YP NET INC
Form 10QSB
February 11, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-QSB

(Mark One)

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2003

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act

For the transition period from _____________ to _______________

Commission File Number 0-24217

YP.NET, INC.
(Exact name of small business issuer as specified in its charter)

NEVADA	85-0206668
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

4840 EAST JASMINE ST. SUITE 105
MESA, ARIZONA 85205
(Address of principal executive offices)

(480) 654-9646
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No ___

APPLICABLE ONLY TO CORPORATE ISSUERS

The number of shares of the issuer's common equity outstanding as of February 10, 2003 was 48,794,302 shares of common stock, par value $.001.

Transitional Small Business Disclosure Format (check one):

Yes ___ No X

YP.NET, INC.

INDEX TO FORM 10-QSB FILING
FOR THE QUARTER ENDED DECEMBER 31, 2003

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

UNAUDITED CONSOLIDATED BALANCE SHEET
AS OF DECEMBER 31, 2003

ASSETS:	
CURRENT ASSETS	
Cash and equivalents	$ 1,156,158
Accounts receivable, net of allowance for doubtful accounts of $3,652,604	10,187,602
Prepaid expenses and other current assets	489,804
Deferred tax asset	1,382,867
Total current assets	13,216,431
ACCOUNTS RECEIVABLE, long term portion, net of allowance for doubtful accounts of $320,064	910,951
CUSTOMER ACQUISITION COSTS, net of accumulated amortization of $1,065,864	3,574,629
PROPERTY AND EQUIPMENT, net	735,373
DEPOSITS AND OTHER ASSETS	113,310
INTELLECTUAL PROPERTY- URL, net of accumulated amortization of $1,979,009	3,402,226

ADVANCES TO AFFILIATES	4,197,460
TOTAL ASSETS	$26,150,380
LIABILITIES AND STOCKHOLDERS' EQUITY:	
CURRENT LIABILITIES:	
Accounts payable	$ 374,142
Accrued liabilities	1,207,798
Notes payable- current portion	115,868
Income taxes payable	3,431,333
Total current liabilities	5,129,141
DEFERRED INCOME TAXES	36,748
Total liabilities	5,165,889
STOCKHOLDERS' EQUITY:	
Series E convertible preferred stock, $.001 par value, 200,000 shares authorized, 131,840 issued and outstanding, liquidation preference $39,552	11,206
Common stock, $.001 par value, 100,000,000 shares authorized, 55,373,636 issued, 48,794,302 outstanding	48,794
Paid in capital	9,464,166
Deferred stock compensation	(4,021,276
Treasury stock at cost	(690,306
Retained earnings	16,171,907
Total stockholders' equity	20,984,491
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$26,150,380

See the accompanying notes to these unaudited financial statements

YP.NET, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTH PERIODS ENDED DECEMBER 31, 2003 AND DECEMBER 31, 2002

	2003	2002
NET REVENUES	$ 13,866,967	$ 5,505,890
OPERATING EXPENSES:		
Cost of services	4,882,402	1,586,585
General and administrative expenses	2,790,743	1,376,078
Sales and marketing expenses	1,290,180	632,435

Depreciation and amortization	196,193	138,932
Total operating expenses	9,159,518	3,734,030
OPERATING INCOME	4,707,449	1,771,860
OTHER (INCOME) AND EXPENSES		
Interest (income) expense	(71,153)	(720)
Other (income) expense	(274,758)	(48,906)
Total other (income)expense	(345,911)	(49,626)
INCOME BEFORE INCOME TAXES	5,053,360	1,821,486
INCOME TAX PROVISION (BENEFIT)	1,768,675	728,594
NET INCOME	$ 3,284,685	$ 1,092,892
NET INCOME PER SHARE:		
Basic	$ 0.07	$ 0.02
Diluted	$ 0.07	$ 0.02
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic	46,752,367	46,515,590
Diluted	46,862,804	46,515,590

See the accompanying notes to these unaudited financial statements

YP.NET, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTH PERIODS ENDED DECEMBER 31, 2003 AND DECEMBER 31, 2002

CASH FLOWS FROM OPERATING ACTIVITIES:	THREE MONTHS ENDED DECEMBER 31, 2003	THREE MONTH ENDED DECEMBER 2002
Net income	$ 3,284,685	$ 1,092
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	196,193	138
Income recognized on forgiveness of debt	-	(45
Amortization of deferred stock compensation	226,779	

Deferred income taxes	229,928	41
Officers & consultants paid common stock	-	453
Common stock surrendered	-	(115
Changes in assets and liabilities:		
Trade and other accounts receivable	(2,646,424)	(953
Customer acquisition costs	(331,388)	(500
Prepaid and other current assets	(335,528)	(35
Other assets	(36,256)	62
Accounts payable	(54,281)	(23
Accrued liabilities	(205,447)	(101
Income taxes payable	538,747	687
Net cash provided by operating activities	867,008	700
CASH FLOWS FROM INVESTING ACTIVITIES:		
Advances made to affiliates and related parties	(2,000,000)	(100
Purchases of intellectual property	-	(6
Purchases of equipment	(89,698)	(163
Net cash (used in) investing activities	(2,089,698)	(270
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from debt	-	147
Principal repayments on notes payable	-	(454
Net cash (used)/provided by financing activities	-	(307
(DECREASE) INCREASE IN CASH	(1,222,690)	122
CASH, BEGINNING OF PERIOD	2,378,848	767
CASH, END OF PERIOD	$ 1,156,158	$ 889

See the accompanying notes to these unaudited financial statements

YP.NET, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTH PERIODS ENDED DECEMBER 31, 2003 AND DECEMBER 31, 2002, continued

SUPPLEMENTAL CASH FLOW INFORMATION:

	Three month period ended December 31, 2003	Three month period ended December 31, 2002
Interest Paid	$ -	$ 6,000

See the accompanying notes to these unaudited financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTH PERIODS ENDED DECEMBER 31, 2003 AND DECEMBER 31, 2002

1. Basis of Presentation

The accompanying unaudited financial statements represent the consolidated financial position of YP.Net, Inc. ("the Company") for the three month periods ended December 31, 2003, and December 31, 2002, which includes results of operations of the Company and Telco Billing, Inc. ("Telco"), its wholly owned subsidiary, and statement of cash flows for the three month periods ended December 31, 2003 and December 31, 2002. These statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments to these unaudited financial statements necessary for a fair presentation of the results for the interim period presented have been made.

2. Company Organization and Operations

YP.Net, Inc., a Nevada corporation (the "Company," "we," "us," or "our"), is in the business of providing Internet-based yellow page advertising space on or through www.Yellow-Page.Net, www.YP.Net and www.YP.com.

The Company's "yellow page" database lists approximately 18 million businesses throughout the United States. Our website enables internet users to search through these "yellow page" listings and is used by businesses and consumers attempting to locate a business and/or service provider in response to a user's specific search criteria.

As our primary source of revenue, we offer a Mini-Webpage(TM) to businesses for a monthly fee. The Mini-Webpage(TM) provides a business with a priority placement listing over non-paying listings and is displayed in a bigger and bolder font at the beginning of, or in the first section of the user's search results - thus featuring our paying customers more prominently to user's of our website. In addition, our paying customers get a Mini-Webpage(TM) which includes a 40-word description of their business, their hours of operation and other useful information, a direct link to the paying customers website, (if they have one and it is provided by the advertiser), map, driving directions to the paying customers location and more. We market for advertisers for this Internet Advertising Package ("IAP"), under the name "Yellow-Page.Net, exclusively to businesses through a direct mail solicitation program. The solicitation includes a promotional incentive (i.e. generally a $3.50 check) which, if cashed by the business, automatically signs the business up for the IAP service for an initial twelve month period with automatic renewals thereafter. This easy subscription process provides a written confirmation (i.e., the check) of the subscription by the newly subscribing business, which is verified by an independent third party (i.e., the paying customers depositing bank). To additionally insure the intention of sign-up, the Company then mails a written confirmation card to the newly subscribing business generally within 30 days from activation. The Company also provides a 120-day cancellation period whereby the subscribing business may cancel and receive a full refund of any amounts paid to the Company.

Each paying customer is billed monthly for that month's service, the vast majority of such monthly billings appear on the subscribing business's local phone bill. Management believes this ability to bill the paying customer through the paying customers phone bill is a significant competitive advantage for the Company as few independent (not owned by a telephone company) yellow page companies are authorized

to bill directly on the phone bill for services rendered.

