

FULLNET COMMUNICATIONS INC
Form 10-Q
November 15, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

- 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: 000-27031

FULLNET COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

OKLAHOMA
(State or other jurisdiction of
incorporation or organization)

73-1473361
(I.R.S. Employer Identification No.)

201 Robert S. Kerr Avenue, Suite 210
Oklahoma City, Oklahoma 73102
(Address of principal executive offices)

(405) 236-8200
(Registrant's telephone number)

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Table of Contents

FORM 10-Q

TABLE OF CONTENTS

| | Page |
|---|------|
| PART I. FINANCIAL INFORMATION | |
| <u>Item 1. Financial Statements</u> | 3 |
| <u>Condensed Consolidated Balance Sheets — September 30, 2010 (Unaudited) and December 31, 2009 (Derived from Audited Statements)</u> | 3 |
| <u>Condensed Consolidated Statements of Operations — Three and Nine months ended September 30, 2010 and 2009 (Unaudited)</u> | 4 |
| <u>Condensed Consolidated Statement of Stockholders' Deficit — Nine months ended September 30, 2010 (Unaudited)</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows — Nine months ended September 30, 2010 and 2009 (Unaudited)</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 23 |
| <u>Item 4. Controls and Procedures</u> | 24 |
| PART II. OTHER INFORMATION | |
| <u>Item 1. Legal Proceedings</u> | 25 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 25 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 25 |
| <u>Item 5. Other Information</u> | 25 |
| <u>Item 6. Exhibits</u> | 26 |
| <u>Signatures</u> | 31 |

Exhibit 31.1

Exhibit 31.2

Exhibit 32.1

Exhibit 32.2

Table of Contents

Item 1. Financial Statements

FullNet Communications, Inc. and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEETS

| | SEPTEMBER 30, 2010 (Unaudited) | DECEMBER 31, 2009 (Derived from Audited Statements) |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash | \$ 8,539 | \$ 11,905 |
| Accounts receivable, net | 29,335 | 15,043 |
| Prepaid expenses and other current assets | 10,135 | 11,705 |
| Total current assets | 48,009 | 38,653 |
| PROPERTY AND EQUIPMENT, net | 92,758 | 120,944 |
| INTANGIBLE ASSETS, net | 67 | 998 |
| OTHER ASSETS | 5,250 | 5,250 |
| TOTAL | \$ 146,084 | \$ 165,845 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| CURRENT LIABILITIES | | |
| Accounts payable, current portion | \$ 559,042 | \$ 492,533 |
| Accrued and other current liabilities, current portion | 1,522,876 | 1,317,892 |
| Notes payable, current portion | 527,349 | 510,636 |
| Deferred revenue | 122,546 | 96,066 |
| Total current liabilities | 2,731,813 | 2,417,127 |
| ACCRUED AND OTHER LIABILITIES, less current portion | 13,698 | — |
| NOTES PAYABLE, less current portion | 280,587 | 297,300 |
| Total liabilities | 3,026,098 | 2,714,427 |
| STOCKHOLDERS' DEFICIT | | |
| Common stock — \$.00001 par value; authorized, 10,000,000 shares; issued and outstanding, 7,852,464 and 7,355,308 shares in 2010 and 2009, respectively | 79 | 74 |
| Common stock issuable, 70,257 and 567,413 shares in 2010 and 2009, respectively | 57,596 | 57,601 |

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10-Q

| | | |
|-----------------------------|--------------|--------------|
| Additional paid-in capital | 8,397,796 | 8,397,733 |
| Accumulated deficit | (11,335,485) | (11,003,990) |
| Total stockholders' deficit | (2,880,014) | (2,548,582) |
| TOTAL | \$ 146,084 | \$ 165,845 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FullNet Communications, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|---------------------|-------------------|------------------|
| | September | September | September | September |
| | 30, | 30, | 30, | 30, |
| | 2010 | 2009 | 2010 | 2009 |
| REVENUES | | | | |
| Access service revenues | \$ 60,131 | \$ 99,640 | \$ 223,797 | \$ 328,905 |
| Co-location and other revenues | 377,553 | 344,138 | 1,033,692 | 1,045,684 |
| Total revenues | 437,684 | 443,778 | 1,257,489 | 1,374,589 |
| OPERATING COSTS AND EXPENSES | | | | |
| Cost of access service revenues | 44,786 | 48,013 | 142,469 | 152,126 |
| Cost of co-location and other revenues | 111,269 | 99,376 | 299,712 | 296,239 |
| Selling, general and administrative expenses | 338,118 | 321,334 | 1,037,043 | 975,952 |
| Depreciation and amortization | 14,952 | 52,835 | 48,635 | 168,714 |
| Total operating costs and expenses | 509,125 | 521,558 | 1,527,859 | 1,593,031 |
| LOSS FROM OPERATIONS | (71,441) | (77,780) | (270,370) | (218,442) |
| INTEREST EXPENSE | (20,567) | (23,672) | (61,125) | (66,365) |
| NET LOSS | \$ (92,008) | \$ (101,452) | (331,495) | (284,807) |
| Net loss per share —basic | \$ (.01) | \$ (.01) | \$ (.04) | \$ (.04) |
| Net loss per share — assuming dilution | \$ (.01) | \$ (.01) | \$ (.04) | \$ (.04) |
| Weighted average shares outstanding — basic | 7,922,721 | 7,425,565 | 7,922,721 | 7,425,565 |
| Weighted average shares outstanding — assuming dilution | 7,922,721 | 7,425,565 | 7,922,721 | 7,425,565 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FullNet Communications, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIT (UNAUDITED)

