ZOOM TECHNOLOGIES INC
Form 10-Q
November 14, 2005

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

or

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

For the transition period from________ to ________

Commission File Number 0-18672

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). YES o NO x

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

The number of shares outstanding of the registrant's Common Stock, $.01 Par Value, as of November 7, 2005, was 9,346,966 shares.

1

ZOOM TECHNOLOGIES, INC. AND SUBSIDIARY
INDEX

Part I.	**Financial Information**	**Page**
Item 1.	Financial Statements:	
	Consolidated Balance Sheets as of September 30, 2005 and December 31, 2004 (unaudited)	3
	Consolidated Statements of Operations for the three and nine months ended September 30, 2005 and 2004 (unaudited)	4
	Consolidated Statements of Cash Flows for the nine months ended September 30, 2005 and 2004 (unaudited)	5
	Notes to Consolidated Financial Statements	6-11
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	11-27
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	27
Item 4.	Controls and Procedures	27
Part II.	**Other Information**	
Item 5.	Other Information	27
Item 6.	Exhibits	28
	Signatures	29
	Exhibit Index	30

PART I - FINANCIAL INFORMATION

ZOOM TECHNOLOGIES, INC. AND SUBSIDIARY
Consolidated Balance Sheets
(unaudited)

		September 30, 2005		December 31, 2004
Assets				
Current assets:				
Cash and cash equivalents	$	8,272,148	$	9,438,596
Accounts receivable, net of reserves for doubtful accounts, returns, and allowances of $1,487,881 at September 30, 2005 and $1,359,455 at December 31, 2004		2,863,717		3,349,781
Inventories		5,132,213		5,030,478
Prepaid expense and other current assets		208,231		529,989
Total current assets		16,476,309		18,348,844
Property, plant and equipment, net		2,549,499		2,703,208
Total assets	$	19,025,808	$	21,052,052
Liabilities and Stockholders' Equity				
Current liabilities:				
Current portion of long-term debt	$	4,943,424	$	229,555
Accounts payable		1,297,487		2,006,819
Accrued expense		1,034,746		1,275,088
Total current liabilities		7,275,657		3,511,462
Long-term debt, less current portion		—		4,872,298
Total liabilities	$	7,275,657	$	8,383,760
Stockholders' equity:				
Common stock, $0.01 par value. Authorized 25,000,000 shares; issued 9,355,366 shares, outstanding 9,346,966 shares at September 30, 2005 and issued 8,935,516 shares, outstanding 8,927,116 shares at December 31, 2004		93,554		89,355
Additional paid-in capital		31,015,978		30,572,727
Retained earnings (accumulated deficit)		(19,768,579)		(18,510,181)
Accumulated other comprehensive income (loss)		416,520		523,713
Treasury stock, at cost		(7,322)		(7,322)
Total stockholders' equity		11,750,151		12,668,292
Total liabilities and stockholders' equity	$	19,025,808	$	21,052,052

See accompanying notes to unaudited consolidated financial statements.

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

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Net sales	$ 5,308,380	$ 7,142,608	$ 18,269,296	$ 23,025,683
Costs of goods sold	4,789,732	5,645,772	14,836,965	16,966,396
Gross profit	518,648	1,496,836	3,432,331	6,059,287
Operating expense:				
Selling	977,718	1,114,928	3,172,332	3,511,959
General and administrative	314,188	780,681	2,867,694	2,797,396
Research and development	664,641	721,942	2,109,347	2,065,603
Total operating expense	1,956,547	2,617,551	8,149,373	8,374,958
Operating income (loss)	(1,437,899)	(1,120,715)	(4,717,042)	(2,315,671)
Other income (expense):				
Interest income	69,984	40,241	151,508	89,848
Interest (expense)	(63,596)	(52,950)	(190,511)	(159,109)
Gain on sale of investment in InterMute	—	—	3,495,516	—
Other, net	56,251	105,035	2,131	219,116
Total other income (expense), net	62,639	92,326	3,458,644	149,855
Income (loss) before income tax expense	(1,375,260)	(1,028,389)	(1,258,398)	(2,165,816)
Income tax expense (benefit)	—	—	—	—
Net income (loss)	$ (1,375,260)	$ (1,028,389)	$ (1,258,398)	$ (2,165,816)
Earnings (loss) per common share:				
Basic	$ (0.15)	$ (0.12)	$ (0.14)	$ (0.26)
Diluted	$ (0.15)	$ (0.12)	$ (0.14)	$ (0.26)
Weighted average common and common equivalent shares:				
Basic	9,341,124	8,791,016	9,158,734	8,486,167
Diluted	9,341,124	8,791,016	9,158,734	8,486,167

See accompanying notes to unaudited consolidated financial statements.

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

	Nine Months Ended September 30, 2005	2004
Cash flows from operating activities:		
Net income (loss)	$ (1,258,398)	$ (2,165,816)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on sale of investment in InterMute	(3,495,516)	—
Depreciation	200,605	330,794
Changes in operating assets and liabilities:		
Accounts receivable, net	381,433	1,331,756
Inventories	(101,735)	(598,394)
Prepaid expense and other assets	321,758	76,626
Accounts payable and accrued expense	(949,674)	(250,203)
Net cash provided by (used in) operating activities	(4,901,527)	(1,275,237)
Cash flows from investing activities:		
Proceeds from sale of investment in InterMute	3,495,516	—
Additions to property, plant and equipment	(46,896)	(145,231)
Net cash provided by (used in) investing activities	3,448,620	(145,231)
Cash flows from financing activities:		
Principal payments on long-term debt	(158,429)	(162,560)
Proceeds from exercise of stock options	447,450	2,021,031
Net cash provided by (used in) financing activities	289,021	1,858,471
Effect of exchange rate changes on cash and cash equivalents	(2,562)	(2,571)
Net increase (decrease) in cash and cash equivalents	(1,166,448)	435,432
Cash and cash equivalents beginning of period	9,438,596	9,904,384
Cash and cash equivalents end of period	$ 8,272,148	$ 10,339,816
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 190,511	$ 159,109
Income taxes	$ —	$ —

See accompanying notes to unaudited consolidated financial statements.

5

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

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation and Principles of Consolidation

The consolidated financial statements of Zoom Technologies, Inc. (the "Company") presented herein have been prepared pursuant to the rules of the Securities and Exchange Commission for quarterly reports on Form 10-Q and do not include all of the information and footnote disclosures required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2004 included in the Company's 2004 Annual Report on Form 10-K.

The consolidated balance sheet as of September 30, 2005, the consolidated statements of operations for the three and nine months ended September 30, 2005 and 2004, and the consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004 are unaudited, but, in the opinion of management, include all adjustments (consisting of normal, recurring adjustments) necessary for a fair presentation of results for these interim periods.

The consolidated financial statements include the accounts and operations of the Company's wholly owned subsidiary, Zoom Telephonics, Inc., a Delaware corporation. All significant intercompany accounts and transactions have been eliminated in consolidation.

The results of operations for the periods presented are not necessarily indicative of the results to be expected for the entire year ending December 31, 2005.

(b) Stock-Based Compensation

The Company accounts for its stock option plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees, and Related Interpretations." No stock-based compensation expense is reflected in net income (loss) for these plans, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and earnings (loss) per share if the Company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123, "Accounting for Stock Based Compensation" to stock-based compensation (See note 11).

	Three Months Ended September 30,				Nine Months Ended September 30,			
		2005		2004		2005		2004
Net income (loss), as reported	$	(1,375,260)	$	(1,028,389)	$	(1,258,398)	$	(2,165,816)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(214,657)		(139,829)		(473,398)		(486,421)
Pro forma net income (loss)	$	(1,589,917)	$	(1,168,218)	$	(1,731,796)	$	(2,652,237)
Earnings (loss) per share:								
Basic - as reported	$	(0.15)	$	(0.12)	$	(0.14)	$	(0.26)
Diluted - as reported	$	(0.15)	$	(0.12)	$	(0.14)	$	(0.26)
Basic - pro forma	$	(0.17)	$	(0.13)	$	(0.19)	$	(0.31)

Diluted - pro forma	$	(0.17)	$	(0.13)	$	(0.19)	$	(0.31)