We were originally incorporated as a New Mexico company in 1969 and the Company was re-incorporated in Nevada in 1996 as Renaissance Center, Inc. Our Articles of Incorporation were restated in July 1997 and our name was changed to Renaissance International Group, Ltd. Effective July 1998, we changed our name to RIGL Corporation. In June 1999, we acquired Telco Billing, Inc. ("Telco") and commenced our current operations through this entity. In October 1999, we amended our Articles of Incorporation to change our corporate name to YP.Net, Inc. to better identify our company with our business focus.

From August through March 1999, we abandoned all subsidiaries previously involved in the multi-media software and medical billing and practice management areas. With the acquisition of Telco, our business focus shifted to the Internet yellow page services business and this business is currently our main source of revenue. Telco is operated as our wholly owned subsidiary.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash and Cash Equivalents: This includes all short-term highly liquid investments that are readily convertible to known amounts of cash and have original maturities of three months or less. At times cash deposits may exceed government insured limits. At December 31, 2003, cash deposits exceeded those insured limits by $899,000.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Telco Billing, Inc. All significant intercompany accounts and transactions are eliminated.

Customer Acquisition Costs: These costs represent the direct response marketing costs that are incurred as the primary method by which customers subscribe to the Company's services. The Company purchases mailing lists and sends advertising materials to prospective subscribers from those lists. Customers subscribe to the services by positively responding to those advertising materials which serve as the contract for the subscription. The Company capitalizes and amortizes the costs of direct-response advertising on a straight-line basis over eighteen months, the estimated average period of retention for new customers. The Company capitalized costs of $1,285,000 and $983,000 during the three months ended December 31, 2003 December 31, 2002, respectively. The Company amortized $1,066,000 and $483,000 of total capitalized costs during the three months ended December 31, 2003 and December 31, 2002, respectively.

The Company also incurs advertising costs that are not considered direct-response advertising. These other advertising costs are expensed when incurred. These advertising expenses were $224,316 and $149,381 for the three months ended December 31, 2003 and December 31, 2002, respectively.

Revenue Recognition: The Company's revenue is generated by customer

subscriptions of directory and advertising services. Revenue is billed and recognized monthly for services subscribed in that specific month. The Company utilizes outside billing companies to transmit billing data, much of which is forwarded to Local Exchange Carriers ("LEC's") that provide local telephone service. Monthly subscription fees are generally included on the telephone bills of the customers. The Company recognizes revenue based on net billings accepted by the LEC's. Due to the periods of time for which adjustments may be reported by the LEC's and the billing companies, the Company estimates and accrues for dilution and fees reported subsequent to year-end for initial billings related to services provided for periods within the fiscal year.

Revenue for billings to certain customers whom are billed directly by the Company and not through the LEC's, is recognized based on estimated future collections. The Company continuously reviews this estimate for reasonableness based on its collection experience.

Income Taxes: The Company provides for income taxes based on the provisions of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, which, among other things, requires that recognition of deferred income taxes be measured by the provisions of enacted tax laws in effect at the date of financial statements.

Financial Instruments: Financial instruments consist primarily of cash, accounts receivable, advances to affiliates, and obligations under accounts payable, accrued expenses and notes payable. The carrying amounts of cash, accounts receivable, accounts payable, accrued expenses and notes payable approximate fair value because of the short maturity of those instruments. The Company has applied certain assumptions in estimating these fair values. The use of different assumptions or methodologies may have a material effect on the estimates of fair values.

Net Income Per Share: Net income per share is calculated using the weighted average number of shares of common stock outstanding during the year. The Company has adopted the provisions of SFAS No. 128, Earnings Per Share.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant estimates made in connection with the accompanying financial statements include the estimate of dilution and fees associated with LEC billings and the estimated reserve for doubtful accounts receivable.

Stock-Based Compensation: Statements of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, ("SFAS 123") established accounting and disclosure requirements using a fair-value based method of accounting for stock-based employee compensation. In accordance with SFAS 123, the Company has elected to continue accounting for stock based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees."

Reclassifications: Certain reclassifications have been made to the income

statement presented for the three months ended December 31, 2002 to conform to the presentation of the income statement presented for the three months ended December 31, 2003.

Impairment of Long-lived Assets: The Company assesses long-lived assets for impairment in accordance with the provisions of SFAS 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of. SFAS 121 requires that the Company assess the value of a long-lived asset whenever there is an indication that its carrying amount may not be recoverable. Recoverability of the asset is determined by comparing the forecasted undiscounted cash flows generated by said asset to its carrying value. The amount of impairment loss, if any, is measured as the difference between the net book value of the asset and its estimated fair value.

Recently Issued Accounting Pronouncements: In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated With Exit or Disposal Activities". This Standard requires costs associated with exit or disposal activities to be recognized when they are incurred. The Company estimates the impact of adopting these new rules will not be material.

In October 2002, the FASB issued SFAS No. 147, "Acquisitions of Certain Financial Institutions." SFAS No. 147 is effective October 1, 2002. The adoption of SFAS No. 147 did not have a material effect on the Company's financial statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," effective for contracts entered into or modified after June 30, 2003. This amendment clarifies when a contract meets the characteristics of a derivative, clarifies when a derivate contains a financing component and amends certain other existing pronouncements. The Company believes the adoption of SFAS No. 149 will not have a material effect on the Company's financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. SFAS No. 150 requires the classification as a liability of any financial instruments with a mandatory redemption feature, an obligation to repurchase equity shares, or a conditional obligation based on the issuance of a variable number of its equity shares. The Company does not have any financial instruments with a mandatory redemption feature. The Company believes the adoption of SFAS No. 150 will not have a material effect on the Company's financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 clarifies the requirements for a guarantor's accounting for and disclosure of certain guarantees issued and outstanding. The initial recognition and initial measurement provisions of FIN 45 are applicable to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements for periods ending after December 15, 2002. The adoption of FIN 45 did not have a significant impact on the Company's financial statements. See Note 10.

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest

Entities" (FIN 46). FIN No. 46 states that companies that have exposure to the economic risks and potential rewards from another entity's assets and activities have a controlling financial interest in a variable interest entity and should consolidate the entity, despite the absence of clear control through a voting equity interest. The consolidation requirements apply to all variable interest entities created after January 31, 2003. For variable interest entities that existed prior to February 1, 2003, the consolidation requirements are effective for annual or interim periods beginning after June 15, 2003. Disclosure of significant variable interest entities is required in all financial statements issued after January 31, 2003, regardless of when the variable interest was created. The Company is presently reviewing arrangements to determine if any variable interest entities exist but does not anticipate the adoption of FIN 46 will have a significant impact on the Company's financial statements.

4. ACCOUNTS RECEIVABLE

The Company provides billing information to third party billing companies for the majority of its monthly billings. Billings submitted are "filtered" by these billing companies and the LEC's. Net accepted billings are recognized as revenue and accounts receivable. The billing companies remit payments to the Company on the basis of cash ultimately received from the LEC's by those billing companies.

The billing companies and LEC's charge fees for their services, which are netted against the gross accounts receivable balance. The billing companies also apply holdbacks to the remittances for potentially uncollectible accounts. These dilution amounts will vary due to numerous factors and the Company may not be certain as to the actual amounts of dilution on any specific billing submittal until several months after that submittal. The Company estimates the amount of these charges and holdbacks based on historical experience and subsequent information received from the billing companies. The Company also estimates uncollectible account balances and provides an allowance for such estimates. The billing companies retain certain holdbacks that may not be collected by the Company for a period extending beyond one year. These balances have been classified as long-term assets in the accompanying balance sheet.

The Company experiences significant dilution of its gross billings by the billing companies. The Company negotiates collections with the billing companies on the basis of the contracted terms and historical experience. Holdbacks, fees, and other matters, which are determined by the LEC's and the billing companies, may affect the Company's cash flow. The Company processes its billings through two primary billing companies.

eBillit, Inc. ("EBI") provides the majority of the Company's billings, collections, and related services. The net receivable due from eBillit at December 31, 2003 was $8,501,002, net of an allowance for doubtful accounts of $2,986,421. The net receivable from EBI at December 31, 2003, represents approximately 77% of the Company's total net accounts receivable at December 31, 2003.

