strengthened its position as a valuable and reliable resource for two of the Regional Bell Companies. Because of these and other strategic relationships, Telecalc throughout the year has introduced a number of new features and three exciting new products, all while continuing to refine and improve its MIS-1 product under demanding field situations. Telecalc also significantly increased expenditures for the development of its next generation product, MIS-2, in an effort to fully capitalize on the unique market knowledge which has been gained over the past two and one half years.

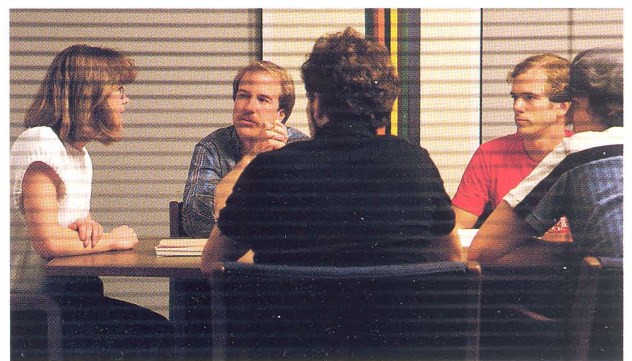
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The new MIS-2 product, scheduled for release in the fall of 1986, represents a significant advance in technological capabilities, but retains the proven features of the current MIS-1 system. It has been designed from the ground up with significant influence from Telecalc's major customers. The primary emphasis was to provide considerably more user configurability and flexibility. Over the past two and one half years, Telecalc has learned that customers needs change over time, and each customer has special needs and problems. The Telecalc MIS-2 system is being designed to allow the customer to shape the system as situations arise in the business environment, a feature that should increase the life cycle of the product. Special efforts have been made to ensure that the current MIS-1 customers will be able to inexpensively and easily upgrade to the newer MIS-2 product.

In less than three years, Telecalc has made excellent headway, progressing from a mere concept to a proven and reliable solution which is currently managing over 100 million phone calls per year while installed in some of America's most respected businesses. Regardless of how well Telecalc is presently positioned with its current and future products, future business prospects depend on how well Telecalc serves its customers by staying close to them. Since its inception, Telecalc's single greatest competitive advantage has been the quality and dedication of its people as judged by the continuing stream of favorable comments received from its customers. Providing outstanding customer support and staying close to its customers is a principal goal of Telecalc as a company, and the most important responsibility of all Telecalc employees. The Company's future will depend on how well each and every Telecalc employee contributes toward achieving that goal in the years ahead.



Above: Customer Support Representatives focus on staying close to the customer. They travel nationally to new customer sites, providing comprehensive hands-on user training. Right: Telecalc's Bellevue, Washington location offers a substantial pool of software engineering talent for designing reliable, state-of-the-art software products that anticipate the needs of a changing market.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

Sales for the year ended January 31, 1986, increased 132% to \$5.7 million over the \$2.4 million recorded for the year ended January 31, 1985. The significant increase in sales is primarily attributable to increased production volume which resulted from a major contract from one of the seven Regional Bell Operating Companies. As of January 31, 1986, such contract was substantially completed.

Cost of sales as a percentage of sales decreased from 44% for the year ended January 31, 1985, to 33% for the comparative year ended January 31, 1986. The principal reasons for this decrease were lower prices paid by the Company for its hardware components, improved manufacturing procedures, and increased sales volumes.

Commission expense as a percentage of sales decreased from 20% for the fiscal year ended January 31, 1985 to 18% for fiscal 1986. The primary reasons for this decrease were lower commission rates under its principal distribution agreement as of October 1985 and greater sales to non-Bell operating companies, which are not subject to the Company's principal distribution agreement and therefore require no commissions.

Other selling expenses increased from 8% of sales for the year ended January 31, 1985, to 15% for the comparative year ended January 31, 1986. This was due to the creation of the Company's direct sales organization in the fall of 1984. These costs are reflected for approximately four months in the year ended January 31, 1985, versus a full twelve months of associated costs for the year ended January 31, 1986. The Company also opened district sales offices in the late summer of 1985, which resulted in additional expenses of approximately \$135,000 for the year ended January 31, 1986. In addition, internal commissions increased as a percentage of sales from .3% to 2% based on increased sales volumes.