6

(c) Recently Issued or Proposed Accounting Pronouncements

In June 2005, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements" ("EITF 05-6"). The guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. The guidance is effective for periods beginning after June 29, 2005. The adoption of EITF 05-6 did not have an effect on the Company's consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 applies to all voluntary changes in accounting principles and requires retrospective application to prior periods' financial statements of changes in accounting principles, unless it is impracticable. SFAS No. 154 requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change of estimate affected by a change in accounting principles. SFAS No. 154 also carries forward without change the guidance in APB Opinion No. 20 with respect to accounting for changes in accounting estimates, changes in the reporting unit and correction of an error in previously issued financial statements. The Company is required to adopt SFAS No. 154 for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material effect on the Company's consolidated financial position or results of operations.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted no later than the first annual period beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS No. 123R allows companies to choose between the modified-prospective and modified-retrospective transition alternatives in adopting SFAS No. 123R. Under the modified-prospective transition method, compensation cost will be recognized in financial statements issued subsequent to the date of adoption for all shared-based payments granted, modified or settled after the date of adoption, as well as for any unvested awards that were granted prior to the date of adoption. Under the modified-retrospective transition method, compensation cost will be recognized in a manner consistent with the modified-prospective transition method, however, prior period financial statements will also be restated by recognizing compensation cost as previously reported in the pro forma disclosures under SFAS No. 123. The restatement provisions can be applied to either a) all periods presented or b) to the beginning of the fiscal year in which SFAS No. 123R is adopted. The Company expects to adopt SFAS No. 123R on January 1, 2006 using the modified-prospective method. As the Company previously adopted only the pro forma disclosure provisions of SFAS No. 123, the Company will recognize compensation cost relating to the unvested portion of awards granted prior to the date of adoption using the same estimate of the grant-date fair value and the same attribution method used to determine the pro forma disclosures under SFAS No. 123. As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123R's fair value method will have an impact on the Company's results of operations, although it will have no impact on the overall financial position. The impact of the adoption of SFAS No. 123R cannot be determined at this time because it will depend upon levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact as described in the disclosure of pro forma net income (loss) and net income (loss) per share pursuant to SFAS No. 123 (see note 1(b) and note 11).

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4”. The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the International Accounting Standards Board toward development of a single set of high-quality accounting standards. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material effect on the Company’s consolidated financial position or results of operations.

(2) Liquidity; Revolving Line of Credit

On September 30, 2005 the Company had working capital of $9.2 million, including $8.3 million in cash and cash equivalents.

On March 16, 2005 Zoom Telephonics, Inc., a wholly owned subsidiary of the Company, entered into a Loan and Security Agreement with Silicon Valley Bank that provides for a revolving line of credit of up to $2 million. The revolving line of credit can be used to (i) borrow under revolving loans for working capital and general corporate purposes, (ii) issue letters of credit, (iii) enter into foreign exchange forward contracts, and (iv) support certain cash management services. Revolving loans bear interest at a floating rate of interest equal to Silicon Valley Bank's prime rate plus 0.5%. The loan rate at September 30, 2005 was 7.25%. This interest rate will be increased to Silicon Valley Bank's prime rate plus 1.0% if the Company records two consecutive quarters of combined losses. The revolving line of credit terminates, and all outstanding obligations under the Loan and Security Agreement become due on March 15, 2006.

The revolving loans under the Loan and Security Agreement are secured by a first priority lien on substantially all of the assets of the Company and Zoom Telephonics, Inc., excluding intellectual property and real estate. The Company guaranteed the obligations of Zoom Telephonics under the revolving line of credit and pledged all of the stock of Zoom Telephonics in support of its guarantee. The Loan and Security Agreement requires that the Company maintain a minimum adjusted quick ratio and a minimum net worth. In addition, Zoom Telephonics is required to obtain Silicon Valley Bank's prior written consent to among other things, dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends, or repurchase stock. This consent may not be unreasonably withheld.

The Loan and Security Agreement contains events of default that include, among other things, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross default to certain other indebtedness, bankruptcy and insolvency events, change of control, and material judgments. Upon occurrence of an event of default, Silicon Valley Bank is entitled to, among other things, accelerate all of Zoom Telephonics' obligations and sell its assets to satisfy obligations under the Loan and Security Agreement. As of September 30, 2005 the Company's availability under the line is $1.7 million. As of September 30, 2005 no amounts were outstanding under the revolving line of credit and the Company was in compliance with all covenants.

To conserve cash and manage liquidity during the past few years, the Company has implemented expense reductions including the reduction of employee headcount and overhead costs. The employee headcount was 185 at December 31, 2002 and 125 at September 30, 2005. The Company will continue to assess its cost structure as it relates to its revenues and cash position and the Company may make further cost reductions if the actions are deemed necessary.

Management believes the Company has sufficient resources to fund its normal operations over the next twelve months. However, if the Company is unable to increase its revenues, reduce or otherwise adequately control its expenses, or raise capital, the Company's longer-term ability to continue as a going concern and achieve its intended business objectives could be adversely affected. Moreover, the Company's liquidity could be significantly impaired if it repays its mortgage through current sources of cash on or before the maturity date in January 2006 and is not able to refinance all or a significant portion of the mortgage and is not able to sell its owned buildings for adequate consideration. See "Risk Factors" below for further information with respect to events and uncertainties that could harm the Company's business, operating results, and financial conditions.

(3) Earnings (loss) per share

The reconciliation of the numerators and denominators of the basic and diluted net earnings (loss) per share computations for the Company’s reported net income (loss) is as follows:

8

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Basic:				
Net income (loss)	$ (1,375,260)	$ (1,028,389)	$ (1,258,398)	$ (2,165,816)
Weighted average shares outstanding	9,341,124	8,791,016	9,158,734	8,486,167
Earnings (loss) per share	$ (0.15)	$ (0.12)	$ (0.14)	$ (0.26)
Diluted:				
Net income (loss)	$ (1,375,260)	$ (1,028,389)	$ (1,258,398)	$ (2,165,816)
Weighted average shares outstanding	9,341,124	8,791,016	9,158,734	8,486,167
Net effect of dilutive stock options based on the Treasury stock method using average market price	—	—	—	—
Weighted average shares outstanding	9,341,124	8,791,016	9,158,734	8,486,167
Earnings (loss) per share	$ (0.15)	$ (0.12)	$ (0.14)	$ (0.26)

Potential common shares for which inclusion would have the effect of increasing diluted earnings per share (i.e., antidilutive) are excluded from the computation for the three and nine months ended September 30, 2005 and 2004. Options to purchase 1,264,900 and 1,054,050 shares of common stock at September 30, 2005 and 2004, respectively, were outstanding, but not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2005 and 2004 as their effect would be antidilutive.

(4) Inventories

Inventories consist of the following:	September 30, 2005	December 31, 2004
Raw materials	$ 2,216,947	$ 2,595,730
Work in process	1,502,688	1,177,602
Finished goods	1,412,578	1,257,146
Total Inventories	$ 5,132,213	$ 5,030,478

During the three months ended September 30, 2005 the company recorded obsolescence charges of $279,700.

(5) Comprehensive Income (Loss)

Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income" establishes rules for the reporting and display of comprehensive income (loss) and its components; however, it has no impact on the Company's net income (loss). SFAS No. 130 requires all changes in equity from non-owner sources to be included in the determination of comprehensive income (loss).

The components of comprehensive income (loss), net of tax, are as follows:

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Net income (loss)	$ (1,375,260)	$ (1,028,389)	$ (1,258,398)	$ (2,165,816)
Foreign currency translation adjustment	(10,356)	(12,779)	(107,193)	83,278
Comprehensive income (loss)	$ (1,385,616)	$ (1,041,168)	$ (1,365,591)	$ (2,082,538)

At September 30, 2005 and December 31, 2004, accumulated other comprehensive income (loss) as reported on the Company's balance sheet is comprised solely of foreign currency translation adjustments.

(6) Long-Term Debt

On January 10, 2001 the Company obtained a mortgage loan for $6 million secured by the real estate property located at 201 and 207 South Street, Boston, Massachusetts. This is a 20-year direct reduction mortgage with a five-year balloon due January 10, 2006. The interest rate is fixed for one year, based on the one-year Federal Home Loan Bank rate plus 2.5 % per annum. In 2004 the interest rate was 3.99%. As of January 10, 2005 the rate of interest changed to 5.80%. The Company renegotiated the rate to 5.0% effective February 10, 2005. As of September 30, 2005 $4.9 million was outstanding on this loan, which is due and payable on January 10, 2006. Because the mortgage loan is due within twelve months, the obligation is classified as a current liability at September 30, 2005.

(7) Gain on sale of investment in InterMute

Since 1999 the Company had a minority interest in a privately held software company, InterMute, Inc., which the Company had been accounting for under the equity method of accounting. The Company made its original investment in 1999, at the time of the company’s formation, and subsequently made additional investments. Under the equity method of accounting, the Company's investment was increased or decreased, not below zero, based upon the Company's proportionate share of the net earnings or losses of InterMute. As a result of the losses incurred by InterMute subsequent to the Company's investments, the Company's investment balance was reduced to zero during 2002. The Company discontinued applying the equity method when the investment was reduced to zero and did not provide for additional losses, as the Company did not guarantee obligations of the investee and was not committed to provide further financial support.

In June 2005 InterMute was acquired by Trend Micro Inc., a U.S. subsidiary of Trend Micro Japan. In connection with the acquisition of InterMute in June 2005, the Company received a payment in exchange for its investment of approximately $3.5 million, also in June 2005. The Company recorded a non-operating, after-tax gain of $3.5 million in its second quarter ended June 30, 2005. The Company may also receive up to $3.0 million in additional payments in 2006 if certain conditions and performance targets are met. The recording of gains from these additional payments will not be made until and unless they are fully earned.