Subscription receivables that are directly billed by the Company are valued and reported at the estimated future collection amount. Determining the expected collections requires an estimation of both uncollectible accounts and refunds. The net subscriptions receivable at December 31, 2003 was $216,026.
Accounts receivable at December 31, 2003 is summarized as follows:

	Current	Long-Term	Total

Gross accounts receivable	$13,840,206	$1,231,015	$15,071,221
Allowance for doubtful accounts	3,652,604	320,064	3,972,668
	$10,187,602	$ 910,951	$11,098,553

Certain receivables have been classified as long-term because the Company's collection experience with those receivables has historically extended beyond one year.

5. INTELLECTUAL PROPERTY

The URL is recorded at its cost net of accumulated amortization. Management believes that the Company's business is dependent on its ability to utilize this URL given the recognition of the Yellow page term. Also, its current customer base relies on the recognition of this term and URL as a basis for maintaining the subscriptions to the Company's service. Management believes that the current revenue

and cash flow generated through use of Yellow-page.net supports the carrying of the asset. The Company periodically analyzes the carrying value of this asset to determine if impairment has occurred. No such impairments were identified during the year ended September 30, 2003 or the three months ended December 31, 2003. The URL is amortized on an accelerated basis over the twenty-year term of the licensing agreement. Amortization expense on the URL was $109,926 and $93,031 for the three months ended December 31, 2003 and December 31, 2002, respectively.

6. PROVISION FOR INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Income taxes for three months ended December 31 is summarized as follows:

	2003	2002
Current Provision	$ 1,538,747	$ 687,344
Deferred (Benefit) Provision	229,928	41,250
Net income tax provision	$ 1,768,675	$ 728,594

During the year ended September 30, 2003, the Company expanded certain operations and revenue generating assets in Nevada where there are no corporate income taxes thereby reducing the statutory rate used for state income taxes.

At December 31, 2003, deferred income tax assets related to differences in book and tax bases of accounts receivable, direct marketing costs and intangible assets.

At December 31, 2003 deferred tax liabilities were comprised of differences in book and tax bases of customer acquisition costs and property and equipment respectively.

7. NET INCOME PER SHARE

Net income per share is calculated using the weighted average number of shares of common stock outstanding during the three months ended December 31, 2003 and December 31, 2002, respectively. Preferred stock dividends are subtracted from the net income to determine the amount available to common shareholders. There were $494 and $395 in preferred stock dividends in the three months ended December 31, 2003 and December 31, 2002, respectively. Warrants to purchase 500,000 shares of common stock were excluded from the calculation for the three months ended December 31, 2002. The exercise price of those warrants was greater than the trading value of the common stock and therefore inclusion of such would be anti-dilutive. Also excluded from the calculation for the three months ended December 31, 2003 were 131,840 shares of Series E Convertible Preferred Stock issued during the year ended September 30, 2002, which are considered anti-dilutive due to the cash payment required by the holders of the securities at the time of conversion. The dilutive effect of unvested restricted awards and certain warrants are included in the calculation of diluted earnings per share for the three month period ended December 31, 2003. Excluded from the calculation of diluted earnings per share for the three month period ended December 31, 2003 are warrants to purchase 375,000 shares of common stock and

unvested restricted stock awards totaling 1,873,572 shares. The securities are excluded from the calculation because their inclusion would be anti-dilutive.

The following presents the computation of basic and diluted loss per share from continuing operations for the three months ended December 31:

	Three Months Ended December 31, 2003			Three Months Ended December 31, 2002		
	Income	Shares	Per Share	Income	Shares	Per share
Net Income	$3,284,685			$ 1,092,892		
Preferred stock dividends	(494)			(395)		
Income available to common Stockholders	$3,284,191			$ 1,092,497		
BASIC EARNINGS PER SHARE:						
Income available to common stockholders	$3,284,191	46,752,367	$ 0.07	$ 1,092,497	46,515,590	$ 0.0
Effect of dilutive securities		110,437				
DILUTED EARNINGS PER SHARE	$3,284,191	46,862,804	$ 0.07	$ 1,092,497	46,515,590	$ 0.0

8. COMMITMENTS AND CONTINGENCIES

Telco Billing

The acquisition of Telco by the Company called for the issuance of 17,000,000 new shares of stock in exchange of the existing shares of Telco. As part of that agreement, the Company gave the former shareholders the right to "Put" back to the Company certain shares of stock at a minimum stock price of 80% of the current trading price with a minimum strike price of $1.00. The net effect of which was that the former Telco shareholders could require the Company to repurchase shares of stock of the Company at a minimum cost of $10,000,000. The agreement required the Company to attain certain market share levels.

The "Put" feature has been renegotiated and retired. As part of the renegotiated settlement, the Company provided a credit facility of up to $20,000,000 to the former Telco shareholders, collateralized by the stock held by these shareholders, with interest at least 0.25 points higher than the Company's average cost of borrowing. Additional covenants warrant that no more that $1,000,000 can be advanced at any point in time and no advances can be made in excess without allowing at least 30 days operating cash reserves or if the Company is in an uncured default with any of its lenders. At December 31, 2003, the Company had advanced $4,197,460 under this agreement. The former Telco shareholders have been making interest payments on the advances but, as allowed under the agreement, have not made any principal repayments.

In the three month period ended December 31, 2003, the Company and the former Telco shareholders agreed to amend the arrangement whereby the Company will be required to advance only an additional $1,300,000 through April 2004 and the ability to draw on that facility will cease at that time. However,

the Company made a commitment in connection with that amendment to begin paying dividends to all of its common stockholders in the fiscal year ended September 30, 2004.

Billing Service Agreements

The Company has entered into a customer billing service agreement with eBillit, Inc. (EBI) also known as PaymentOne. EBI provides billing and collection and related services associated to the telecommunications industry. The agreement term is for two years, automatically renewable in two-year increments unless appropriate notice to terminate is given by either party. The agreement will automatically renew on September 1, 2005, unless either party gives notice of termination 90 days prior to that renewal date. Under the agreement, EBI bills, collects and remits the proceeds to Telco net of reserves for bad debts, billing adjustments, telephone company fees and EBI fees. If either the Company's transaction volume decreases by 25% from the preceding month, or less than 75% of the traffic is billable to major telephone companies, EBI may at its own discretion increase the reserves and holdbacks under this agreement. EBI handles all billing information and collection of receivables. The Company's cash receipts on trade accounts receivable are dependent upon estimates pertaining to holdbacks and other factors as determined by EBI. EBI may at its own discretion increase the reserves and holdbacks under this agreement.

The Company has also entered into an agreement with ACI Communications, Inc. ACI provides billing and collection and related services associated to the telecommunications industry.

These agreements with the billing companies provide significant control to the billing companies over cash receipts and ultimate remittances to the Company. The Company estimates the net realizable value of its accounts receivable on historical experience and information provided by the billing companies reflecting holdbacks and reserves taken by the billing companies and LEC's.

Other

The Company's Board of Directors has committed the Company to pay for the costs of defending a civil action filed against its CEO and Chairman. The action involved a business that the CEO was formerly involved in. The Company and at least one officer had received subpoenas in connection with this matter and the Board believes that it is important to help resolve this matter as soon as possible. The Board action included the payment of legal and other fees for any other officers and directors that may have become involved in this civil action. During the three months ended December 31, 2003, the Company paid costs of approximately $54,000 on behalf of its CEO relative to this matter. The amounts expensed in the current period are presented as compensation expense within general and administrative expenses in the accompanying statement of operations for the three months ended December 31, 2003. The Company believes that all civil actions against the CEO related to this matter have been dismissed or are being dismissed. However, additional legal costs will be incurred to address all matters in finalizing this issue and, at this time, the Company cannot estimate what additional costs may be incurred to continue covering the costs related to this matter, but all such costs shall be deemed to be additional compensation to the CEO.

The Company has entered into "Executive Consulting Agreements" with four entities controlled by four of the Company's officers individually. These agreements call for fees to be paid for the services provided by these individuals as officers of the Company as well as their respective staffs. These agreements are not personal service contracts of these officers individually. The agreements extend through 2007 and require annual performance bonuses that aggregate up to approximately $320,000 depending upon available cash and meeting of certain performance criteria.

9. RELATED PARTY TRANSACTIONS

During the three months periods ended December 31, 2003 and 2002, the Company entered into the related party transactions with Board members, officers and affiliated entities as described below:

Directors & Officers

Board of Director fees for the three month periods ended December 31, 2003 and 2002 were $20,000 and $40,000 respectively. These amounts are in included in the amounts discussed below.