Customer Support and General and Administrative expenses both declined as a percentage of sales from 9% and 23%, respectively, for the year ended January 31, 1985, to 5% and 13%, respectively, for the year ended January 31, 1986. This occurred primarily as a result of increased sales without a comparable increase in overhead.

Research and Development increased from \$335,000 to \$737,000, an increase of 120% for the comparative twelve month periods. This resulted from a rapid increase in research and development expenditures relating to enhancements of existing products and addition of new products. In mid-year the Company committed additional resources to the development

of its next generation Management Information System.

Interest expense of \$61,000 for the year ended January 31, 1986, was partially offset by interest income of \$48,000 resulting from investments in short-term interest bearing obligations since Telecalc's initial public offering on August 7, 1985.

Net income for the year ended January 31, 1986, amounted to \$.08 per share compared to a loss of \$.32 per share for the previous year.

The year ended January 31, 1986, includes the effect of utilizing net operating loss carryforwards for federal income tax purposes. The effect on net income and earnings per share is \$44,000 and \$.02 respectively, and has been accounted for as an extraordinary item.

Liquidity and Financial Resources

Working capital increased by \$2,355,000 during fiscal 1986. The majority of the increase is a result of the Company's initial public offering on August 7, 1985. The Company currently has an operating line of credit facility totaling \$1,000,000 with interest at 1.0% over prime and a \$400,000 revolving equipment loan with interest at 1.5% over prime with a bank.

The Company had maximum bank borrowings during the year ended January 31, 1986 of \$572,000. As of January 31, 1986, the Company had no bank loans outstanding. The Company had maximum borrowings of \$661,000 from certain shareholders during fiscal 1986 which were subsequently paid off by August 31, 1985. As of April 7, 1986, the Company borrowed \$106,000 against its bank equipment loan.

Capital expenditures during fiscal 1986 totaled \$310,000 of which 83% or \$258,000 was for new equipment. The Engineering Department purchased the majority of the total new equipment for research and development purposes in developing new software programs. The Company is contemplating acquisition of a computer system for its business requirements which may result in capital expenditures of approximately \$100,000 during fiscal 1987.

Impact of Inflation

Inflation has not had a material impact on the operations and financial condition of the Company. The Company's primary inventory consists of electronic parts, computers and peripherals whose prices have remained stable or actually decreased in some instances.

STATEMENT OF OPERATIONS

Year Ended January 31	1986	1985
Net sales — Notes F and G	\$5,669,808	\$2,437,088
Costs and expenses:		
Cost of sales	1,868,804	1,071,505
Commissions — Note G	1,004,888	477,726
Other selling	844,233	194,117
Customer support	302,339	218,540
Research and development	737,128	334,508
General and administrative	719,968	563,556
	5,477,360	2,859,952
Operating income (loss)	192,448	(422,864)
Other income (expense):		
Interest expense	(61,030)	(68,635)
Interest income	47,986	
Other, net	6,281	1,702
	(6,763)	(66,933)
Income (loss) before income taxes and extraordinary item	185,685	(489,797)
Provision for income taxes	44,000	
Income (loss) before extraordinary item	141,685	(489,797)
Extraordinary item — utilization of operating loss carryforwards — Note D	44,000	
Net income (loss)	\$ 185,685	\$ (489,797)
Earnings (loss) per share — primary and fully diluted — Note H:		
Income (loss) before extraordinary item	\$.06	\$ (.32)
Net income (loss)	\$.08	\$ (.32)
Average shares outstanding, including common stock equivalents	2,294,423	1,540,671

See notes to financial statements.