(8) Commitments

During the nine months ended September 30, 2005, other than the line of credit discussed in Note 2 above, there were no material changes to the capital commitments and contractual obligations of the Company from those disclosed in the Form 10-K for the year ended December 31, 2004.

(9) Segment and Geographic Information

The Company’s operations are classified into one reportable segment. The Company’s United States and international net sales for the three and nine months ended September 30, 2005 and 2004, respectively, were comprised as follows:

	Three Months Ended September 30, 2005	% of Total	Three Months Ended September 30, 2004	% of Total	Nine months Ended September 30, 2005	% of Total	Nine months Ended September 30, 2004	% of Total
North America	$ 2,668,030	50%	$ 3,321,564	46%	$ 8,701,050	48%	$ 10,938,878	48%
Turkey	973,349	18%	1,135,603	16%	3,113,560	17%	3,197,954	14%
UK	1,108,810	21%	1,835,555	26%	4,057,410	22%	6,219,888	27%
All Other	558,191	11%	849,886	12%	2,397,276	13%	2,668,963	11%
Total	$ 5,308,380	100%	$ 7,142,608	100%	$ 18,269,296	100%	$ 23,025,683	100%

(10) Customer Concentrations

Relatively few customers have accounted for a substantial portion of the Company’s net sales. In the third quarter of 2005 the Company’s net sales to its top three customers accounted for 38% of its total net sales, with the Company’s sales to a large Turkish distributor accounting for 18% of the total net sales. The remaining 20% was divided fairly equally between the other two customers, both with a 10% share. In the first nine months of 2005 the Company's net sales to its top three customers accounted for 39% of its total net sales. Zoom's fourth largest customer in the second quarter of 2005 and sixth largest customer in the first nine months of 2005 was Granville Technologies, Ltd., which in late July 2005 went into "administration," a U.K. form of receivership. No sales to Granville were recorded in the third quarter of 2005. The administrators have decided to discontinue the company as a going concern and sell the business assets to help satisfy creditors. The Company had a receivable of $.8 million and $.3 million of consigned inventory with Granville Technologies at the time that Granville was placed into "administration." Because of our assessment of the improbability of the collection of the receivables and the recovery of the inventory at that time, the Company's results of operations for the second quarter of 2005 included a $1.1 million reserve for these receivables and inventory. The expenses associated with these reserves were recorded as a general and administrative expense in the second quarter of 2005. In the third quarter of 2005 the Company recovered the entire $.3 million of consigned inventory from the administrators and confirmed that the VAT portion of the receivable is recoverable from the U.K. government Customs agency, HM Customs. These recoveries resulted in a $.4 million reversal in the third quarter of 2005 of the general and administrative expenses associated with the $1.1 million reserve established in the second quarter of 2005. Additional recoveries are highly unlikely.

The Company's customers generally do not enter into long-term agreements obligating them to purchase our products. The Company may not continue to receive significant revenues from any of these or from other large customers. A reduction or delay in orders from any of the Company's significant customers, or a delay or default in payment by any significant customer could materially harm the Company's business and prospects. Because of the Company's significant customer concentration, its net sales and operating income could fluctuate significantly due to changes in political or economic conditions, or the loss, reduction of business, or less favorable terms for any of the Company's significant customers.

(11) Subsequent Event

On October 26, 2005 the Company accelerated the vesting of all stock options previously awarded to employees and officers that were scheduled to vest on or before May 6, 2006. These stock options had exercise prices in excess of $1.76, the closing price of the Company's Common Stock on October 26, 2005, the effective date of the acceleration. As a result of the acceleration, stock options to purchase 317,500 shares became exercisable immediately. These accelerated stock options represent 33% of the total outstanding unvested stock options and approximately 25% of the total outstanding stock options. The weighted average exercise price of the accelerated stock options is $2.44 per share.

The primary purpose of the acceleration of the vesting of these stock options is to reduce the Company's future reported compensation expense upon the planned adoption of Statement of Financial Accounting Standards (SFAS) No. 123R, "Share Based Payment" effective January 1, 2006. As a result of the acceleration, the Company expects to reduce the stock option expense, a non-cash charge, it otherwise would be required to record by approximately $130,000 total for the first two quarters of 2006.

The pro-forma compensation expense reported in footnote 1(b), Stock-Based Compensation, in this document is not impacted by the vesting acceleration. The impact will be reflected in the Stock-Based Compensation footnote in the 2005 10-K.

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

The following discussion and analysis should be read in conjunction with the safe harbor statement and the risk factors contained herein and set forth in our Annual Report on Form 10-K for the year ended December 31, 2004. Readers should also be cautioned that results of any reported period are often not indicative of results for any future period.

Overview

We derive our net sales primarily from sales of Internet related hardware products, principally broadband and dial-up modems and related products, to retailers, distributors, Internet Service Providers and Original Equipment Manufacturers. We sell our products through a direct sales force and through independent sales agents. Our employees are primarily located at our headquarters in Boston, Massachusetts, our support office in Boca Raton, Florida, and our sales office in the United Kingdom. We typically design our hardware products, though we do sometimes use another company's design if it meets our requirements. Electronic assembly and testing of our products in accordance with our specifications is typically done in China. We perform most of the packaging and distribution effort at our production and warehouse facility in Boston, Massachusetts, which also engages in firmware programming and in testing.

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

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

Over the past several years our net sales have declined. In response to the declining sales volume, we have cut costs by reducing staffing and some overhead costs. On December 31, 2002, our total headcount of full-time employees, including temporary workers, was 185, which was reduced to 154 at year-end 2004. On September 30, 2005, our full-time employee headcount was 125.

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

In the first nine months of 2005 our net sales were down 20.7% over the same nine-month period in the prior year. The main reason for the decrease was the decline in dial-up modem sales, more than offsetting a growth in DSL modem sales. While we have generally experienced growth in our DSL modem sales, these sales are currently concentrated with a small number of customers, and this reduces the predictability of our results. In fact, as described below, one of our larger DSL customers, Granville Technologies Ltd., went into receivership in July 2005, and this is one important reason that our total DSL sales were only up 5% from the third quarter of 2004 to the third quarter of 2005. In Turkey Zoom has had a relatively high share of the small DSL market that is one of the fastest growing in the world in percentage terms; and in the future we will compete to try to maintain or grow our share in what is expected to be a high-growth market. We are also continuing our efforts to expand our DSL customer base and product line, and to enter new markets. Because of our significant customer concentration, however, our net sales and operating income could fluctuate significantly due to changes in political or economic conditions or the loss, reduction of business, or less favorable terms for any of our significant customers.

Zoom’s fourth largest customer in the second quarter of 2005 and sixth largest customer in the first nine months of 2005 was Granville Technologies, Ltd., which was reported in late July 2005 to have gone into “administration,” a U.K. form of receivership. No sales to Granville were recorded in the third quarter of 2005. The administrators have decided to discontinue the company as a going concern and sell the business assets to help satisfy creditors. The Company had a receivable of $.8 million and $.3 million of consigned inventory with Granville Technologies at the time that Granville was placed into “administration.” Because of our assessment of the improbability of the collection of the receivables and the recovery of the inventory at that time, the Company's results of operations for the second quarter of 2005 included a $1.1 million reserve for these receivables and inventory. The expenses associated with these reserves were recorded as a general and administrative expense in the second quarter of 2005. In the third quarter of 2005 the Company recovered the entire $.3 million of consigned inventory from the administrators and confirmed that the VAT portion of the receivable is recoverable from the U.K. government Customs agency, HM Customs. These recoveries resulted in a $.4 million reversal in the third quarter of 2005 of the general and administrative expenses associated with the $1.1 million reserve established in the second quarter of 2005. Additional recoveries are highly unlikely.

Since 1999 we had a minority interest in a privately held software company, InterMute, Inc. In June 2005 InterMute was acquired by Trend Micro Inc., a U.S. subsidiary of Trend Micro Japan. In connection with the acquisition, in June 2005, we received a payment in exchange for our investment of approximately $3.5 million. We recorded a non-operating gain of $3.5 million in our second quarter of 2005 in connection with this sale. We may also receive up to $3.0 million in additional payments in 2006 if certain conditions and performance targets are met. We will not record gains from these additional payments, if any, until and unless they are fully earned.

Our cash and cash equivalents balance at September 30, 2005 was $8.3 million, down from $9.4 million at December 31, 2004. This was due primarily to our operating losses for the nine months and a reduction of accounts payable and accrued expenses, partially offset by the receipt of $3.5 million from the sale of the Company's investment in InterMute.

Critical Accounting Policies and Estimates

The following is a discussion of what we view as our more significant accounting policies and estimates. As described below, management judgments and estimates must be made and used in connection with the preparation of our consolidated financial statements. Where noted, material differences could result in the amount and timing of our net sales, costs, and expense for any period if we made different judgments or used different estimates.