Nine Months Ended September 30, 2010

| | Common stock | | Common | Additional | Accumulated | Total |
|---|--------------|--------|-----------|--------------|-----------------|----------------|
| | Shares | Amount | Stock | Paid In | Deficit | |
| | | | Issuable | Capital | | |
| Balance at January 1, 2010 | 7,355,308 | \$ 74 | \$ 57,601 | \$ 8,397,733 | \$ (11,003,990) | \$ (2,548,582) |
| Common stock issuable at December 31, 2009 issued on January 20, 2010 | 497,156 | 5 | (5) | — | — | — |
| Stock compensation expense | — | — | — | 63 | — | 63 |
| Net loss | — | — | — | — | (331,495) | (331,495) |
| Balance at September 30, 2010 | 7,852,464 | \$ 79 | \$ 57,596 | \$ 8,397,796 | \$ (11,335,485) | \$ (2,880,014) |

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

FullNet Communications, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| | Nine Months Ended | |
|--|--------------------------|--------------------------|
| | September 30, 2010 | September 30, 2009 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | \$ (331,495) | \$ (284,807) |
| Adjustments to reconcile net loss to net cash provided by operating activities | | |
| Depreciation and amortization | 48,635 | 168,714 |
| Stock compensation | 63 | 69 |
| Provision for uncollectible accounts receivable | 5,052 | 2,703 |
| Net (increase) decrease in | | |
| Accounts receivable | (19,344) | (8,867) |
| Prepaid expenses and other current assets | 1,570 | (997) |
| Net increase (decrease) in | | |
| Accounts payable — trade | 66,509 | (7,843) |
| Accrued and other liabilities | 218,682 | 150,389 |
| Deferred revenue | 26,480 | (14,689) |
| Net cash provided by (used in) operating activities | 16,152 | 4,672 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of property and equipment | (19,518) | (4,125) |
| Net cash used in investing activities | (19,518) | (4,125) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Principal payments on borrowings under notes payable | — | (100) |
| Net cash used in financing activities | — | (100) |
| Net increase (decrease) in cash | (3,366) | 447 |
| Cash at beginning of period | 11,905 | 11,753 |
| Cash at end of period | \$ 8,539 | \$ 12,200 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | |
| Cash paid for interest | \$ 15,112 | \$ 3,566 |
| Warrant extension granted in settlement of liabilities | — | 3,445 |

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

FullNet Communications, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. UNAUDITED INTERIM FINANCIAL STATEMENTS

The unaudited condensed consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the audited consolidated financial statements of the Company and notes thereto for the year ended December 31, 2009.

The information furnished reflects, in the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results of the interim periods presented. Operating results of the interim period are not necessarily indicative of the amounts that will be reported for the year ending December 31, 2010.

2. MANAGEMENT'S PLANS

At September 30, 2010, current liabilities exceed current assets by \$2,683,804. The Company does not have a line of credit or credit facility to serve as an additional source of liquidity. Historically the Company has relied on shareholder loans as an additional source of funds. The Company is in default on various loans (see Note 9 Notes Payable). These factors raise substantial doubts about the Company's ability to continue as a going concern.