The CEO, a Subsidiary Officer, a Subsidiary Officer and Corporate Secretary as well as the CFO are paid for their services and those of their respective staffs through separate entities controlled by these individuals who pre-date their association with the Company. The following describes the compensation paid to these entities.

Sunbelt Financial Concepts, Inc.

Sunbelt Financial Concepts, Inc. ("Sunbelt") provides the services of the Chairman and CEO and his staff to the Company.

Sunbelt provides the strategic and overall planning as well as the operations management to the Company. Sunbelt's team is experienced in all areas of management and administration.

During the three month period ended December 31, 2003, the Company paid a total of approximately $156,000 to Sunbelt. Included in that amount is $105,600 in fees for services rendered by Sunbelt. In addition, the Company paid approximately $54,000 on behalf of the CEO to attorneys for legal fees incurred by Sunbelt related to the personal legal matters discussed in Note 8. Approximately $532,000 of total amounts due Sunbelt remain accrued at December 31, 2003.

Advertising Management & Consulting Services, Inc.

Advertising Management & Consulting Services, Inc. ("AMCS") provides the services of a Subsidiary Officer, a Director of the Company, and his staff to the Company. AMCS is a marketing and advertising company experienced in designing Direct Marketing Pieces, insuring compliance with regulatory authorities for those pieces and designing new products that can be mass marketed through the mail. AMCS' president is a director of the Company.

The Company outsources the design and testing of its many direct mail pieces to AMCS for a fee. AMCS is also responsible for new products that have been added to the Company's website and is working on new mass-market products to offer the Company's customers.

Total amount paid to this director and AMCS during the three month period ended December 31, 2003 was approximately $187,000. At December 31, 2003, the total amount accrued to AMCS is $92,300.

Advanced Internet Marketing, Inc.

Advanced Internet Marketing, Inc. ("AIM") provides the services of a Subsidiary Officer, Corporate Secretary and a Director of the Company, and his staff to the Company.

The Company outsources the design and marketing of it's website on the World Wide Web to AIM. AIM's team of designers is experienced in all areas of web design and has created all of the Company's logos and images for branding.

The total amount paid to AIM during the three month period ended December 31, 2003 was approximately $97,000. At December 31, 2003, the total amount accrued to AIM is approximately $81,000.

MAR & Associates

The services of the Company's Chief Financial Officer and his staff are paid to MAR & Associates ("MAR"). The total amount paid to MAR during the three month period ended December 31, 2003 was $81,400. At December 31, 2003, the total amount accrued to MAR is approximately $61,000.

Other

The Company made additional advances to former Telco shareholders of $2,000,000 during the three month period ended December 31, 2003. Interest earned on these advances was $71,256 for the three months ended December 31, 2003.

Advances to affiliates are summarized as follows at December 31, 2003:

Morris & Miller	$2,877,399
Mathew & Markson	1,320,061
	$4,197,460

On December 22, 2003, the Company entered into an agreement with the former Telco shareholders that terminates the line of credit agreement effective April 9, 2004.

Simple.Net, Inc. ("SN")

The Company had contracted with Simple.Net, Inc. ("SN"), an internet service provider owned by a director of the Company, to provide internet dial-up and other services to its customers. SN had sold said services to the Company at below market rate prices from time to time. During the three month periods ended December 31, 2003 and 2002, the Company paid SN approximately $315,058 and $34,390, respectively for said services. At December 31, 2003, $73,000 due SN was accrued in accounts payable.

In addition, SN paid a monthly fee to the Company for technical support and customer service provided to SN's customers by the Company's employees. The Company charged SN for these services according to a per customer pricing formula:

Customer Service & Management Agreement fees are calculated by number of customer records of SN multiplied by a base cost of $1.02.

Technical Support fees are calculated by number of customer records of SN multiplied by a base cost of 60 cents.

For the three month periods ended December 31, 2003 and 2002, the Company recorded other income of $274,758 and $113,277, respectively, from SN for these services.

On December 29, 2003, we entered into a separation agreement with Simple.Net which becomes effective January 31, 2004. Under this agreement, Simple.Net will no longer provide any services to us. Although the Separation Agreement provides for a 30-day extension until March 2, 2004.

10. CONCENTRATION OF CREDIT RISK

The Company maintains cash balances at banks in Arizona. Accounts are insured by the Federal Deposit Insurance Corporation up to $100,000. At December 31, 2003, the Company had bank balances exceeding those insured limits of $899,000.

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily trade accounts receivable. The trade accounts receivable are due primarily from business customers over widespread geographical locations within the LEC billing areas across the United States.

The Company historically has experienced significant dilution and customer credits due to billing difficulties and uncollectible trade accounts receivable. The Company estimates and provides an allowance for uncollectible accounts receivable. The handling and processing of cash receipts pertaining to trade accounts receivable is maintained primarily by two third party billing companies. The Company is dependent upon these billing companies for collection of its accounts receivable. As discussed in Note 4, the net receivable due from a single billing services provider at December 31, 2003 was $8,501,002, net of an allowance for doubtful accounts of $2,986,421. The net receivable from that billing services provider at December 31, 2003, represents approximately 77% of the Company's total net accounts receivable at December 31, 2003.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

For a description of our significant accounting policies and an understanding of the significant factors that influenced our performance during the three months ended December 31, 2003, this "Management's Discussion and Analysis" should be read in conjunction with the Consolidated Financial Statements, including the related notes, appearing in Item 1 of this Annual Report.

Forward-Looking Statements

This portion of this Quarterly Report on Form 10-QSB, includes statements that constitute "forward-looking statements." These forward-looking statements are often characterized by the terms "may," "believes," "projects," "expects," or "anticipates," and do not reflect historical facts. Specific forward-looking statements contained in this portion of the Annual Report include, but are not limited to: (i) our belief that dilution is not expected to increase at the same rate in the foreseeable future; (ii) our belief that capital expenditures are not expected to increase at the same rate for the foreseeable future (iii) our intention to increase the monthly price to our current customers after such customers have completed six months of advertising at their current monthly price and (iv) our expectation to begin paying a $0.01 per share quarterly dividend.

Forward-looking statements involve risks, uncertainties and other factors, which may cause our actual results, performance or achievements to be materially different from those expressed or implied by such forward-looking statements. Factors and risks that could affect our results and achievements and cause them to materially differ from those contained in the forward-looking statements include those identified in the section below titled "Certain Risk Factors Affecting Our Business," as well as other factors that we are currently unable to identify or quantify, but may exist in the future.

In addition, the foregoing factors may affect generally our business, results of operations and financial position. Forward-looking statements speak only as of the date the statement was made. We do not undertake and specifically decline any obligation to update any forward-looking statements.

Overview

YP.Net, Inc., a Nevada corporation (the Company, "we, "us," or "our") is a national Internet Yellow Page publisher. Through our wholly-owned subsidiary, Telco Billing, Inc. ("Telco"), we only publish our Yellow Pages online at or through the following URL's: <u>www.Yellow-Page.Net</u>, <u>www.YP.Net</u> and <u>www.YP.Com</u>. Any information contained on the foregoing websites or any other websites

referenced in this Quarterly Report are not a part of this Quarterly Report.

We use a business model similar to print Yellow Page publishers. We publish basic directory listings ("Basic Listings"), free of charge. Like Yellow Page publishers, we generate revenues from those advertisers ("Advertisers") that desire increased exposure for their businesses. Our Basic Listings contain the business name, address and phone number for almost

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18 million U.S. businesses. We strive to maintain a listing for almost every business in America in this format.

As described below, Advertisers pay us monthly fees in the same manner that advertisers pay additional fees to traditional print Yellow Page providers for enhanced advertisement font, location or display. The users ("Users") of our website(s) are prospective customers for our Advertisers.

We offer several different upgrades to our advertising customers:

Internet Advertising Package(TM) ("IAP"). Under this package, the Advertiser pays for additional exposure by purchasing a Mini-WebPage(TM). This Mini-WebPage contains, among other useful information, a 40-word description of the business, hours of operation and detailed contact information. This product is easily searched by Users on their personal computers, as well as cellular phones and other hand-held devices. In order to provide search traffic to the Advertiser's Mini-WebPage, we elevate the Advertiser to a preferred listing ("Preferred Listing") status, at no additional charge. As such, the preferred Advertiser enjoys the benefit of having its advertisement displayed in a primary position before all Basic Listings in that particular category when Users perform searches on our site(s). The Mini-WebPage is easily accessed and modified by Advertisers. We also provide our Internet Advertising customers with enhanced presentation and additional unique products:

- larger font;
- bolded business name;
- map directions;
- a Click2Call feature, whereby a User can place a telephone call to the Internet Advertising customer by clicking the icon that is displayed on the Mini-WebPage. This call is free of charge to both the User and the Internet Advertising customer;
- a link to the Internet Advertiser's own webpage; and
- additional distribution network for Preferred Listings. This feature gives additional exposure to our Internet Advertising customers by placing their Preferred Listing on several online directory systems. This service is currently free of charge to our Advertisers.