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

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

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

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

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

Our VoIP service revenues to date were recorded as the end-user-customer consumed billable VoIP services. The end-user-customer became a service customer by electing to sign up for the Global Village billable service on the Internet. Zoom recorded revenue either as billable services were consumed or as a monthly flat-fee service was billed.

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

Price Protection Refunds. We have a policy of offering price protection to certain of our retailer and distributor customers for some or all their inventory. Under the price protection policies, when we reduce our prices for a product, the customer receives a credit for the difference between the original purchase price and our reduced price for their unsold inventory of that product. Our estimates for price protection refunds are based on a detailed understanding and tracking by customer and by sales program. Estimated price protection refunds are recorded in the same period as the announcement of a pricing change. Information from customer inventory-on-hand reports or from direct communications with the customers is used to estimate the refund, which is recorded as a reduction of net sales and a reserve against accounts receivable. Reductions in our net sales due to price protection were $.7 million in 2002, $.2 million in 2003, and $.1 million in 2004. In the three and nine months ended September 30, 2005, Zoom's recorded price protection was $.1 million and $.2 million, respectively.

Sales and Marketing Incentives. Many of our retailer customers require sales and marketing support funding, usually set as a percentage of our sales in their stores. The incentives were primarily reported as reductions in our net sales and were $1.7 million in 2002, $1.5 million in 2003, and $1.3 million in 2004. In the three and nine months ended September 30, 2005, Zoom's net sales were reduced by $.2 million and $.9 million, respectively, due to sales and marketing support funding. The declining trend was primarily due to lower retailer sales.

Consumer Mail-In and In-Store Rebates and Store Rebates. Our estimates for consumer mail-in rebates are based on a detailed understanding and tracking by customer and sales program, supported by actual rebate claims processed by the rebate redemption centers plus an accrual for an estimated lag in processing at the redemption centers. Our estimates for store rebates are comprised of actual credit requests from the eligible customers. The estimate for mail-in and store rebates is recorded as a reserve against accounts receivable and a reduction of net sales in the same period that the rebate obligation was triggered. Reductions in our net sales due to the consumer rebates were $1.6 million in 2002, $2.1 million in 2003, and $1.4 million in 2004. In the three and nine months ended September 30, 2005, Zoom's recorded consumer and store rebates were $.2 million and $.9 million respectively. The declining trend was primarily due to lower retailer sales.

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

Accounts Receivable Valuation. We establish accounts receivable reserves equal to the above-discussed net sales adjustments for estimates of product returns, price protection refunds, and consumer and store rebates. These reserves are drawn down as actual credits are issued to the customer's accounts. Other than the $.7 million reserve recorded against the Granville Technologies receivable in the nine months ended September 30, 2005 in connection with the reported administration status of that company, over the past several years our bad-debt write-offs have not been significant. The Granville accounts receivable charge was recorded to general and administrative expense.

Inventory Valuation and Cost of Goods Sold. Inventory is valued on a standard cost basis where the material standards are periodically updated for current material pricing. Reserves for obsolete inventory are established by management based on usability reviews performed each quarter. Our reserves against the inventory of a particular product range from 0% to 100%, based on management's estimate of the probability that the material will not be consumed or that it will be sold below cost. Our valuation process is to compare our cost to the selling prices each quarter, and if the selling price of a product is less than the "if completed" cost of our inventory, we write-down the inventory on a "lower of cost or market" basis. In 2002 and 2003, we recorded charges against inventory of $.7 million and $.3 million respectively as a result of lower of cost or market valuation issues. No lower of cost or market charges against inventory were recorded in 2004 or the nine months ended September 30, 2005. In the third quarter ended September 30, 2005 we recorded increased obsolescence reserves of $.3 million for older models of ADSL modems and VOIP hardware.

Along with the expected loss of receivables from the aforementioned Granville Technologies, Ltd. business failure, we also had $.3 million of consigned inventory at one of Granville's facilities. We believed that recovery of this inventory was uncertain and we recorded an inventory reserve of $.3 million in the second quarter of 2005. We recovered the entire inventory from the Granville administrators and reversed the $.3 million inventory reserve in the third quarter of 2005.

During the last three years we benefited from various component supply arrangements that provided us with free products based on the amount of goods we purchased from the supplier. The favorable impact to our statement of operations was recognized as the products employing the acquired components were sold. A new supply arrangement for 2005, with free products to be earned on purchases, received similar accounting treatment in the quarter and nine months ended September 30, 2005.

Valuation and Impairment of Deferred Tax Assets. As part of the process of preparing our consolidated financial statements we are required to estimate our income tax expense and deferred income tax position. This process involves the estimation of our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations.

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

Results of Operations

Summary. Net sales were $5.3 million for our third quarter ended September 30, 2005, down 25.7% from $7.1 million in the third quarter of 2004. We had a net loss of $1.4 million for the third quarter of 2005, compared to a net loss of $1.0 million in the third quarter of 2004. We had a loss per diluted share of $.15 for the third quarter of 2005 compared to a net loss per diluted share of $.12 for the third quarter of 2004.

Net sales were $18.3 million for the nine months ended September 30, 2005, down 20.7% from $23.0 million in the first nine months of 2004. We had a net loss of $1.3 million for the first nine months of 2005, compared to a net loss of $2.2 million in the first nine months of 2004. We recorded a net loss per diluted share of $.14 for the first nine months of 2005 compared to a net loss per diluted share of $.26 for the first nine months of 2004.

Net Sales. Our net sales for the third quarter of 2005 decreased 25.7% from the third quarter of 2004, primarily due to a 43% decrease in dial-up modem sales partially offset by a 5.4% increase in DSL modem sales. Dial-up modem net sales declined to $2.2 million in the third quarter of 2005 compared to $3.9 million in the third quarter of 2004, primarily due to a decrease of both dial-up modem unit sales, primarily resulting from the continued decline of the dial-up modem after-market, and to a lesser extent, lower dial-up modem average selling prices. DSL modem net sales were $2.6 million in the third quarter of 2005 compared to $2.5 million in the third quarter of 2004. The modest growth was primarily due to numerous new and repeat customer sales, at retailers, distributors, value-added resellers, and internet service providers worldwide, partially offset by by a slight decrease in DSL modem sales to our large distributor customer in Turkey.

Net sales in our other product sales categories, which include cable modems, cameras, ISDN modems, telephone dialers, and wireless networking equipment declined $.4 million, or 42% from $.8 million from the third quarter of 2004 to $.4 million in the third quarter of 2005, primarily due to decreased sales emphasis on many of these products. During the third quarter of 2005 we did not realize any significant revenue from our Global Village phone services.

Our net sales for the first nine months of 2005 decreased 20.7% from the first nine months of 2004, primarily due to a 38% decrease in dial-up modem sales, partially offset by a 16% increase in DSL modem sales. Dial-up modem net sales declined to $8.1 million in the first nine months of 2005 compared to $13.0 million in the first nine months of 2004, primarily due to a decrease of both dial-up modem unit sales, primarily resulting from the continued decline of the dial-up modem after-market, and to a lesser extent, lower dial-up modem average selling prices. DSL modem net sales increased to $8.9 million in the first nine months of 2005 compared to $7.6 million in the first nine months of 2004, primarily due to increased unit net sales of DSL modems in Turkey and other countries. Net sales in our other product sales categories, which include cable modems, cameras, ISDN modems, telephone dialers, and wireless networking equipment declined $1.1 million, or 46% from $2.4 million for the first nine months of 2004 to $1.3 million in the first nine months of 2005, primarily due to decreased sales emphasis on many of these products.

Our net sales in North America were $2.7 million in the third quarter of 2005, a decrease from $3.3 million in the third quarter of 2004. Our net sales in Turkey were $1.0 million in the third quarter of 2005, a decrease from $1.1 million in the third quarter of 2004. Our net sales in the U.K. were $1.1 million in the third quarter of 2005, a decrease from $1.8 million in the third quarter of 2004. Our net sales other than North America, Turkey and the U.K. were $.6 million in the third quarter of 2005, a decrease from $.9 million in the third quarter of 2004. We attribute the declining sales in Turkey in part to customer's overstock of inventory. However, we cannot assure that our sales to Turkey will recover. The changes in the other market areas reflect our declining sales of dial-up modems, particularly in North America and the U.K.

Our net sales in North America were $8.7 million in the first nine months of 2005, a decline from $10.9 million in the first nine months of 2004. Our net sales in Turkey were $3.1 million in the first nine months of 2005 and $3.2 million in the first nine months of 2004. Our net sales in the U.K. were $4.1 million in the first nine months of 2005, a decline from $6.2 million in the first nine months of 2004. The sales decline in North America and the U.K. reflect our declining sales of dial-up modems. Our net sales other than North America, Turkey and the U.K. were $2.4 million in the first nine months of 2005 and $2.7 million in the first nine months of 2004, also reflective of our declining sales of dial-up modems. In the third quarter ended September 30, 2005 the Company’s largest customer, accounting for 18% of total net sales, was a large distributor in Turkey. In the first nine months ended September 30, 2005 the Company's two largest customers were our Turkish Distributor and a large North American retailer, accounting for 17% and 14% of total net sales, respectively. Because of our significant customer concentration, our net sales and operating income could fluctuate significantly due to changes in political or economic conditions or the loss, reduction of business, or less favorable terms for any of our significant customers. For example, we expect our ongoing net sales to be adversely affected by the administration status of Granville Technologies in July 2005. Granville Technologies accounted for 0% and 6% of our net sales in the third quarter and first nine months of 2005, respectively, compared to 6% and 5% of our net sales in the third quarter and first nine months of 2004, respectively.