During September 2005, the Company received an invoice from AT&T (formerly SBC) of approximately \$230,000 for services alleged to have been rendered to it between June 1, 2004 and June 30, 2005. Since then, the Company has received a number of additional invoices from AT&T which cover services through February 2007 and total approximately \$7,970,000. AT&T then stopped invoicing the Company for these monthly services and simply sent monthly Inter Company Billing Statements reflecting the balance of approximately \$7,970,000 with no further additions. The last Inter Company Billing Statement received by the Company was dated December 15, 2007 and reflected a balance of approximately \$7,970,000. The alleged services were eventually identified by AT&T as Switched Access services. The Company formally notified AT&T in writing that it disputes these invoices and requested that AT&T withdraw and/or credit all of these invoices in full. AT&T has not responded to the Company's written dispute. The Company believes AT&T has no basis for these charges. Therefore, the Company has not recorded any expense or liability related to these billings. An adverse outcome regarding this claim could have a materially adverse effect on the Company's ability to continue as a going concern.

The ability of the Company to continue as a going concern is dependent upon continued operations of the Company that in turn is dependent upon the Company's ability to meet its financing requirements on a continuing basis, to maintain present financing, to achieve the objectives of its business plan and to succeed in its future operations. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

Table of Contents

The Company's business plan includes, among other things, expansion of its Internet access services through mergers and acquisitions and the development of its web hosting, co-location, and traditional telephone services. Execution of the Company's business plan will require significant capital to fund capital expenditures, working capital needs and debt service. Current cash balances will not be sufficient to fund the Company's current business plan beyond the next few months. As a consequence, the Company is currently focusing on revenue enhancement and cost cutting opportunities as well as working to sell non-core assets and to extend vendor payment terms. The Company continues to seek additional convertible debt or equity financing as well as the placement of a credit facility to fund the Company's liquidity. There can be no assurance that the Company will be able to obtain additional capital on satisfactory terms, or at all, or on terms that will not dilute the shareholder's interests.

3. USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures; accordingly, actual results could differ from those estimates.

4. LOSS PER SHARE

Loss per share — basic is calculated by dividing net loss by the weighted average number of shares of stock outstanding during the period, including shares issuable without additional consideration. Loss per share — assuming dilution is calculated by dividing net loss by the weighted average number of shares outstanding during the period adjusted for the effect of dilutive potential shares calculated using the treasury stock method.

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------|-------------------|--------------|
| | September | September | September | September |
| | 30, | 30, | 30, | 30, |
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net loss | \$ (92,008) | \$ (101,452) | \$ (331,495) | \$ (284,807) |
| Denominator: | | | | |
| Weighted average shares outstanding — basic | 7,922,721 | 7,425,565 | 7,922,721 | 7,425,565 |
| Effect of dilutive stock options | — | — | — | — |
| Effect of dilutive warrants | — | — | — | — |
| Weighted average shares outstanding — assuming dilution | 7,922,721 | 7,425,565 | 7,922,721 | 7,425,565 |
| Net loss per share — basic | \$ (.01) | \$ (.01) | \$ (.04) | \$ (.04) |
| Net loss per share — assuming dilution | \$ (.01) | \$ (.01) | \$ (.04) | \$ (.04) |

Basic and diluted loss per share was the same for the three and nine months ended September 30, 2010 and 2009 because there was a net loss for each period.

Table of Contents

5. ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

| | September 30, 2010 | December 31, 2009 |
|---|--------------------------|-------------------------|
| Accounts receivable | \$ 224,966 | \$ 205,622 |
| Less allowance for doubtful accounts | (195,631) | (190,579) |
| | \$ 29,335 | \$ 15,043 |

6. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

| | September 30, 2010 | December 31, 2009 |
|-------------------------------|-----------------------|-------------------------|
| Computers and equipment | \$ 1,497,244 | \$ 1,477,727 |
| Leasehold improvements | 966,915 | 966,915 |
| Software | 57,337 | 57,337 |
| Furniture and fixtures | 28,521 | 28,521 |
| | 2,550,017 | 2,530,500 |
| Less accumulated depreciation | (2,457,259) | (2,409,556) |
| | \$ 92,758 | \$ 120,944 |

Depreciation expense for the three months ended September 30, 2010 and 2009 was \$14,721 and \$51,504, respectively. Depreciation expense for the nine months ended September 30, 2010 and 2009 was \$47,704 and \$161,390, respectively.

Table of Contents

7. INTANGIBLE ASSETS

Intangible assets consist primarily of acquired customer bases and covenants not to compete and are carried net of accumulated amortization. The Company amortizes these intangible assets over their estimated useful lives and in direct relation to any decreases in the acquired customer bases to which they relate. Management believes that such amortization reflects the pattern in which the economic benefits of the intangible asset are consumed or otherwise used.