The Internet Advertising Package currently costs the Advertiser $24.95 per month ($21.95 for new Advertisers). As of December 31, 2003, we had signed up approximately 283,064 Internet Advertising Packages and we have gathered Mini-WebPage information on 231,071 IAP's. Currently, this product accounts for over 95% of our revenue.

Online QuickSite Package(TM) ("QuickSite(TM)"). For those IAP Advertisers that do not have their own website and that desire to provide more information than is offered through the IAP Mini-WebPage, we will design and create an eight page, template-driven, website for the Advertiser, a QuickSite. We charge the Advertiser a set-up fee of $200.00 and an additional $39.95 per month for hosting services for their QuickSite. Once set up, the Advertiser can access their new QuickSite online and make modifications at their discretion. This essentially serves the same function as do display advertisements in the print

Yellow Page books, except that it can be changed more often to meet Advertisers' needs. Users can access these QuickSites

on the World Wide Web or from the Advertisers Preferred Listing or Mini-WebPage. As of December 31, 2003, we had created and currently host approximately 272 QuickSites.

Internet Dial-Up Package(TM) ("IDP"). We offer our Internet Advertising customers a cost-effective and efficient Internet dial-up package to take advantage of the benefits offered by on-line access. This allows our Advertisers who do not have Internet access to take full advantage of the IAP and QuickSite packages that we offer. In certain geographical areas, we have offered a bundled product whereby the IAP Advertiser can either pay for the advertising or the IDP, in which case they will receive the other service free. As of December 31, 2003, approximately 47,940 Internet Advertising customers utilize the service without charge. However, we intend to expand and market this package to new Advertisers in the next fiscal year at a cost of $34.95 per month for a bundled product. Those Advertisers that already have the free service will retain their current bundled pricing.

Marketing. Unlike most print Yellow Page companies that sell advertising space by visiting or calling potential advertisers in their area, we solicit advertisers for our Internet Advertising Package exclusively by direct mail. We believe this enables us to offer our products and services at more affordable rates than our competitors. Moreover, we believe direct mail is a less expensive form of marketing than visiting or calling potential customers. Currently, our direct mail marketing program includes a promotional incentive, generally in the form of a $3.50 activation check that a solicited business simply deposits to activate the service and become an Internet Advertising customer on a month-by-month basis. As a method of third-party verification, the depositing bank verifies that the depositing party is in fact the solicited business. Upon notice of activation by a depositing bank, we immediately contact the business to confirm the order and obtain the information necessary to build their Mini-WebPage. Within 30 days of activation, we also send a confirmation card to the business. To ensure our goal of 100% customer satisfaction, we offer a cancellation period of 120 days and a full refund. Our direct mail marketing program complies with and, in many instances, exceeds the United States Federal Trade Commission ("FTC") requirements as established by agreement signed between the Company and the FTC in September 2001.

Billing. Similar to the local Regional Bell Operating Companies, we are approved to bill our products and services directly on most of our Advertisers' local phone bill. We believe that this is a significant competitive advantage as few independent Yellow Page companies are authorized to do business in this fashion.

Benefits to Advertisers. For advertisers, we believe that online Yellow Pages provide significant competitive advantages over existing print directories. For example, the ability of online advertisers to access and modify their displays and advertisements often results in more current information. Additionally, online advertisers can more readily advertise temporary or targeted specials or discounts. We provide added value to our Advertisers who have purchased our Internet Advertising Packages through promotion and branding of our website to bring customers to our Advertisers. We believe that the large number of Internet Advertising Packages, that includes the Mini-WebPages, provides Users with more information, which is more readily available on our sites, compared to our competitors. We believe that we provide Users with what they are looking for, more quickly and more efficiently. We believe the attraction of such Users will, over the long-term, result in more

sales for our Internet Advertisers.

Moreover, we provide additional value through our relationships. We provide the vast majority of the Preferred Listings on a number of competitors' websites, including www.switchboard.com, www.myareaguide.com, as well as on www.go2.com. The go2 site has exclusive contracts with providers like Verizon Wireless, AT&T Wireless, ALLTEL, Nextel and Sprint to also provide this information to their cellular phone and hand-held device subscribers.

From a User's Standpoint. A national, online Yellow Pages allows the User to access information nationally rather than relying exclusively on local listings like those provided in print Yellow Page directories. In addition, our product offerings allow Users to find and take advantage of advertisers' current special offerings and discounts. We also provide easy access to such information through desktop or laptop computers, cellular phones or hand-held devices, such as personal digital assistants. We believe our offering of a national online Yellow Pages service meets the growing demand for immediate access and the increasing need and trend of Users who are more frequently traveling to areas outside the areas serviced by their local print directories.

Directory Service and Search Engine. We also believe that our products offer many competitive advantages over standard search engines. Our directory service and search engine format allows the User to search by location using either a business name or business category. Unlike popular commercial search engines, our search engine does not search the Internet to provide results. Instead, it searches our defined database, resulting in a more focused, refined and, oftentimes, quicker and more accurate search.

Recent Developments

Las Vegas Office

In October 2003, our wholly owned subsidiary, Telco, signed a three-year lease on a facility in Las Vegas, Nevada consisting of annual lease payments of approximately $201,000. This facility is approximately 3,500 square feet and is the primary operating facility of Telco. The lease is an operating lease for accounting purposes. This location will shortly replace Telco's facility in Boulder City, Nevada. This space was necessary to accommodate Telco's expanding sales and accounting staff.

Termination of Credit Agreement with Former Telco Shareholders

On December 22, 2003, the Company entered into an agreement with the former Telco shareholders that terminates the line of credit agreement effective April 9, 2004.

Separation Agreement with Simple.Net

On December 29, 2003, we entered into a separation agreement with Simple.Net, which becomes effective January 31, 2004. Under this agreement, Simple.Net will no longer provide any services to us. Although the Separation Agreement provides for a 30-day extension until March 2, 2004.

Amendment to 2003 Stock Plan

On December 31, 2003, The Board of Directors voted to approve an increase in the 2003 Plan from 3,000,000 to 5,000,000 shares. Our stockholders are being asked to approve the increase at the Company's 2004 Annual Meeting of Stockholders.

Future Outlook

We intend to pursue the following growth strategies and initiatives in fiscal 2004:

Internet Advertising Package. We currently derive almost all of our revenue from selling IAPs. During fiscal 2003, we continued our direct mail marketing program to acquire additional Internet advertising customers. We regularly solicit potential advertisers from a database of approximately 18 million U.S. businesses. This database is continually updated to account for new or closed businesses, as well as updated contact information. As a result of this program, we have increased our IAP customer count from 168,980 at December 31, 2002 to 283,064 at December 31, 2003. This total represents less than 2% of the total available market of approximately 18 million U.S. businesses according to Acxiom USA. During fiscal 2004 and beyond, we plan to continue aggressively marketing additional IAPs using our direct mail marketing program.

Branding. We plan to further embark upon a substantial campaign to brand our YP.Com name and our products. We seek to become the "internet yellow pages of choice" to advertisers and Users performing searches. We plan to use various forms of media, which may include print, television, radio, billboard and movie-theater advertising in select markets or nationally. We believe such branding will help to attract Users to our websites, as well as advertisers to sign-up for our IAP and/or other service offerings. The goal of our branding is to obtain instant customer recognition of our offerings that, over time, may enhance the response rate of our direct mail marketing program. However, we expect to incur significant costs relating to our branding prior to such benefits being realized which we expect to fund from our internal cash flow.

Expansion of Service Offerings to Other Countries. We are currently exploring our ability to offer our services in other English-speaking countries, which we believe we could accomplish without hiring a significant number of additional people or incurring additional training costs.

Marketing of QuickSite. Until recently, we have not focused our marketing efforts on the QuickSite service offering. As a part of a test market, we maintained three full time sales people and experimented with less traditional lines of selling, such as through third party agents like EZsitemaster, Inc. Through these efforts, we acquired an immaterial number of QuickSite customers during fiscal 2003. In fiscal 2004, we will continue these efforts, as well as test marketing the use of our direct mail marketing program tailored for this product. We believe that this marketing effort may produce additional revenues.