Gross Profit. Our total gross profit was $.5 million or 9.8% of net sales in the third quarter of 2005, down from $1.5 million or 21% of net sales in the third quarter of 2004. The reduced gross profit resulted primarily from the reduction in sales and from lower gross margin on those sales. Gross margin was lower due to obsolescence charges for slow-moving models, the negative effect of manufacturing overhead spread over lower sales, and the shift of Zoom’s product mix away from dial-up modems, Zoom’s highest margin product category.

Our total gross profit was $3.4 million in the first nine months of 2005, a decline from $6.1 million in the first nine months of 2004. Our gross margin percent of net sales decreased to 18.8% in the first nine months of 2005 from 26.3% in the first nine months of 2004. Gross margins were lower primarily because of the negative effect of manufacturing overhead spread over lower sales and the shift of Zoom’s product mix away from dial-up modems, Zoom’s highest margin product category.

Selling Expense. Selling expense decreased $.1 million to $1.0 million or 18.4% of net sales in the third quarter of 2005 from $1.1 million or 15.6% of net sales in the third quarter of 2004. Selling expense was lower primarily due to

Zoom's moving most European customer support from the U.K. to the U.S., which resulted in a net reduction in headcount.

Selling expense decreased $.3 million to $3.2 million or 17.4% of net sales in the first nine months of 2005 from $3.5 million or 15.3% of net sales in the first nine months of 2004. Selling expense was lower primarily because of lower personnel and related costs resulting from employee headcount reductions, including the impact of moving most European customer support from the U.K. to the U.S., partially offset by higher distribution and outbound product delivery expense.

General and Administrative Expense. General and administrative expense decreased $.5 million to $.3 million, or 5.9% of net sales in the third quarter of 2005 from $.8 million, or 10.9% of net sales in the third quarter of 2004. The decrease of $.5 million was primarily due to the reversal of $.4 million of the $1.1 million reserve established last quarter when a customer in the U.K., Granville Technology Group, went into “administration,” a U.K. form of receivership. The $.4 million favorable adjustment was primarily due to the successful recovery of $.3 million of the consigned inventories and the confirmation that $.1 million of the Value Added Tax (VAT) we paid on certain uncollectable sales was refundable by HM Customs, the U.K. government VAT agency.

General and administrative expense increased $.1 million to $2.9 million, or 15.7% of net sales in the first nine months of 2005 from $2.8 million, or 12.1% of net sales, in the first nine months of 2004. The increase of $.1 million was primarily due to a $.7 million charge to general and administrative expense for the reserve against receivables for Granville Technologies, the U.K customer now in administration, partially offset by lower legal and accounting expense due to acquisition-related expense in the second quarter of 2004, lower personnel costs, lower employee health expense, and other expense reductions.

Research and Development Expense. Research and development expense was $.7 million or 12.5% of net sales in the third quarter of 2005 and $.7 million or 10.1% of net sales in the third quarter of 2004. These costs reflected increases primarily in licenses and approvals and outside services that were offset by decreases primarily in employee compensation and depreciation expense.

Research and development expense was $2.1 million or 11.5% of net sales in the first nine months of 2005 and $2.1 million or 9.0% of net sales in the first nine months of 2004. These costs reflected increases primarily in outside services and licenses and approvals that were offset by decreases primarily in depreciation and employee compensation. Development and support continues on all of our major product lines with particular emphasis on VoIP hardware, the Global Village phone services, and DSL modems.

Other Income (Expense), Net. Other income, net was $.1 million in the third quarter of 2005, compared to $.1 million in the third quarter of 2004.

Other income, net was $3.5 million in the first nine months of 2005, compared to $.1 million in the first nine months of 2004. The reason for the $3.3 million increase in other income, net was the $3.5 million gain from the InterMute transaction, offset slightly by a decline of rental income received from leasing excess space at our headquarters facility.

Income Tax Expense (Benefit). We did not record any income tax expense in the third quarter or the nine months ended September 30, 2005 or September 30, 2004. The net deferred tax asset balance at September 30, 2005 is zero. This accounting treatment is described in further detail under the caption **Critical Accounting Policies and Estimates** above.

Liquidity and Capital Resources

On September 30, 2005 we had working capital of $9.2 million, including $8.3 million in cash and cash equivalents. In the first nine months of 2005 operating activities used $4.9 million in cash. Our net loss in the first nine months of 2005 was $1.3 million. Adjustments to reconcile net loss to net cash used in operating activities included a $3.5

million gain on the sale of our investment in InterMute and depreciation of $.2 million. Net cash used in operating activities included an increase of inventory of $.1 million and a reduction of accounts payable and accrued expenses of $1.0 million. Net cash provided by operating activities included a $.4 million decrease in accounts receivable and a decrease of prepaid expense of $.3 million. The $.4 million decrease of accounts receivable was not a source of cash as it was primarily the result of the $.7 million reserve recorded against receivables for Granville Technologies, the U.K customer now in administration status.

In the first nine months of 2005 investing activities provided $3.5 million of cash, due to the receipt of a $3.5 million cash payment in exchange for our investment in InterMute. In the first nine months of 2005 financing activities provided $.3 million, primarily from $.4 million from the exercise of employee stock options, partially offset by $.2 million in cash for monthly principal payments on our $6.0 million mortgage, with a current outstanding balance of $4.9 million.

Zoom may also receive additional payments of up to approximately $3 million in 2006 in connection with the InterMute sale if certain conditions and performance targets are met.

Our mortgage is a 5-year balloon mortgage, payable in full in January 2006 that is amortized on a 20-year basis. The interest rate is adjusted annually in January of each year based on the Federal Home Loan Bank rate plus 2.5% per annum. In 2004 the interest rate was 3.99%. As of January 10, 2005 the rate of interest changed to 5.80%. We renegotiated the rate to 5.0% effective February 10, 2005. As of September 30, 2005 $4.9 million was outstanding on this loan, which will be due and payable on January 10, 2006. Because the mortgage is due within twelve months, the mortgage loan is reflected as a current liability. We believe that we have sufficient resources to repay the mortgage on or before the maturity date in January 2006. We also believe that we should be able to sell our owned buildings on favorable terms if we require additional liquidity. If we were to sell the portion of our owned buildings that includes our principal headquarters, we believe we would be able to lease back a portion of the sold property or otherwise find suitable space for our principal headquarters on satisfactory terms.

On March 16, 2005 we entered into a Loan and Security Agreement with Silicon Valley Bank that provides for a revolving line of credit of up to $2 million. The revolving line of credit can be used to (i) borrow under revolving loans for working capital and general corporate purposes, (ii) issue letters of credit, (iii) enter into foreign exchange forward contracts, and (iv) support certain cash management services. Revolving loans bear interest at a floating rate of interest equal to Silicon Valley Bank's prime rate plus 0.5%. The rate at September 30, 2005 was 7.25%. This interest rate will be increased to Silicon Valley Bank's prime rate plus 1.0% if we record two consecutive quarters of combined losses. The revolving line of credit terminates and all outstanding obligations under the Loan and Security agreement become due on March 15, 2006.

The revolving loans under the Loan and Security Agreement are secured by a first priority lien on substantially all of our assets, excluding intellectual property and real estate. We guaranteed the obligations of Zoom Telephonics under the revolving line of credit and pledged all of the stock of Zoom Telephonics in support of our guarantee. The Loan and Security Agreement requires that we maintain a minimum adjusted quick ratio and a minimum net worth. In addition, we are required to obtain Silicon Valley Bank's prior written consent to among other things, dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends, or repurchase stock. This consent may not be unreasonably withheld.

The Loan and Security Agreement contains events of default that include among other things, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross default to certain other indebtedness, bankruptcy and insolvency events, change of control and material judgments. Upon occurrence of an event of default, Silicon Valley Bank is entitled to, among other things, accelerate all of our obligations under the Loan and Security Agreement and sell our assets to satisfy our obligations under the Loan and Security Agreement. As of September 30, 2005 our availability under the revolving line of credit is $1.7 million. We have no outstanding borrowings and are in compliance with the covenants under the revolving line of credit as of September 30, 2005.

To conserve cash and manage our liquidity, we continue to implement cost cutting initiatives including the reduction of employee headcount and overhead costs. The employee headcount was 154 at December 31, 2004 and has been reduced to 125 at September 30, 2005. We plan to continue to assess our cost structure as it relates to our revenues and cash position, and we may make further reductions if the actions are deemed necessary.