BALANCE SHEETS

January 31	1986	1985
Assets		
Current assets		
Cash and cash equivalents	\$ 797,134	\$ 60,251
Accounts receivable, less allowance of \$12,000 in 1986	1,179,681	526,637
Inventories—Note A	1,035,248	614,607
Prepaid expenses	76,529	24,889
Total current assets	3,088,592	1,226,384
Equipment		
Equipment	438,778	180,395
Furniture and fixtures	73,929	35,345
Leasehold improvements	31,219	18,544
	543,926	234,284
Less accumulated depreciation and amortization	111,156	31,560
	432,770	202,724
Deposits and other assets	25,226	7,237
	\$3,546,588	\$1,436,345
Liabilities and Stockholders' Equity		
Current liabilities		
Notes payable to bank		\$ 418,979
Notes payable to stockholders—Note E		411,125
Accounts payable	\$260,413	134,023
Commissions payable	139,292	60,211
Accrued compensation	94,280	49,031
Accrued expenses	60,093	50,287
Warranty reserve	15,000	
Unearned income	71,570	
Current portion of long-term liabilities	6,512	16,257
Total current liabilities	647,160	1,139,913
Long-term liabilities		6,512
Stockholders' equity—Note E		
Common stock, par value \$.01 per share—authorized 5,000,000 shares	21,660	16,652
Additional paid-in capital	3,803,036	1,384,221
Retained earnings deficit	(925,268)	(1,110,953)
	2,899,428	289,920
	\$3,546,588	\$1,436,345

See notes to financial statements.

STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended January 31, 1986 and 1985	Common Stock Issued and Outstanding		Additional Paid-In Capital	Retained Earnings Deficit	Total
	Shares	Amount			
Balance at February 1, 1984	1,056,775	\$10,568	\$ 875,462	\$ (621,156)	\$ 264,874
Sale of common stock, net of expenses of \$17,213	130,625	1,306	503,981		505,287
Stock options exercised	477,800	4,778	4,778		9,556
Net loss				(489,797)	(489,797)
Balance at January 31, 1985	1,665,200	16,652	1,384,221	(1,110,953)	289,920
Sale of common stock, net of expenses of \$568,677	488,750	4,888	2,358,935		2,363,823
Conversion of debt to equity	12,000	120	59,880		60,000
Net income				185,685	185,685
Balance at January 31, 1986	2,165,950	\$21,660	\$3,803,036	\$ (925,268)	\$2,899,428

See notes to financial statements.

STATEMENTS OF CHANGES IN FINANCIAL POSITION

Year Ended January 31	1986	1985
Source of working capital		
Income (loss) before extraordinary item	\$ 141,685	\$(489,797)
Add depreciation and amortization which does not affect working capital	79,596	30,431
Funds provided from (used in) operations before extraordinary item	221,281	(459,366)
Extraordinary item — income tax benefit from utilization of loss carryforward	44,000	
Funds provided from (used in) operations	265,281	(459,366)
Net proceeds of common stock issue	2,363,823	514,843
Conversion of debt to common stock	60,000	
	2,689,104	55,477
Application of working capital		
Acquisition of equipment	309,642	191,026
Increase in deposits and other assets	17,989	7,237
Decrease in long-term liabilities	6,512	15,687
	334,143	213,950
Increase (decrease) in working capital	\$2,354,961	\$(158,473)
Changes in components of working capital		
Increase (decrease) in current assets:		
Cash and cash equivalents	\$ 736,883	\$ (64,295)
Accounts receivable	653,044	457,113
Inventories	420,641	444,787
Prepaid expenses	51,640	(57,164)
	1,862,208	780,441
Increase (decrease) in current liabilities:		
Notes payable to bank	(418,979)	418,979
Notes payable to stockholders	(411,125)	365,000
Accounts payable	126,390	23,796
Commissions payable	79,081	60,211
Accrued compensation	45,249	40,025
Accrued expenses	9,806	23,099
Warranty reserve	15,000	
Unearned income	71,570	
Current portion of long-term liabilities	(9,745)	7,804
	(492,753)	938,914
Increase (decrease) in working capital	\$2,354,961	\$(158,473)

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

NOTE A: Summary of Significant Accounting Policies

General: Telecalc, Inc. (the Company) is engaged in one line of business, the development, manufacture, and sale of microcomputer-based management information systems (MIS) for use in telephone communications.

Research and Development Costs: Research and development costs are charged to expense as incurred.

Inventories: Inventories are stated at the lower of cost (first-in, first-out method) or market as noted below:

January 31	1986	1985
Raw materials	\$ 453,719	\$326,415
Work in process	512,427	228,432
Finished goods	69,102	59,760
	\$1,035,248	\$614,607

Equipment: Equipment is recorded at cost. Depreciation and amortization of equipment is provided on the straight-line method over the assets' estimated useful lives.

Investment Tax Credits: Investment tax credits will be recorded as a reduction of the provision for income taxes in the year realized.