Amortization expense for the three months ended September 30, 2010 and 2009 relating to intangible assets was \$231 and \$1,331, respectively. Amortization expense for the nine months ended September 30, 2010 and 2009 relating to intangible assets was \$931 and \$7,324, respectively.

8. ACCRUED AND OTHER CURRENT LIABILITIES

Accrued and other current liabilities consist of the following:

| | September 30, 2010 | December 31, 2009 |
|----------------------------------|--------------------------|----------------------|
| Accrued interest | \$ 507,957 | \$ 463,676 |
| Accrued deferred compensation | 819,923 | 700,157 |
| Accrued other liabilities | 208,694 | 154,059 |
| | 1,536,574 | 1,317,892 |
| Less current portion | 1,522,876 | 1,317,892 |
| | \$ 13,698 | \$ — |

Table of Contents

9. NOTES PAYABLE

Notes payable consist of the following:

| | September 30, 2010 | December 31, 2009 |
|---|--------------------------|-------------------------|
| Convertible promissory notes; interest at 12.5% of face amount, payable quarterly; these notes are unsecured and are matured at September 30, 2010 (convertible into approximately 1,003,659 shares at September 30, 2010 and December 31, 2009) (2) | \$ 510,636 | \$ 510,636 |
| Secured promissory note from a shareholder; interest at 6%, requires monthly installments of interest only for the first year then monthly installments of \$3,301 including principal and interest; maturing December 30, 2011; secured by all tangible and intangible assets of the Company (1) | 297,300 | 297,300 |
| | 807,936 | 807,936 |
| Less current portion | 527,349 | 510,636 |
| | \$ 280,587 | \$ 297,300 |

- (1) The Company agreed to issue additional shares of stock to the shareholder in the event that any additional shares are issued at less than \$.50 per share, excluding employee stock options, prior to the payment in full of the secured promissory note. At September 30, 2010, the outstanding principal and interest of the secured promissory note was \$297,300.
- (2) During 2000 and 2001, the Company issued 11% convertible promissory notes or converted other notes payable or accounts payable to convertible promissory notes in an amount totaling \$2,257,624. The terms of the Notes are 36 months with limited prepayment provisions. Each of the Notes may be converted by the holder at any time at \$1.00 per common stock share and by the Company upon registration and when the closing price of the Company's common stock has been at or above \$3.00 per share for three consecutive trading days. Additionally, the Notes are accompanied by warrants exercisable for the purchase of the number of shares of Company common stock equal to the number obtained by dividing 25% of the face amount of the Notes purchased by \$1.00. These warrants are exercisable at any time during the five years following issuance at an exercise price of \$.01 per share. Under the terms of the Notes, the Company was required to register the common stock underlying both the Notes and the detached warrants by filing a registration statement with the Securities and Exchange Commission within 45 days following the Final Expiration Date of the Offering (March 31, 2001). On May 31, 2001, the Company exchanged 2,064,528 shares of its common stock and warrants (exercisable for the purchase of 436,748 shares of common stock at \$2.00 per share) for convertible promissory notes in the principal amount of \$1,746,988 (recorded at \$1,283,893) plus accrued interest of \$123,414. The warrants expired on May 31, 2006. This exchange was accounted for as an induced debt conversion and a debt conversion expense of \$370,308 was recorded.

Pursuant to the provisions of the convertible promissory notes, the conversion price was reduced from \$1.00 per share on January 15, 2001 to \$.49 per share on December 31, 2003 for failure to register under the Securities Act of 1933, as amended, the common stock underlying the convertible promissory notes and underlying warrants on February 15, 2001. Reductions in conversion price are recognized at the date of reduction by an increase to additional paid-in capital and an increase in the discount on the convertible promissory notes. Furthermore, the interest rate was increased to 12.5% per annum from 11% per annum because the registration

statement was not filed before March 1, 2001. At September 30, 2010, the outstanding principal and interest of the convertible promissory notes was \$1,018,593.

On January 1, 2002, the Company recorded 11,815 shares of common stock issuable in payment of \$11,815 accrued interest on a portion of the Company's convertible promissory notes.

In November and December 2003 and March 2004, \$455,000, \$50,000 and \$5,636, respectively, of these convertible promissory notes matured. The Company has not made payment or negotiated an extension of these notes, and the lenders have not made any demands. The Company is currently developing a plan to satisfy these notes subject to the approval of each individual note holder.