Management believes we have sufficient resources to fund our normal operations over the next 12 months, through September 30, 2006. However, if we are unable to increase our revenues, reduce or otherwise adequately control our expenses, or raise capital, our longer-term ability to continue as a going concern and achieve our intended business objectives could be adversely affected. Moreover, our liquidity could be significantly impaired if we repay our mortgage with our current sources of cash on or before the maturity date in January 2006 and we are not able to refinance all or a significant portion of the mortgage and we are not otherwise able to sell our owned buildings for adequate consideration. See "Risk Factors" below, for further information with respect to events and uncertainties that could harm our business, operating results, and financial condition.

Commitments

During the nine months ended September 30, 2005, there were no material changes to our capital commitments and contractual obligations from those disclosed in the Form 10-K for the year ended December 31, 2004, other than the revolving line of credit we obtained in March 2005, which is described in Note 2 of the Notes to Consolidated Financial Statements.

“Safe Harbor” Statement under the Private Securities Litigation Reform Act of 1995.

Some of the statements contained in this report are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements involve known and unknown risks, uncertainties and other factors which may cause our or our industry’s actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Forward-looking statements include, but are not limited to statements regarding: Zoom’s plans, expectations and intentions, including statements relating to Zoom’s prospects and plans relating to sales of our dial-up, cable and DSL modems, wireless and VoIP products; the expected effects resulting from the failure of Granville Technologies; the anticipated development and timing of new product introductions; the decline of the dial-up modem market; the level of demand for Zoom’s products; Zoom’s ability to obtain debt or equity financing; Zoom’s sufficiency of capital resources; Zoom’s ability to obtain debt or equity financing; Zoom’s sufficiency of capital resources; Zoom’s ability to repay its mortgage with current cash resources and/or refinancing all or a portion of the mortgage; Zoom’s ability to sell its owned real property if it chooses to do so and Zoom’s ability to lease suitable space for its principal headquarters if it chooses to sell its owned real property; the anticipated impact of changes in the accounting treatment of stock options; and Zoom’s financial condition or results of operations.

In some cases, you can identify forward-looking statements by terms such as “may,” “will,” “should,” “could,” “wou “expects,” “plans,” “anticipates,” “believes,” “estimates,” “projects,” “predicts,” “potential” and similar expressio identify forward-looking statements. These statements are only predictions and involve known and unknown risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. Given these uncertainties you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this report. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained in this report to reflect any change in our expectations or any change in events, conditions or circumstances on which any of our forward-looking statements are based. Factors that could cause or contribute to differences in our future financial results include those discussed in the risk factors set forth below as well as those discussed elsewhere in this report and in our filings with the Securities and Exchange Commission. We qualify all of our forward-looking statements by these cautionary statements.

RISK FACTORS

This report contains forward-looking statements that involve risks and uncertainties, such as statements of our objectives, expectations and intentions. The cautionary statements made in this report should be read as applicable to all forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this report.

We may continue to incur net losses if we are unable to increase sales of our broadband modems.

Our net sales have been declining primarily due to the decline in the dial-up modem market, continuing decreases in the average selling prices of dial-up modems, and the trend toward faster connection speeds and broadband access products. Despite numerous cost reductions over the last few years, we have continued to incur significant net losses primarily due to our continuous decline in net sales from dial-up modems. We believe that the future of our business is largely dependent on the success of our broadband modems and other products. Although we believe that we have sufficient resources to fund our planned operations over the next year, if we fail to increase our net sales of our broadband modems and other products, our longer-term ability to stay in business and to achieve our intended business objectives could be adversely effected. Our continuing losses could also adversely affect our ability to fund the growth of our business should our strategies prove successful.

Our liquidity may be significantly impaired if we repay our mortgage prior to the maturity of our mortgage in January 2006 with our current sources of cash and are not able to refinance all or a significant portion of our mortgage or otherwise sell our owned buildings for adequate consideration.

Our mortgage loan on the two buildings constituting our headquarters facility, of which $4.9 million was outstanding on September 30, 2005, will be due and payable on January 10, 2006. We believe that we have sufficient resources to repay the mortgage through current sources of cash and/or by refinancing all or a portion of the mortgage on or before the maturity date in 2006. We also believe that, in connection with or following the repayment of the mortgage, we will be able to sell our owned building on favorable terms if we require additional liquidity. Our liquidity could be significantly impaired if we repay our mortgage with our current sources of cash on or before the maturity date in January 2006 and we are not able to refinance all or a significant portion of the mortgage or we are not otherwise able to sell our owned buildings for adequate consideration.

If we were to sell the portion of our owned buildings that includes our principal headquarters, we believe we would be able to lease back a portion of the sold property or otherwise find suitable space for our principal headquarters on satisfactory terms. If we are unable to lease back a portion of the sold property or otherwise find suitable space for our principal headquarters on satisfactory terms, our business may be harmed.

To stay in business we may require future additional funding which we may be unable to obtain on favorable terms, if at all.

In addition to obtaining funds to refinance or repay our mortgage, over the next twelve months we may require additional financing for our operations either to fund losses beyond those we anticipate or to fund growth in our inventory and accounts receivable. Additional financing may not be available to us on a timely basis if at all, or on terms acceptable to us. If we fail to obtain acceptable additional financing when needed, we may be required to further reduce planned expenditures or forego business opportunities, which could reduce our net sales, increase our losses, and harm our business. Moreover, additional equity financing could dilute the per share value of our common stock held by current shareholders, while additional debt financing could restrict our ability to make capital expenditures or incur additional indebtedness, all of which would impede our ability to succeed.

Our net sales and operating results have been adversely affected because of a decline in average selling prices for our dial-up modems and because of the decline in the retail market for dial-up modems.

The dial-up modem industry has been characterized by declining average selling prices and a declining retail market. The decline in average selling prices is due to a number of factors, including technological change, lower component costs, and competition. The decline in the size of the retail market for dial-up modems is primarily due to the inclusion of dial-up modems as a standard feature contained in new PCs, and the advent of broadband products. Due to these factors and others, one of our significant retail customers has notified us that they want to purchase on a consignment basis for their dial-up modem category. That customer has also indicated that they plan to reduce the number of brands of dial-up modems they sell, and that they cannot assure that they will continue to sell our products. Less advantageous terms of sales, decreasing average selling prices and reduced demand for our dial-up modems have resulted and may in the future result in decreased net sales for dial-up modems. If we fail to replace declining revenue from the sales of dial-up modems with the sales of our other products, including our broadband modems, our business and results of operation will be harmed.

Our reliance on a limited number of customers for a large portion of our revenues could materially harm our business and prospects.

Relatively few customers have accounted for a substantial portion of our net sales. In 2004, our net sales to each of three companies constituted over 10% of our net sales and together these three customers accounted for 35% of our total net sales. In the third quarter of 2005, our net sales to our top three customers accounted for 38% of our total net sales, with our sales to one customer accounting for 18% of our total net sales. Our customers generally do not enter into long-term agreements obligating them to purchase our products. We may not continue to receive significant revenues from any of these or from other large customers. Because of our significant customer concentration, our net sales and operating income could fluctuate significantly due to changes in political or economic conditions or the loss, reduction of business, or less favorable terms for any of our significant customers. For example, we expect our ongoing net sales to be adversely affected by the failure of Granville Technologies in July 2005. Granville Technologies accounted for 0% and 6% of our net sales in the third quarter and first nine months of 2005, respectively compared to 6% and 5% of our net sales in the third quarter and first nine months of 2004. A reduction or delay in orders from any of our significant customers, or a delay or default in payment by any significant customer could materially harm our business and prospects.

Our international operations are subject to a number of risks inherent in international activities.

Our sales outside of North America continue to represent an increasingly significant portion of our sales. Sales outside of North America have increased from 38% of net sales in 2001 to approximately 55% of our net sales in 2004, including 27% in the UK and 16% in Turkey. In the third quarter of 2005, our sales outside of North America accounted for 50% of our total net sales, including 18% in Turkey and 21% in the U.K. Currently our operations are significantly dependent on our international operations, particularly sales of our DSL modems, and may be materially and adversely affected by many factors including:

- international regulatory and communications requirements and policy changes;
- favoritism toward local suppliers;
- delays in the rollout of broadband services by cable and DSL service providers;
- local language and technical support requirements;
- difficulties in inventory management, accounts receivable collection and the management of distributors or representatives;
- difficulties in staffing and managing foreign operations;
- political and economic changes and disruptions;
- governmental currency controls;
- shipping costs;
- currency exchange rate fluctuations; and
- tariff regulations

We anticipate that our international sales will continue to account for a significant percentage of our net sales. If foreign markets for our current and future products develop more slowly than currently expected, our sales and our future results of operations may be harmed.

We believe that our future success will depend in large part on our ability to more successfully penetrate the broadband modem markets, which have been challenging markets, with significant barriers to entry.