Internet Dial-up Package. We will begin to charge new Advertisers for our bundled product, consisting of the IAP and IDP, in certain geographical areas. Initially, this bundled product will cost the new Advertiser $34.95 per month, or at least $5 more per month than the IAP alone. This pricing will save the Advertiser approximately 40% over the individual stand

alone prices. We believe this offering will enhance revenue by raising the price to the Advertiser for each ISP/IDP sold at very little additional cost to us.

National Accounts Marketing. Currently, we have limited our marketing efforts to individual business units, rather than national accounts, such as hotel chains, automobile dealers, etc. We believe a significant opportunity exists to offer our IAP and other service offerings to such national accounts on a bulk basis, which, if successful, may result in additional revenues. We plan to hire or contract with a dedicated sales force, as well as customer account set-up/maintenance personnel.

Results Of Operations

Net revenue for the three month period ended December 31, 2003, was $13,866,967 compared to $5,505,890 for the three month period ended December 31, 2002, an increase of approximately 152%. This increase in net revenue is primarily the result of two factors: an increase in the number of our IAP Advertisers and an increase in our monthly pricing. These two factors are discussed further below.

Our IAP Advertiser count increased to 283,064 at December 31, 2003 compared to 168,980 at December 31, 2002, an increase of approximately 68%. Relating to our price increase, we charged $21.95 monthly versus $17.95 previously for new IAP Advertisers. In addition, the monthly charge to existing IAP Advertisers was increased to $24.95 per month upon the first anniversary of their listing. This price increase was instituted on March 20, 2003. As of January 1, 2004, we increased our monthly price for new IAP Advertisers to $29.95. For current customers, we intend to increase their monthly price to $29.95 from their current pricing after such customers have completed six months of advertising at their current monthly price.

We recently revised the method by which we count our customers. We believe that the new methodology is more accurate and can be more consistently applied to each period. We believe that the disclosure of customer counts including total Activated customers and paying customers provides the most insight into our business.

Activated customers include those Advertisers that are currently paying for the IAP service, as well as those Advertisers that have signed-up for the IAP service but have not necessarily been billed and begun their payment for the service. Based upon these revisions, we had 283,064 Activated IAP customers at December 31, 2003, 255,376 Activated IAP customers at September 30, 2003, 235,162 Activated IAP customers at June 30, 2003, 222,092, Activated IAP customers at March 31, 2003 and 168,980 Activated IAP customers at December 31, 2002.

Regarding Paying customers, the Company had 252,915 Paying customers at December 31, 2003, 221,537 Paying customers at September 30, 2003, 167,000 Paying customers at June 30, 2003, 151,173 Paying customers at March 31, 2003 and 137,346 Paying customers at December 31, 2002. The amount and frequency of collections on invoice- billed customers is significantly less than for customers billed on their monthly telephone bill. Therefore, revenue can be negatively impacted if the billing method used to bill a preferred listing customer converts from monthly telephone bill invoicing to direct invoicing. Also, revenue can be negatively impacted by customer requests for refunds and/or cancellations.

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Cost of services for the three month periods ended December 31, 2003 and December 31, 2002 were $4,882,402 and $1,586,585 respectively, an increase of approximately 208%. Cost of services is comprised of billing aggregator dilution expenses, certain direct mailer marketing costs and the amortization of such costs, allowances for bad debt and our billing costs including billing fees

charged by our billing aggregators. Dilution expenses include customer credits and any other receivable write-downs. The primary reason our cost of services has continued to increase is due primarily to the previously mentioned increase in IAP customers as well as increased dilution and billing fees resulting from our direct solicitation mailing efforts. Cost of services as a percent of net revenue was approximately 35% for the three months ended December 31, 2003 compared to approximately 29% for the same period in the prior fiscal year.

These increased costs resulted from the previously mentioned increased customer counts, as well as increased dilution costs resulting from the conversion of direct invoice billed customers to monthly telephone billing. We do not expect such dilution costs to increase at this same rate in the future. Amortization of direct marketing costs included in cost of sales is $1,065,864 for the three months ended December 31, 2003 and $932,816 for the prior year period.

Gross profits increased to $8,984,565 for the three months ended December 31, 2003 from $3,919,305 for the prior year period. Gross margins decreased to approximately 65% in the three months ended December 31, 2003 compared to approximately 71% in the prior year period.

General and administrative expense for the three month periods ended December 31, 2003 and December 31, 2002 were $2,790,743 and $1,376,078, respectively, an increase of approximately 102%. General and administrative expenses increased due to an increase in costs and employees relating to our growth in IAP customers, our Quality Assurance and Outbound marketing initiatives as well as an increase in certain officers' compensation relating to employment contracts with such officers. As a percent of net revenue, general and administrative expenses were approximately 20% for the three months ended December 31, 2003 compared to 25% for the comparable period in 2002. The reduction in general and administrative expenses as a percent of net revenue is the result of the leveraging our fixed cost infrastructure over a larger customer base.

Sales and marketing expenses are primarily the costs associated with our marketing relating to our direct mail solicitations. Sales and marketing expenses for the three month periods ended December 31, 2003 and December 31, 2002 were $1,290,180 and 632,435, respectively, an increase of approximately 104 %. The primary reason for the increase in sales and marketing is due to the Company fully re-instituting its marketing solicitation program and the implementation of new market strategies and modification of direct mail marketing pieces. Such marketing has resulted in the increase in IAP customers cited previously. As discussed in cost of services above, we capitalize certain direct marketing expenses and amortize those costs over an 18 month period based on the customer attrition rates analyzed by the Company. As a percent of net revenues, sales and marketing expenses were approximately 9% and approximately 11% for the three month periods ended December 31, 2003 and 2002, respectively.

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Depreciation and amortization primarily relates to the amortization of the Company's intellectual property and depreciation of equipment. Amortization relating to the capitalization of our direct mail marketing costs is included in cost of sales as discussed previously.

Depreciation and amortization expense was $196,193 in the three months ended December 31, 2003 compared to $138,932 for the three months ended December 31, 2002. Depreciation and amortization for the three ended December 31, 2003 increased slightly compared to the comparable period in 2002 due to additional purchases of equipment relating to our upgrade in infrastructure in the information technology department, hardware purchased relating to our Quality

Assurance and Outbound Marketing initiatives as well as a result of our agreement with OnRamp Access, Inc. to license the YP.Com Uniform Resource Locator ("URL"). Regarding the Company's other intellectual property, the cost of our Yellow-Page.Net URL license was capitalized at $5,000,000. The URL is amortized on an accelerated basis over the twenty-year term of the agreement. Amortization expense on the URL was $82,013 and $91,125 for the three month periods ended December 31, 2003 and December 31, 2002, respectively. Annual amortization expense in future years related to the URL is anticipated to be approximately $250,000-$350,000 As a result of the significant equipment purchases relating to the Company's previously-mentioned infrastructure additions, depreciation expense is expected to be greater in the current year periods compared to the prior year periods. However, we do not anticipate capital expenditures to grow at the same rate in the current fiscal year compared to the prior fiscal year.

Operating income for the three month period ended December 31, 2003 was $4,707,449 compared to $1,771,860 in the prior year period, an increase of approximately 166%. Operating margins increased to approximately 34% from approximately 32% in the prior year period. The increase in operating income is the result of the increased revenue discussed above and the leveraging of certain fixed expenses over a larger customer base.

Interest income , net of interest expense for the three month periods ended December 31, 2003 was $71,153. This compares to interest income, net of interest expense, of $720 for the three months ended December 31, 2002. The increase in the interest income, net of interest expense, primarily results from the Company's increased average cash position resulting from the Company's increased profitability as well as increased interest income resulting from the increase in advances to affiliates. We recorded other income of $ $274,758 and $48,906, respectively, for the three month periods ended December 31, 2003 and December 31, 2002.

The primary components of other income in the current year period is revenue of $221,778 received from Simple.Net, a related party (See Footnote 9 to the Financial Statements) for customer and technical services provided by the Company to Simple.Net. The primary component of other income in the prior year period was $48,906 recorded as a gain on the previously disclosed Van Sickle settlement. Net income before taxes for the three month periods ended December 31, 2003 and December 31, 2002 were $5,053,360 and $1,821,486, respectively, an increase of over 177%. Pre-tax margins increased to approximately 36% in the current period compared to approximately 33% in the prior year period. The increase in pre-tax income is a result of those factors that resulted in the increase in operating income in addition to the increased interest income and other income discussed above.