Earnings Per Share: Earnings per share are computed using the weighted average number of common shares outstanding, including common stock equivalents. Stock options and warrants are considered common stock equivalents when the market price of the Company's stock exceeds the exercise price.

Reclassifications: Certain 1985 amounts have been reclassified to conform with the 1986 presentation.

NOTE B: Credit Facilities

The Company has a \$1,000,000 line of credit facility and a \$400,000 revolving equipment loan facility with a bank. At January 31, 1986, no amounts are outstanding under these facilities. The line of credit facilities expire on October 31, 1986.

NOTE C: Lease Obligations

The Company leases production and office space under four operating leases requiring varying monthly lease payments (maximum \$10,132) through July 31, 1987. The leases contain renewal options and provide for increased rentals based upon increases in property taxes and building operating expenses.

Future minimum lease commitments under all operating leases at January 31, 1986 are as follows:

Year Ending January 31	
1987	\$119,300
1988	37,000
	\$156,300

Total rental expense was approximately \$128,000 and \$76,000 for fiscal years ended January 31, 1986 and 1985, respectively.

NOTE D: Income Taxes

The Company has net operating loss carryforwards of approximately \$373,000 and \$456,000 for book and tax purposes, respectively, expiring in the year 2000. Research and development and investment tax credit carryforwards totaling \$107,745 and \$42,486, respectively, expire from 1999 to 2001.

A portion of the net operating loss carryforward was utilized in 1986 to offset taxable income. This offset was recorded as an extraordinary credit in the accompanying financial statements.

A reconciliation of the 1986 provision for income taxes at statutory rates to the provision for income taxes follows:

Income taxes at statutory rate	\$ 85,415	46%
Amortization of research and development costs capitalized for tax, not book	(22,331)	(12)
Effect of graduated tax rates	(20,250)	(11)
Other	1,166	1
Provisions for Income Taxes	\$44,000	24%

NOTE E: Stockholders' Equity and Notes Payable to Stockholders

Common Stock: Effective May 22, 1985, the Company split its stock two-and-one-half for one. All share and per share information was retroactively adjusted to reflect this stock split.

Preferred Stock: The Company has authorized 1,000,000 shares of preferred stock, par value of \$.01 per share. No shares are issued or outstanding as of January 31, 1986.

Stock Options: The Company has a stock option plan under which options to purchase up to an aggregate of 750,000 shares of common stock can be granted to key employees by the Board of Directors. Options granted are exercisable over periods established when granted at fair market value determined by the Board of Directors on the date of grant.

Since March 1984, the Company has granted options to purchase 163,756 shares of Common Stock to 38 employees as follows:

Shares	Price Per Share	Expiration Date
57,575	\$2.04	March 1989
55,848	4.00	July-October 1989
18,750	4.40	November 1989
16,583	6.00	July 1990
15,000	7.25	October 1990
163,756		

One-third of the options are exercisable after each of the first three years after grant, and all options expire five years after grant. Under the plan, 108,444 options remain available for grant.

Warrants: In October 1984, the Company and certain stockholders entered into an agreement to extend credit to the Company. Each stockholder making loans under the agreement (which totaled \$370,000 with interest at 2% over the prime rate) became entitled to warrants to purchase common stock of the Company exercisable for a period expiring January 31, 1987 at a price equal to 120% of the fair market value of the Company's Common Stock at January 31, 1985, which exercise price has been determined as \$6 per share.

Pursuant to the agreement, warrants to purchase an aggregate of 61,670 shares at an exercise price of \$6 per share were issued. Of outstanding notes payable related to these warrants, which were payable January 31, 1985, \$370,000 were extended by the stockholders to April 30, 1985. On April 30, 1985, \$100,000 was repaid to certain stockholders and \$60,000 was converted from debt-to-equity. The remaining \$210,000 was repaid from the proceeds of the Company's public offering in August 1985. As a result of this extension, warrants to purchase an additional 86,670 shares at an exercise price of \$6 were issued.

In January 1985, the Company obtained an additional \$400,000 standby line of credit from a stockholder of the Company. \$100,000 was advanced under this line with interest at 2% above the prime rate. In consideration for extending the commitment and advancing the \$100,000, the stockholder was granted warrants to purchase 62,500 shares of the Company's Common Stock at an exercise price of \$4 per share.