Table of Contents

10. COMMON STOCK OPTIONS AND WARRANTS

The following table summarizes the Company's employee stock option activity for the three and nine months ended September 30, 2010:

| | Three Months Ended September 30, 2010 | Weighted Average Exercise Price | Nine Months Ended September 30, 2010 | Weighted Average Exercise Price |
|--|--|--|---|--|
| Options outstanding, beginning of the period | 2,258,251 | \$.39 | 2,368,384 | \$.50 |
| Options cancelled during the period | (69,000) | 1.60 | (179,133) | 2.28 |
| Options outstanding, end of the period | 2,189,251 | \$.36 | 2,189,251 | \$.36 |

The Company records compensation cost for new and modified awards over the related vesting period of such awards prospectively.

In January 2009, the Company agreed to extend the expiration date on 425,000 of common stock purchase warrants for a lessor in return for a credit of \$3,445 on an operating lease.

The following table summarizes the Company's common stock purchase warrant and non-employee stock option activity for the three and nine months ended September 30, 2010:

| | Three Months Ended September 30, 2010 | Weighted Average Exercise Price | Nine Months Ended September 30, 2010 | Weighted Average Exercise Price |
|--|--|--|---|--|
| Warrants and non-employee stock options outstanding, beginning and end of the period | 591,000 | \$.49 | 591,000 | \$.49 |

11. RECENTLY ISSUED ACCOUNTING STANDARDS

Fair Value Measurements and Disclosures (Accounting Standards Update ("ASU") No. 2010-06)

In January 2010, previously released guidance on fair value measurements and disclosures was amended. The amendment requires disclosure of transfers into and out of Level 1 and Level 2 fair value measurements, and also requires more detailed disclosure about the activity within Level 3 fair value measurements. The fair value measurements hierarchy gives the highest priority ("Level 1") to unadjusted quoted prices in active markets for identical assets and liabilities and the lowest priority ("Level 3") to unobservable inputs. Fair value measurements primarily based on observable market information are given a "Level 2" priority. A portion of the amendment was effective for the Company on January 1, 2010 and requires the disclosure of transfers into and out of Level 1 and Level 2 fair value measurements; the amendment's requirements related to Level 3 disclosures are effective for the Company on January 1, 2011. This guidance affects new disclosures only and will have no impact on the

Company's consolidated financial statements.

-12-

Table of Contents

12. COMMON STOCK

On December 29, 2009 the Company converted \$248,578 of accrued interest on an interim loan from a shareholder into 497,156 restricted shares of the Company's common stock valued at \$.50 per share. These shares were issuable at December 31, 2009, were equal to approximately 6.8% of the total number of shares outstanding and were issued on January 20, 2010. During the fourth quarter of 2009 this transaction was accounted for as a troubled debt restructuring and a gain on debt forgiveness of \$235,663 was recorded. In connection with the conversion, the Company also agreed to issue additional shares of stock to the holder of a secured promissory note in the event that any additional shares are issued at less than \$.50 per share, excluding employee stock options, prior to the payment in full of the secured promissory note (see Note 9 — Notes Payable). During the nine months ended September 30, 2010, no shares were issued by the Company at less than \$.50 per share.

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC 820-10 requires that an entity disclose the fair value of financial instruments for which it is practicable to estimate the value. The Company considers the carrying value of certain financial instruments on the balance sheets, including cash, accounts receivable, and other assets to be reasonable estimates of fair value. At September 30, 2010 and December 31, 2009, the carrying amount of the Company's liabilities for corporate borrowings and other obligations was \$3,026,098 and \$2,714,427, respectively, and the fair value was estimated to be approximately \$146,000 and \$165,000, respectively. These amounts are based on the present value of estimated future cash outflows which is discounted based on the risk of nonperformance due to the uncertainty of the Company's ability to continue as a going concern.

14. CERTAIN RELATIONSHIPS

The Company has an operating lease for certain equipment which is leased from one of its shareholders whose parent company holds a \$297,300 secured promissory note (see Note 9 — Notes Payable). The original lease was dated November 21, 2001 and the terms were \$6,088 per month for 12 months with a fair market purchase option at the end of the lease. Upon default on the lease, the Company was allowed to continue leasing the equipment on a month-to-month basis at the same monthly rate as the original lease. The Company was unable to make the month-to-month payments. In January and November 2006, the Company agreed to extend the expiration date on of common stock purchase warrants exercisable for the purchase of 425,000 common stock shares and a credit of \$17,960 and for the purchase of 140,000 common stock shares and a credit of \$3,940, respectively, on the operating lease. In September 2007, the lessor agreed to cease the monthly lease payments effective January 1, 2007 which generated a total of \$54,795 of forgiveness of debt income. The lessor also agreed to accept payments of \$499 per month on the balance owed. In January and December 2009, the Company agreed to extend the expiration date on 425,000 and 140,000, respectively, of common stock purchase warrants exercisable for the purchase of 425,000 common stock shares and a credit of \$3,445 and for the purchase of 140,000 common stock shares and a credit of \$773, respectively, on the operating lease. At September 30, 2010 and December 31, 2009 the Company had recorded \$256,443 in unpaid lease payments. The loss of this equipment would have a material adverse effect on the Company's business, financial condition and results of operations. The Company has been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lessor has not made any formal demands for payment or instituted collection action; however the Company is in discussions with the lessor to restructure this liability.