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The income tax provision was $1,768,675 in the three months ended December 31, 2003 compared to 728,594 in the prior year period. The increase in the income tax provision is the result of our increased profitability in current year period compared to the previous year period.

Net income for the three month periods ended December 31, 2003 and December 31, 2002 were $3,284,685, or $0.07 per diluted share, and $1,092,892, or $0.02 per diluted share, respectively, an increase in net income of over 200%. In the three month period ended December 31, 2003 compared to the comparable period in 2002, net income increased primarily due to the increase in IAP customers cited above with a less than corresponding increase in the expenses to service such customers due to nature of certain fixed infrastructure expenses which do not necessarily increase as revenues increase offset by costs incurred relating to the previously cited infrastructure additions. Net income as a percent of net

revenues for the three months ended December 31, 2003 was approximately 24% compared to approximately 20% for the comparable prior year period. The increase in the net margin is the result of the leveraging of certain fixed expenses over a larger customer base in the current year period.

Liquidity And Capital Resources

Net cash provided by operating activities for the three-month period ended December 31, 2003, was $867,008 compared to $700,104 for the three-month period ended December 31, 2002. The increase in cash generated from operations is primarily due to a significant increase in net income and corresponding income tax payable resulting from an increase in IAP customers offset by an increase in the accounts receivable balance from such growth and funds expended for mailings related to the Company's marketing efforts.

We had working capital of $8,087,290 as of December 31, 2003 compared to $3,964,798 as of December 30, 2002. The increase is due primarily to increases in cash of $266,626, accounts receivable of $5,657,656 and deferred taxes of $1,382,867 offset by increases in accrued liabilities of $1,125,822 and income taxes payable of $2,257,746. Cash used in investing activities was $2,089,698 for the three-month period ended December 31, 2003. The primary component of cash used was advances to affiliates of $2,000,000. As previously disclosed and discussed below, advances to affiliates are expected to cease in Fiscal 2004. We intend to institute a quarterly $0.01 per share dividend on our common stock at that time. This compares to the three-month period ended December 31, 2002, where cash used of $270,680 consisted primarily of purchases of equipment of $163,919 and lower advances to affiliates of $100,000. There was no cash used or provided by financing activities for the three-month period ended December 31, 2003, compared to cash used in financing activities of $307,000 for the three-month period ended December 31, 2002. The cash used represents total payments of $454,000 to reduce the principal balances of our outstanding debt reduced by financing of $147,000 under the Company's trade acceptance draft program with AcTrade Financial Technologies, Ltd. ("AcTrade"). In the past, the Company has borrowed from two credit facilities. These credit facilities are maintained primarily for safety and security back-up purposes as our cash flow is generally more than sufficient to maintain and grow the business. In Fiscal 2003, we established a Trade Acceptance Draft program with AcTrade, which enables us to borrow up to $150,000. A trade acceptance draft ("TAD") is a draft signed by us and made payable to the order of a vendor providing us services. AcTrade provides payment to the vendor and collects from us the amount advanced to the vendor (plus interest) under extended payment terms, generally 30, 60 or 90

days. When used, we pay a rate of one percent per month of the amount of the TAD. There is no term to the agreement with AcTrade and either party may terminate the agreement at any time.

We understand that AcTrade is currently in Chapter 11 bankruptcy. Therefore, the availability of this facility is uncertain. During Fiscal 2003, we signed an unsecured credit facility of $250,000 with Bank of the Southwest. The facility is for one year and interest on borrowings, if any, will be an interest rate of 0.5% above the Prime Rate, as defined. During recent discussions with the Bank of the Southwest, it was indicated to us that this credit facility will not be renewed as a result of their desire to focus on relationships with private rather than public companies. In Fiscal 2004, we expect to pursue other credit facilities to replace the aforementioned credit facilities.

We incurred debt in the acquisition of the license right to the

Yellow-Page.Net URL. A total of $5,000,000 was borrowed, $2,000,000 from Joseph and Helen Van Sickle, $1,000,000 from our shareholders and $2,000,000 as a Note from Mathew & Markson Ltd. We had dedicated payments in the amount of $100,000 per month for the payment of the Van Sickle note, which was paid in full in early Fiscal 2003. The original note has been paid in full while a balance of $115,866 remains on another note to Mathew & Markson.

As previously described, collections on accounts receivables are received primarily through the billing service aggregators under contract to administer this billing and collection process. The billing service aggregators generally do not remit funds until they are collected. The billing companies maintain holdbacks for refunds and other uncertainties. Generally, cash is collected and remitted to us over a 90 to 120 day period subsequent to the billing dates. In August 2002, we entered into a new agreement with its primary billing service provider, PaymentOne, whereby cash is remitted to us on a sixty day timetable beginning November 2002.

We market our products primarily through the use of direct mailers to businesses throughout the United States. We generally pay for these marketing costs when incurred and amortize the costs of direct-response advertising on a straight-line basis over eighteen months. The amortization lives are based on estimated attrition rates. During the three months ended December 31, 2003, we paid $ 1,284,770 in advertising and marketing compared to $983,810 in the prior year period. We anticipate the outlays for direct-response advertising to remain consistent over the next year.

We have an agreement with two of our largest shareholders, Morris & Miller, Ltd. and Mathew and Markson, Ltd., which is memorialized in a third Amendment to the original Stock Purchase Agreement. This agreement cancels the prior revolving lines of credit with these parties effective April 9, 2004 upon the payment of the following final specific advances to each of them:

Morris & Miller, Ltd.

$275,000 on January 30, 2004
$300,000 on February 27, 2004
$500,000 on March 31, 2004

Sufficient funds to pay 3 years interest on April 9, 2004

Mathew and Markson, Ltd.

$50,000 on January 30, 2004
$100,000 on February 27, 2004
$75,000 on March 31, 2004
Sufficient funds to pay 3 years interest on April 9, 2004

The Company expects to begin paying a $0.01 per share dividend each quarter after the above-described advances have been fully paid.

Prior to December 31, 2003, we created YP Charities, an Internal Revenue Code 501(c)(3) corporation, established to make charitable contributions to worthy causes on our behalf and to encourage other companies that are good corporate citizens to do the same. As of this filing, we have not remitted any amounts to YP Charities but plan to contribute $100,000 during fiscal 2004. At this time, the Board of Directors of YP Charities is identical to the Board of Directors of the Company.

Certain Risk Factors Affecting Our Business

Our business is subject to numerous risks, including those discussed below. If any of the events described in these risks occurs, our business, financial condition and results of operations could be seriously harmed.

OUR GROSS MARGINS MAY DECLINE OVER TIME. We expect that gross margins may be adversely affected because we have determined that profit margins from the electronic Yellow Pages offerings that we have profited from in the past have fluctuated. We have experienced a decrease in revenue from the LEC from the effects of the Competitive Local Exchange Carriers (CLEC) that are participating in providing local telephone services to customers. We have begun to address this problem and we are implementing data filters to reduce the effects of the CLEC's. We have also sought other billing methods to reduce the adverse effects of the CLEC billings. These other billing methods may be cheaper or more expensive than our current LEC billing and we have not yet determined if they will be less or more effective. We continue to look for profitable Internet opportunities; however there are no assurances that we will be successful, and presently we have no acquisitions in progress.

WE ARE DEPENDANT UPON KEY PERSONNEL. Our performance is substantially dependant on the performance of our executive officers and other key employees and our ability to attract, train, retain and motivate high quality personnel, especially highly qualified technical and managerial personnel. The loss of services of any executive officers or key employees could have a material adverse effect on our business, results of operations or financial condition. Competition for talented personnel is intense, and there is no assurance that we will be able to continue to attract, train, retain or motivate other highly qualified technical and managerial personnel in the future.

OUR OPERATING RESULTS ARE DIFFICULT TO PREDICT. Since our growth rate may slow, operating results for a particular quarter are difficult to predict: We expect that in the future, our net sales may grow at a slower rate on a quarter-to-quarter basis than experienced in previous periods. This may be a direct cause of a lower response rate, changes to our direct marketing pieces or regulatory matters discussed below. As a consequence, operating results for a particular quarter are extremely difficult to predict. Our ability to meet financial expectations could also be hampered if we are unable to correct the billing/dilution through the billing aggregators and CLEC markets seen recently or if direct mailing solicitations are not completed on a timely basis each month or if the timing whereby monthly billings are submitted to billing aggregators varies from month to month.