In connection with the 1985 public offering, the Company granted the underwriter warrants to purchase 42,500 shares of the Company's Common Stock at an exercise price of \$7.20 per share.

In summary, warrants outstanding are as follows:

Warrants	Price Per Share	Expiration Date
148,340	\$6.00	January 1987
62,500	4.00	January 1988
42,500	7.20	August 1990
253,340		

NOTE F: *Major Customer*

For the year ended January 31, 1986, 86% of net sales were to two customers, Mountain Bell and Northwestern Bell. In 1985, 74% of net sales were to Pacific Bell and Mountain Bell.

NOTE G: *Distribution Agreement*

The Company has an amended distribution agreement under which American Telecorp, Inc. has the exclusive right to sell the Company's MIS product to certain of the Regional Bell Operating Companies. The commission expense reflected in the statement of operations results from commissions earned by American Telecorp, Inc. per the distribution agreement. Under the agreement, American Telecorp receives commissions of 25% on the first \$5,000,000 in commissionable sales and 20% on the next \$5,000,000 in commissionable sales, at which time the agreement terminates. To date, under the 25% commission provision, American Telecorp has received \$1,250,000; under the 20% commission provision, it has received approximately \$271,000, leaving a balance of approximately \$729,000 in future commissions on the remaining \$3,644,000 in commissionable sales. American Telecorp will also receive a commission from 7½% to 15% on any sales resulting from contracts to purchase existing at the time the \$10 million commissionable sales level is reached. American Telecorp also has a nonexclusive right to sell the Company's MIS product to customers other than Bell Operating Companies.

NOTE H: *Earnings per Share*

In 1985, common stock equivalents are not included in the earnings per share calculation because they have a dilutive effect on the loss per share.

If the proceeds from the 1985 public offering had been used to pay off the notes to the bank and shareholders at the beginning of the period, earnings per share for 1986 would have been as follows:

Earnings per share — primary and fully diluted:

Income before extraordinary item	\$.08
Net income	\$.10

REPORT OF ERNST & WHINNEY

Stockholders and Board of Directors

Telecalc, Inc.

Bellevue, Washington

We have examined the balance sheets of Telecalc, Inc. as of January 31, 1986 and 1985, and the related statements of operations, changes in stockholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Telecalc, Inc. at January 31, 1986 and 1985, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Whinney

Seattle, Washington
March 21, 1986

CORPORATE INFORMATION

Board of Directors

Michael S. Bledsoe	<i>Chairman, President and Chief Executive Officer and Director</i>
Ronald P. Erickson	<i>Director. Partner in the Seattle law firm of Kargianis and Austin</i>
Robert W. Greer	<i>Director. Private Investments</i>
W. Hunter Simpson	<i>Director. Formerly President, Chief Executive Officer and Director of Physio Control Corporation (a wholly-owned subsidiary of Eli Lilly & Co.) from 1966 to 1986; Director, Data I-O Corp.</i>
Dennis W. Wassman	<i>Vice President of Finance, Secretary, Treasurer and Director</i>

Officers

Michael S. Bledsoe	<i>Chairman, President and Chief Executive Officer</i>
Stephen F. Blecksmith	<i>Vice President of Markets, Products and Services</i>
Robert H. Coyle	<i>Vice President of Sales</i>
Craig L. Morrison	<i>Vice President of Operations</i>
Dennis W. Wassman	<i>Vice President of Finance, Secretary, Treasurer</i>

Transfer Agent & Registrar

Seattle First National Bank
Stock Transfer Services
Box 24186
Seattle, Washington 98124

Legal Counsel

Foster, Pepper & Riviera
1111 Third Avenue
Seattle, Washington 98101

Auditors

Ernst & Whinney
999 Third Avenue-Suite 3300
Seattle, Washington 98104

Investor Relations Counsel

Corporate Communications, Inc.
200 W. Mercer-Suite 412
Seattle, Washington 98119

Form 10-K

The Company files an annual report with the Securities and Exchange Commission. Shareholders may obtain a copy of this report without charge by writing:

Dennis W. Wassman, Vice President of Finance
TELECALC, INC.
4122 128th Avenue S.E.
Bellevue, Washington 98006