With the shrinking of the dial-up modem market, we believe that our future success will depend in large part on our ability to more successfully penetrate the broadband modem markets, DSL and cable, and the VoIP market. These markets have been challenging markets, with significant barriers to entry that have adversely affected our sales to these markets. Although some cable and DSL modems are sold at retail, the high volume purchasers of these modems are concentrated in a relatively few large cable, telecommunications, and Internet service providers which offer broadband modem services to their customers. These customers, particularly cable services providers, also have extensive and varied approval processes for modems to be approved for use on their network. These approvals are expensive, time consuming, and continue to evolve. Successfully penetrating the broadband modem market therefore presents a number of challenges including:

- the current limited retail market for broadband modems;

- the relatively small number of cable, telecommunications and Internet service provider customers that make up a substantial part of the market for broadband modems;

- the significant bargaining power of these large volume purchasers;
- the time consuming, expensive, uncertain and varied approval process of the various cable service providers; and
- the strong relationships with cable service providers enjoyed by incumbent cable equipment providers like Motorola and Scientific Atlanta.

Our sales of broadband products have been adversely affected by all of these factors. Sales of our broadband products in European countries have fluctuated and may continue to fluctuate due to approvals and delays in the deployment by service providers of cable and DSL service in these countries. We cannot assure that we will be able to successfully penetrate these markets.

Our failure to meet changing customer requirements and emerging industry standards would adversely impact our ability to sell our products and services.

The market for PC communications products and high-speed broadband access products and services is characterized by aggressive pricing practices, continually changing customer demand patterns, rapid technological advances, emerging industry standards and short product life cycles. Some of our product and service developments and enhancements have taken longer than planned and have delayed the availability of our products and services, which adversely affected our sales and profitability in the past. Any significant delays in the future may adversely impact our ability to sell our products and services, and our results of operations and financial condition may be adversely affected. Our future success will depend in large part upon our ability to:

- identify and respond to emerging technological trends and industry standards in the market;
- develop and maintain competitive products that meet changing customer demands;
- enhance our products by adding innovative features that differentiate our products from those of our competitors;
- bring products to market on a timely basis;
- introduce products that have competitive prices;
- manage our product transitions, inventory levels and manufacturing processes efficiently;
- respond effectively to new technological changes or new product announcements by others; and
- meet changing industry standards.

Our product cycles tend to be short, and we may incur significant non-recoverable expenses or devote significant resources to sales that do not occur when anticipated. Therefore, the resources we devote to product development, sales and marketing may not generate material net sales for us. In addition, short product cycles have resulted in and may in the future result in excess and obsolete inventory, which has had and may in the future have an adverse affect on our results of operations. In an effort to develop innovative products and technology, we have incurred and may in the future incur substantial development, sales, marketing, and inventory costs. If we are unable to recover these costs, our financial condition and operating results could be adversely affected. In addition, if we sell our products at reduced prices in anticipation of cost reductions and we still have higher cost products in inventory, our business would be harmed and our results of operations and financial condition would be adversely affected.

We have been selling our VoIP service for a limited period and there is no guarantee that this service will gain broad market acceptance.

We have only recently introduced our VoIP service. Given our limited history with offering this service, there are many difficulties that we may encounter, including technical hurdles, multiple and changing regulations and industry standards, and other problems that we may not anticipate. To date, we have not generated significant revenue from the sale of our VoIP products and services, and there is no guarantee that we will be successful in generating significant revenues.

We may be subject to product returns resulting from defects, or from overstocking of our products. Product returns could result in the failure to attain market acceptance of our products, which would harm our business.

If our products contain undetected defects, errors, or failures, we could face:

- delays in the development of our products;
- numerous product returns; and
- other losses to us or to our customers or end users.

Any of these occurrences could also result in the loss of or delay in market acceptance of our products, either of which would reduce our sales and harm our business. We are also exposed to the risk of product returns from our customers as a result of contractual stock rotation privileges and our practice of assisting some of our customers in balancing their inventories. Overstocking has in the past led and may in the future lead to higher than normal returns.

Our failure to effectively manage our inventory levels could materially and adversely affect our liquidity and harm our business.

Due to rapid technological change and changing markets we are required to manage our inventory levels carefully to both meet customer expectations regarding delivery times and to limit our excess inventory exposure. In the second and third quarters of 2005 our gross inventory levels of our DSL products continued to increase due to the rescheduling of customer orders in Turkey and resulting decreased sales. An inventory obsolescence provision of $.3 million was recorded in the third quarter of 2005 for older models of DSL modems and VOIP hardware. In the event this trend continues or we otherwise fail to effectively manage our inventory our liquidity may be adversely affected and we may face increased risk of inventory obsolescence, a decline in market value of the inventory, or losses from theft, fire, or other casualty.

We may be unable to produce sufficient quantities of our products because we depend on third party manufacturers. If these third party manufacturers fail to produce quality products in a timely manner, our ability to fulfill our customer orders would be adversely impacted.

We use contract manufacturers to partially manufacture our products. We use these third party manufacturers to help ensure low costs, rapid market entry, and reliability. Any manufacturing disruption could impair our ability to fulfill orders, and failure to fulfill orders would adversely affect our sales. Although we currently use four contract manufacturers for the bulk of our purchases, in some cases a given product is only provided by one of these companies. The loss of the services of any of our significant third party manufacturers or a material adverse change in the business of or our relationships with any of these manufacturers could harm our business. Since third parties manufacture our products and we expect this to continue in the future, our success will depend, in part, on the ability of third parties to manufacture our products cost effectively and in sufficient quantities to meet our customer demand.

We are subject to the following risks because of our reliance on third party manufacturers:

- reduced management and control of component purchases;
- reduced control over delivery schedules, quality assurance and manufacturing yields;
- lack of adequate capacity during periods of excess demand;
- limited warranties on products supplied to us;

- potential increases in prices;
- interruption of supplies from assemblers as a result of a fire, natural calamity, strike or other significant event; and
- misappropriation of our intellectual property.

We may be unable to produce sufficient quantities of our products because we obtain key components from, and depend on, sole or limited source suppliers.

We obtain certain key parts, components, and equipment from sole or limited sources of supply. For example, we purchase most of our dial-up and broadband modem chipsets from Conexant Systems, Agere Systems, and Analog Devices. Integrated circuit product areas covered by at least one of these companies include dial-up modems, DSL modems, cable modems, networking, routers, and gateways. In the past we have experienced delays in receiving shipments of modem chipsets from our sole source suppliers. We may experience similar delays in the future. In addition, some products may have other components that are available from only one source. We believe the market for chipsets is currently experiencing shortages and there are increased lead times for some chipsets. If we are unable to obtain a sufficient supply of components from our current sources, we would experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage relationships with our customers and our customers could decide to purchase products from our competitors. Inability to meet our customers' demand or a decision by one or more of our customers to purchase products from our competitors could harm our operating results.

The market for high-speed communications products and services has many competing technologies and, as a result, the demand for our products and services is uncertain.

The market for high-speed communications products and services has a number of competing technologies. For instance, Internet access can be achieved by:

- using a standard telephone line and appropriate service for dial-up modems;
- ISDN modems, or DSL modems, possibly in combination;
- using a cable modem with a cable TV line and cable modem service;
- using a router and some type of modem to service the computers connected to a local area network; or
- other approaches, including wireless links to the Internet.

Although we currently sell products that include these technologies, the market for high-speed communication products and services is fragmented and evolving. The introduction of new products by competitors, market acceptance of products based on new or alternative technologies, or the emergence of new industry standards could render and have in the past rendered our products less competitive or obsolete. If any of these events occur, we may be unable to sustain or grow our business. Industry analysts believe that the market for our dial-up modems will continue to decline. If we are unable to increase demand for and sales of our broadband modems, we may be unable to sustain or grow our business.

We face significant competition, which could result in decreased demand for our products or services.

We may be unable to compete successfully. A number of companies have developed, or are expected to develop, products that compete or will compete with our products. Furthermore, many of our current and potential competitors have significantly greater resources than we do. Intense competition, rapid technological change and evolving industry standards could result in less favorable selling terms to our customers, decrease demand for our products or make our products obsolete.

Changes in the accounting treatment of stock options may adversely affect our results of operations.

In December 2004 the FASB issued SFAS 123R, which is a revision of SFAS 123. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and does not permit pro forma disclosure as an alternative to financial statement recognition. SFAS 123R will be effective for us beginning in the first quarter of 2006. The adoption of the SFAS 123R fair value method may have a significant adverse impact on our reported results of operations because the stock-based compensation expense will be charged directly against our reported earnings. The impact of our adoption of SFAS 123R cannot be predicted at this time because that will depend on the future fair values and number of share-based payments granted in the future.

On October 26, 2005 the Company accelerated the vesting of all stock options previously awarded to employees and officers that were scheduled to vest on or before May 6, 2006. These stock options had exercise prices in excess of $1.76, the closing price of the Company's Common Stock on October 26, 2005, the effective date of the acceleration. As a result of the acceleration, stock options to purchase 317,500 shares became exercisable immediately. These accelerated stock options represent 33% of the total outstanding unvested stock options and approximately 25% of the total outstanding stock options. The weighted average exercise price of the accelerated stock options is $2.44 per share.