WE ARE SUBJECT TO A STRICT REGULATORY ENVIRONMENT. Existing laws and regulations and any future regulation may have a material adverse effect on our business. These effects could include substantial liability including fines and criminal penalties, preclusion from offering certain products or services and the prevention or limitation of certain marketing practices. As a result of such changes, our ability to increase our business through Internet usage could also be substantially limited.

OUR QUARTERLY RESULTS OF OPERATIONS COULD FLUCTUATE DUE TO FACTORS OUTSIDE OF OUR CONTROL, WHICH MAY CAUSE FLUCTUATIONS AND A CORRESPONDING DECREASE TO THE PRICE OF OUR SECURITIES. Our quarterly operating results may fluctuate for reasons that are not within our control, including:

- demand for our services, which may depend on a number of factors including economic conditions, customer response rates to our direct marketing, customer refunds/cancellations and our ability to continue to bill customers on their monthly telephone bills, ACH or credit card

rather than through direct invoicing;

- timing of new service or product introductions and market acceptance of new or enhanced versions of our services or products;

- our ability to develop and implement new services and technologies in a timely fashion to meet market demand as well as our ability to execute the mailing of our monthly direct mail solicitations;

- the actions of our competitors;

- the timing of billing and receipt of amounts from LEC's may vary, such that billing and revenues may fall into the subsequent fiscal quarter;

- the ability of our check processing service-providers to continue to process and provide billing information regarding our solicitation checks.

The fluctuation of our quarterly operating results, as well as other factors, could cause the market price of our securities to fluctuate and decrease. Some of these factors include:

- the announcement of new customers or strategic alliances or the loss of significant customers or strategic alliances;

- announcements by our competitors;

- sales or purchases of Company securities by officers, directors and insiders;

- government regulation;

- announcements regarding restructuring, borrowing arrangements, technological innovations, departures of key officers, directors or employees, or the introduction of new products; and

- general market conditions and other factors, including factors unrelated to our operating performance or that of our competitors.

Investors in our securities should be willing to incur the risk of such price fluctuations.

OUR ABILITY TO EFFICIENTLY PROCESS ADVERTISER SIGN-UP'S AND BILL OUR ADVERTISERS MONTHLY IS DEPENDENT UPON OUR CHECK PROCESSING SERVICE PROVIDERS AND BILLING AGGREGATORS, RESPECTIVELY. The Company currently uses three check processing companies to provide us with Advertiser information at the point of sign-up for our IAP. One of these processors has indicated that it will be outsourcing this function in the future. Our ability to gather information to bill our Advertisers at the point of sign-up could be adversely affected if one or more of these providers experienced a disruption in their operations or ceased to do business with us.

We also are dependent upon our billing aggregators to efficiently bill and collect monies from the LEC's relating to the LEC's billing and collection of our monthly charges from Advertisers. We currently have agreements with two billing aggregators and are currently in the process of negotiating an agreement with an additional billing aggregator. Any disruption in our billing aggregators' ability to perform these functions could adversely affect our financial condition and results of operations

WE FACE INTENSE COMPETITION, INCLUDING FROM COMPANIES WITH GREATER RESOURCES. THIS COMPETITIVE PRESSURE COULD LEAD TO CONTINUED DECREASES IN OUR REVENUES, WHICH WOULD ADVERSELY AFFECT OUR OPERATING RESULTS. Several companies currently market yellow-page services that directly compete with our services and products, including Yahoo and Microsoft. For several reasons, we may not compete effectively with existing and potential competitors. These reasons may include:

- Some competitors have greater financial resources and are in better financial condition than us;

- Some competitors have more extensive marketing and customer service and support capabilities;

- Some competitors may supply a broader range of services, enabling them to serve more or all of their customers' needs. This could limit sales for us and strengthen existing relationships that competitors have with customers, including our current and potential customers;

- Some competitors may be able to better adapt to changing market conditions and customer demand; and

- Other competitors not currently involved in the Internet-based yellow-page advertising business may enter the market or develop technology that reduces the need for our services.

Increased competitive pressure could lead to lower prices and reduced margins for our services. If we experience reductions in our revenue for any reason, our margins may continue to be reduced, which would adversely affect our results of operations. We cannot assure you that we will be able to compete successfully in the future.

STOCK PRICES OF TECHNOLOGY COMPANIES HAVE DECLINED PRECIPITOUSLY OVER THE LAST SEVERAL YEARS AND THE TRADING PRICE OF OUR COMMON STOCK IS LIKELY TO BE VOLATILE, WHICH COULD RESULT IN SUBSTANTIAL LOSSES TO INVESTORS. The trading price of our common stock has risen significantly over the past six months and could continue to be volatile in response to factors including the following, some of which are beyond our control:

- decreased demand in the Internet-services sector;

- variations in our operating results;

- announcements of technological innovations or new services by us or our competitors;

- changes in expectations of our future financial performance, including financial estimates by securities analysts and investors;

- changes in operating and stock price performance of other technology companies similar to us;

- conditions or trends in the technology industry;

- additions or departures of key personnel; and

- future sales of our common stock.

Domestic and international stock markets often experience significant price and volume fluctuations. These fluctuations, as well as general economic and political conditions unrelated to our performance, may adversely affect the price of our common stock.

TERRORIST ATTACKS AND THREATS OR ACTUAL WAR MAY NEGATIVELY IMPACT ALL ASPECTS OF OUR OPERATIONS, REVENUES, COSTS AND STOCK PRICE. Recent terrorist attacks in the United

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States, as well as future events occurring in response or connection to them, including, without limitation, future terrorist attacks against United States targets, rumors or threats of war, actual conflicts involving the United States or its allies or military or trade disruptions impacting our domestic or foreign suppliers of parts, components and subassemblies, may impact our operations, including, among other things, causing delays or losses in the delivery of supplies to us and decreased sales of our products. More generally, any of these events could cause consumer confidence and spending to decrease or result in increased volatility in the United States and worldwide financial markets and economy. They also could result in economic recession in the United States or abroad. Any of these occurrences could have a significant impact on our operating results, revenues and costs.

ITEM 3 CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed with an objective of ensuring that information required to be disclosed in our periodic reports filed with the Securities and Exchange Commission, such as this Quarterly Report on Form 10-QSB, is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Disclosure controls are also designed with an objective of ensuring that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, in order to allow timely consideration regarding required disclosures.

The evaluation of our disclosure controls by our principal executive officer and principal financial officer included a review of the controls' objectives and design, the operation of the controls, and the effect of the controls on the information presented in this Quarterly Report. Our management, including our chief executive officer and chief financial officer, does not expect that disclosure controls can or will prevent or detect all errors and all fraud, if any. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Also, projections of any evaluation of the disclosure controls and procedures to future periods are subject to the risk that the disclosure controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on their review and evaluation as of a date within 45 days of the filing of this Form 10-QSB, and subject to the inherent limitations all as described above, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective as of the end of the period covered by this report. They are not aware of any significant changes in our disclosure controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II - OTHER INFORMATION

Items 1-5 are not applicable and have been omitted.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K UPDATE

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(a) The following exhibits are either attached hereto or incorporated herein by reference as indicated:

Exhibit Number	Description
10	Amended and Restated YP.Net, Inc. 2003 Stock Plan
31	Certification pursuant to SEC Release No. 33-8238, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) The Registrant filed the following Current Reports on Form 8-K during the three-month period covered by this Quarterly Report:

- On October 14, 2003, the Company filed a Current Report on Form 8-K to disclose an Investor Fact Sheet under Regulation FD.
- On October 24, 2003, the Company filed a Current Report on Form 8-K to report the execution of an agreement with Integrated Payment Systems Inc. for additional third-party verification services and the execution of another agreement with UDS Directory Corp, d/b/a go2 Directory Systems to allow for the prominent display of certain customers' advertisements on wireless and hand-held devices provided by leading manufacturers.
- On December 31, 2003, the Company filed a Current Report on Form 8-K attaching a press release concerning the Company's earnings and results of operations for the Company's fiscal year ended September 30, 2003.

SIGNATURES

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

YP.NET, INC.

Dated: February 11, 2004 /s/ Angelo Tullo

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Angelo Tullo, Chairman of the Board and
Chief Executive Officer (Principal
Executive Officer)

Dated: February 11, 2004 /s/ David Iannini

David Iannini, Chief Financial Officer
(Principal Accounting Officer)

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EXHIBIT INDEX

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