The primary purpose of the acceleration of the vesting of these stock options is to reduce the Company's future reported compensation expense upon the planned adoption of Statement of Financial Accounting Standards (SFAS) No. 123R, "Share Based Payment" effective January 1, 2006. As a result of the acceleration, the Company expects to reduce the stock option expense, a non-cash charge, it otherwise would be required to record by approximately $130,000 total for the first two quarters of 2006.

Changes in existing regulations or adoption of new regulations affecting the Internet could increase the cost of our products or otherwise affect our ability to offer our products and services over the Internet.

Congress has adopted legislation that regulates certain aspects of the Internet, including online content, user privacy, taxation, liability for third-party activities and jurisdiction. In addition, a number of initiatives pending in Congress and state legislatures would prohibit or restrict advertising or sale of certain products and services on the Internet, which may have the effect of raising the cost of doing business on the Internet generally. Federal, state, local and foreign governmental organizations are considering other legislative and regulatory proposals that would regulate the Internet. We cannot predict whether new taxes will be imposed on our services, and depending on the type of taxes imposed, whether and how our services would be affected thereafter. Increased regulation of the Internet may decrease its growth and hinder technological development, which may negatively impact the cost of doing business via the Internet or otherwise harm our business.

New regulations to reduce the use of hazardous materials in products scheduled to be implemented in 2006 could increase our manufacturing costs and harm our business.

The European Union and the US have announced plans to reduce the use of hazardous materials, such as lead, in electronic equipment. The implementation of these new requirements, currently scheduled to begin in Europe in 2006 and the US in 2007, would require us and other electronics companies to change or discontinue many products. We believe that our transition process to comply with these new requirements is difficult, and will typically increase our product costs by from zero to $.50 per unit, depending on the product. In addition, we may incur additional costs involved with the disposal of inventory or with returned products that do not meet the new requirements, which could further harm our business.

Changes in current or future laws or governmental regulations and industry standards that negatively impact our products, services and technologies could harm our business.

The jurisdiction of the Federal Communications Commission, or the FCC, extends to the entire United States communications industry including our customers and their products and services that incorporate our products. Our products are also required to meet the regulatory requirements of other countries throughout the world where our products and services are sold. Obtaining government regulatory approvals is time-consuming and very costly. In the past, we have encountered delays in the introduction of our products, such as our cable modems, as a result of government certifications. We may face further delays if we are unable to comply with governmental regulations. Delays caused by the time it takes to comply with regulatory requirements may result in cancellations or postponements of product orders or purchases by our customers, which would harm our business.

In addition to reliability and quality standards, the market acceptance of our VoIP products and services is dependent upon the adoption of industry standards so that products from multiple manufacturers are able to communicate with each other. Standards are continuously being modified and replaced. As standards evolve, we may be required to modify our existing products or develop and support new versions of our products. The failure of our products to comply, or delays in compliance, with various existing and evolving industry standards could delay or interrupt volume production of our products, which could harm our business.

Future legislation or regulation of Internet telephony could restrict our VoIP business, prevent us from offering service, or increase our cost of doing business.

VoIP services currently have different regulations from traditional telephony in most countries including the US. Regulatory bodies including the FCC and regulators in various states and countries may impose surcharges, taxes or new regulations upon providers of Internet telephony. These surcharges could include access charges payable to local exchange carriers to carry and terminate traffic, contributions to the Universal Service Fund (USF) or other charges. The imposition of any such additional fees, charges, taxes and regulations on IP communications services could materially increase our costs and may limit or eliminate our competitive pricing. Regulations requiring compliance with the Communications Assistance for Law Enforcement Act (CALEA) or provision of the same type of 911 services as required for traditional telecommunications providers could also place a significant financial burden on us depending on the technical changes required to accommodate the requirements. In May 2005 the FCC issued an order requiring interconnected VoIP providers to deliver 911 calls to the customer's local emergency operator as a standard feature of the service. We believe our VoIP products are capable of meeting the FCC requirements. In the event our VoIP products do not meet the FCC requirements, we may need to modify our products, which could increase our costs.

In many countries outside the US in which we operate or our services are sold, we cannot be certain that we will be able to comply with existing or future requirements, or that we will be able to continue to be in compliance with any such requirements. Our failure to comply with these requirements could materially adversely affect our ability to continue to offer our VoIP services in these jurisdictions.

Fluctuations in the foreign currency exchange rates in relation to the U.S. Dollar could have a material adverse effect on our operating results.

Changes in currency exchange rates that increase the relative value of the U.S. dollar may make it more difficult for us to compete with foreign manufacturers on price, may reduce our foreign currency denominated sales when expressed in dollars, or may otherwise have a material adverse effect on our sales and operating results. A significant increase in our foreign currency denominated sales would increase our risk associated with foreign currency fluctuations. A weakness in the U.S. dollar relative to various Asian currencies including the Chinese renminbi could increase our product costs.

Our future success will depend on the continued services of our executive officers and key product development personnel.

The loss of any of our executive officers or key product development personnel, the inability to attract or retain qualified personnel in the future, or delays in hiring skilled personnel could harm our business. Competition for skilled personnel is significant. We may be unable to attract and retain all the personnel necessary for the development of our business. In addition, the loss of Frank B. Manning, our president and chief executive officer, or Peter Kramer, our executive vice president, some other member of the senior management team, a key engineer or salesperson, or other key contributors, could harm our relations with our customers, our ability to respond to technological change, and our business.

We may have difficulty protecting our intellectual property.

Our ability to compete is heavily affected by our ability to protect our intellectual property. We rely primarily on trade secret laws, confidentiality procedures, patents, copyrights, trademarks, and licensing arrangements to protect our intellectual property. The steps we take to protect our technology may be inadequate. Existing trade secret, trademark and copyright laws offer only limited protection. Our patents could be invalidated or circumvented. We have more intellectual property assets in some countries than we do in others. In addition, the laws of some foreign countries in which our products are or may be developed, manufactured or sold may not protect our products or intellectual property rights to the same extent as do the laws of the United States. This may make the possibility of piracy of our technology and products more likely. We cannot assure that the steps that we have taken to protect our intellectual property will be adequate to prevent misappropriation of our technology.

We could infringe the intellectual property rights of others.

Particular aspects of our technology could be found to infringe on the intellectual property rights or patents of others. Other companies may hold or obtain patents on inventions or may otherwise claim proprietary rights to technology necessary to our business. We cannot predict the extent to which we may be required to seek licenses. We cannot assure that the terms of any licenses we may be required to seek will be reasonable. We are often indemnified by our suppliers relative to certain intellectual property rights; but these indemnifications do not cover all possible suits, and there is no guarantee that a relevant indemnification will be honored by the indemnifying.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We own financial instruments that are sensitive to market risks as part of our investment portfolio. The investment portfolio is used to preserve our capital until it is required to fund operations, including our research and development activities. None of these market-risk sensitive instruments are held for trading purposes. We do not own derivative financial instruments in our investment portfolio. The investment portfolio contains instruments that are subject to the risk of a decline in interest rates. Investment Rate Risk - Our investment portfolio consists entirely of money market funds, which are subject to interest rate risk. Due to the short duration and conservative nature of these instruments, we do not believe that it has a material exposure to interest rate risk.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of September 30, 2005 we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic SEC filings within the required time period.

There have been no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 5. OTHER INFORMATION

On October 26, 2005 the Company accelerated the vesting of all stock options previously awarded to employees and officers that were scheduled to vest on or before May 6, 2006 . These stock options had exercise prices in excess of $1.76, the closing price of the Company’s Common Stock on October 26, 2005, the effective date of the acceleration. As a result of the acceleration, stock options to purchase 317,500 shares became exercisable immediately. These accelerated stock options represent 33% of the total outstanding unvested stock options and approximately 25% of the total outstanding stock options. The weighted average exercise price of the accelerated stock options is $2.44 per share.

The primary purpose of the acceleration of the vesting of these stock options is to reduce the Company's future reported compensation expense upon the planned adoption of Statement of Financial Accounting Standards (SFAS) No. 123R, "Share Based Payment" effective January 1, 2006. As a result of the acceleration, the Company expects to reduce the stock option expense, a non-cash charge, it otherwise would be required to record by approximately $130,000 total for the first two quarters of 2006.

ITEM 6. EXHIBITS

Exhibits

31.1 CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

ZOOM TECHNOLOGIES, INC. AND SUBSIDIARY

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ZOOM TECHNOLOGIES, INC.
(Registrant)

Date: November 10, 2005	**By: /s/ Frank B. Manning**
	Frank B. Manning, President
Date: November 10, 2005	**By: /s/ Robert Crist**
	Robert Crist, Vice President of Finance and Chief Financial Officer (Principal Financial and Accounting Officer)

EXHIBIT INDEX

Exhibit No.	Description
31.1	CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.