Table of Contents

15. CONCENTRATIONS

During the nine months ended September 30, 2010 and 2009, the Company had one customer that comprised approximately 14% and 12%, respectively, of total revenues. During the three months ended September 30, 2010 and 2009, this customer comprised approximately 13% and 14%, respectively, of total revenues.

16. EMPLOYEE BENEFIT PLANS

The Company offers a SIMPLE IRA plan for all eligible employees. Employees meeting certain eligibility requirements can participate in the plan. Under the plan, the Company matches employee contributions to the plan up to 3% of the employee's salary. The Company made matching contributions of \$2,841 and \$3,476, respectively, during the quarters ended September 30, 2010 and 2009. The Company made matching contributions of \$8,611 and \$10,088, respectively, during the nine months ended September 30, 2010 and 2009.

17. CONTINGENCIES

During September 2005, the Company received an invoice from AT&T (formerly SBC) of approximately \$230,000 for services alleged to have been rendered to the Company between June 1, 2004 and June 30, 2005. Through February 2006, the Company received a number of additional invoices from AT&T making adjustments to these amounts and expanding the service period through September 30, 2005, at which point the balance due was alleged to be approximately \$400,000.

AT&T then began invoicing the Company on a monthly basis (two months in arrears of the alleged service date) for these services and continued invoicing the Company for these monthly services through February 2007, at which point the alleged balance due was approximately \$7,970,000. AT&T then stopped invoicing the Company for these monthly services and simply sent monthly Inter Company Billing Statements reflecting the balance of approximately \$7,970,000 with no further additions.

The last Inter Company Billing Statement received by the Company was dated December 15, 2007 and reflected a balance of approximately \$7,970,000. The alleged services were eventually identified by AT&T as Switched Access services. The Company formally notified AT&T in writing that it disputed these billings and requested that AT&T withdraw and/or credit all of these billings in full. AT&T has not responded to the Company's written dispute, nor has it sent the Company any further Inter Company Billing Statements since December 15, 2007. AT&T has never taken any other steps to attempt to collect these amounts nor has it ever responded to the Company's written dispute of said amounts. The Company believes AT&T has no basis for these charges. Therefore, the Company has not recorded any expense or liability related to these billings.

Table of Contents

As a provider of telecommunications, the Company is affected by regulatory proceedings in the ordinary course of its business at the state and federal levels. These include proceedings before both the Federal Communications Commission and the Oklahoma Corporation Commission (“OCC”). In addition, in its operations the Company relies on obtaining many of its underlying telecommunications services and/or facilities from incumbent local exchange carriers or other carriers pursuant to interconnection or other agreements or arrangements. In January 2007, the Company concluded a regulatory proceeding pursuant to the Federal Telecommunications Act of 1996 before the OCC relating to the terms of its interconnection agreement with Southwestern Bell Telephone, L.P. d/b/a AT&T, which succeeds a prior interconnection agreement. The OCC approved this agreement in May 2007. This agreement may be affected by regulatory proceedings at the federal and state levels, with possible adverse impacts on the Company. The Company is unable to accurately predict the outcomes of such regulatory proceedings at this time, but an unfavorable outcome could have a material adverse effect on the Company’s business, financial condition or results of operations.

During February 2009, the Enforcement Bureau of the Federal Communications Commission issued an Omnibus Notice of Apparent Liability for Forfeiture (“NAL”) to the Company in the amount of \$20,000 for failure to timely file a certification report concerning so-called Customer Proprietary Network Information (“CPNI”). There were approximately 690 other telecommunications companies included in the NAL. Each company has the opportunity to submit further evidence and arguments in response to the NAL to show that no forfeiture should be imposed or that some lesser amount should be assessed. The Company filed a formal response to the NAL pursuant to which a waiver of the Forfeiture was requested. In October 2010 the FCC agreed to settle this issue for \$700. The Company recorded an accrual for this NAL at September 30, 2010.

18. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the time of filing these financial statements with the Securities and Exchange Commission.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion is qualified in its entirety by the more detailed information in our Form 10-K and the financial statements contained therein, including the notes thereto, and our other periodic reports filed with the Securities and Exchange Commission since December 31, 2009 (collectively referred to as the "Disclosure Documents"). Certain forward-looking statements contained in this Report and in the Disclosure Documents regarding our business and prospects are based upon numerous assumptions about future conditions which may ultimately prove to be inaccurate and actual events and results may materially differ from anticipated results described in such statements. Our ability to achieve these results is subject to certain risks and uncertainties, including those inherent risks and uncertainties generally in the Internet service provider and competitive local exchange carrier industries, the impact of competition and pricing, changing market conditions, and other risks. Any forward-looking statements contained in this Report represent our judgment as of the date of this Report. We disclaim, however, any intent or obligation to update these forward-looking statements. As a result, the reader is cautioned not to place undue reliance on these forward-looking statements. References to us in this report include our subsidiaries: FullNet, Inc. ("FullNet"), FullTel, Inc. ("FullTel") and FullWeb, Inc. ("FullWeb").

Overview

We are an integrated communications provider offering integrated communications and Internet connectivity to individuals, businesses, organizations, educational institutions and government agencies. Through our subsidiaries, we provide high quality, reliable and scalable Internet access, web hosting, equipment co-location and traditional telephone services. Our overall strategy is to become a successful integrated communications provider for residents and small to medium-sized businesses in Oklahoma.

Our principal executive offices are located at 201 Robert S. Kerr Avenue, Suite 210, Oklahoma City, Oklahoma 73102, and our telephone number is (405) 236-8200. We also maintain Internet sites on the World Wide Web ("WWW") at www.fullnet.net and www.fulltel.com. Information contained on our Web sites is not and should not be deemed to be a part of this Report.

Company History

We were founded in 1995 as CEN-COM of Oklahoma, Inc., an Oklahoma corporation, to bring dial-up Internet access and education to rural locations in Oklahoma that did not have dial-up Internet access. We changed our name to FullNet Communications, Inc. in December 1995. Today we are a total solutions provider to individuals and companies seeking a "one-stop shop" in Oklahoma.

Our current business strategy is to become a successful integrated communications provider in Oklahoma. We expect to grow through the acquisition of additional customers for our carrier-neutral co-location space and traditional telephone services, as well as through the acquisition of Internet service providers.

We market our carrier neutral co-location solutions in our network operations center to other competitive local exchange carriers, Internet service providers and web-hosting companies. Our co-location facility is carrier neutral, allowing customers to choose among competitive offerings rather than being restricted to one carrier. Our network operations center is Telco-grade and provides customers a high level of operative reliability and security. We offer flexible space arrangements for customers and 24-hour onsite support with both battery and generator backup.

Table of Contents

Through FullTel, our wholly owned subsidiary, we are a fully licensed competitive local exchange carrier or CLEC in Oklahoma. FullTel activates local access telephone numbers for the cities in which we market, sell and operate our retail FullNet Internet service provider brand, wholesale dial-up Internet service; our business-to-business network design, connectivity, domain and Web hosting businesses; and traditional telephone services. At September 30, 2010 FullTel provided us with local telephone access in approximately 232 cities.

Our common stock trades on the OTC Bulletin Board under the symbol FULO. While our common stock trades on the OTC Bulletin Board, it is very thinly traded, and there can be no assurance that our stockholders will be able to sell their shares should they so desire. Any market for the common stock that may develop, in all likelihood, will be a limited one, and if such a market does develop, the market price may be volatile.

Results of Operations

The following table sets forth certain statement of operations data as a percentage of revenues for the three and nine months ended September 30, 2010 and 2009:

| | Three Months Ended | | | | Nine Months Ended | | | |
|---|-----------------------|--------------|-----------------------|--------------|-----------------------|--------------|-----------------------|--------------|
| | September 30, 2010 | | September 30, 2009 | | September 30, 2010 | | September 30, 2009 | |
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| Revenues: | | | | | | | | |
| Access service revenues | \$ 60,131 | 13.7% | \$ 99,640 | 22.45% | \$ 223,797 | 17.8% | \$ 328,905 | 23.9% |
| Co-location and other revenues | 377,553 | 86.3 | 344,138 | 77.5 | 1,033,692 | 82.2 | 1,045,684 | 76.1 |
| Total revenues | 4.37,684 | 100.0 | 443,778 | 100.0 | 1,257,489 | 100.0 | 1,374,589 | 100.0 |
| Cost of access service revenues | | | | | | | | |
| Cost of access service revenues | 44,786 | 10.2 | 48,013 | 10.8 | 142,469 | 11.3 | 152,126 | 11.1 |
| Cost of co-location and other revenues | | | | | | | | |
| Cost of co-location and other revenues | 111,269 | 25.4 | 99,376 | 22.4 | 299,712 | 23.8 | 296,239 | 21.5 |
| Selling, general and administrative expenses | | | | | | | | |
| Selling, general and administrative expenses | 338,118 | 77.3 | 321,334 | 72.4 | 1,037,043 | 82.5 | 975,952 | 71.0 |
| Depreciation and amortization | | | | | | | | |
| Depreciation and amortization | 14,952 | 3.4 | 52,835 | 11.9 | 48,635 | 3.9 | 168,714 | 12.3 |
| Total operating costs and expenses | | | | | | | | |
| Total operating costs and expenses | 509,125 | 116.3 | 521,558 | 117.5 | 1,527,859 | 121.5 | 1,593,031 | 115.9 |
| Loss from operations | | | | | | | | |
| Loss from operations | (71,441) | (16.3) | (77,780) | (17.5) | (270,370) | (21.5) | (218,442) | (15.9) |
| Interest expense | | | | | | | | |
| Interest expense | (20,567) | (4.7) | (23,672) | (5.3) | (61,125) | (4.9) | (66,365) | (4.8) |
| Net loss | | | | | | | | |
| Net loss | \$ (92,008) | (21.0)% | \$ (101,452) | (22.8)% | \$ (331,495) | (26.4)% | \$ (284,807) | (20.7)% |

Table of Contents

Three Months Ended September 30, 2010 (the “2010 3rd Quarter”) Compared to Three Months Ended September 30, 2009 (the “2009 3rd Quarter”)

Revenues

Access service revenues decreased \$39,509 or 39.7% to \$60,131 for the 2010 3rd Quarter from \$99,640 for the same period in 2009 primarily due to a decline in number of our customers.

Co-location and other revenues increased \$33,415 or 9.7% to \$377,553 for the 2010 3rd Quarter from \$344,138 for the same period in 2009. This increase was primarily attributable to non-recurring revenues of \$36,719 and the net addition of new customers and the sale of additional services to existing customers of \$12,278 offset by a decline in usage by our wholesale customers of \$15,582.

Operating Costs and Expenses

Cost of access service revenues decreased \$3,227 or 6.7% to \$44,786 for the 2010 3rd Quarter from \$48,013 for the same period in 2009. This decrease was primarily due to reductions in recurring costs associated with our network. Cost of access service revenues as a percentage of access service revenues increased to 74.5% during the 2010 3rd Quarter, compared to 48.2% during the same period in 2009.

Cost of co-location and other revenues increased \$11,893 or 12.0% to \$111,269 for the 2010 3rd Quarter from \$99,376 for the same period in 2009 primarily due to non-recurring costs of \$14,011 offset by reductions in recurring rental costs and equipment maintenance costs. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 29.5% during the 2010 3rd Quarter, compared to 28.9% during the same period in 2009.

Selling, general and administrative expenses increased \$16,784 or 5.2% to \$338,118 for the 2010 3rd Quarter compared to \$321,334 for the same period in 2009 primarily attributable to increases in employee related costs and rent of \$16,142 and \$12,985, respectively. These increases were offset primarily by decreases in professional services and utilities of \$7,018 and \$4,756, respectively. Selling, general and administrative expenses as a percentage of total revenues increased to 77.3% during the 2010 3rd Quarter from 72.4% during the same period in 2009.

Depreciation and amortization expense decreased \$37,883 or 71.7% to \$14,952 for the 2010 3rd Quarter compared to \$52,835 for the same period in 2009 primarily related to several assets reaching full depreciation.

Interest Expense

Interest expense decreased \$3,105 or 13.1% to \$20,567 for the 2010 3rd Quarter compared to \$23,672 for the same period in 2009 primarily due to a lower interest rate resulting from the conversion of an interim loan to a secured promissory note in December 2009.

Table of Contents

Nine Months Ended September 30, 2010 (the “2010 Period”) Compared to Nine Months Ended September 30, 2009 (the “2009 Period”)

Revenues

Access service revenues decreased \$105,108 or 32.0% to \$223,797 for the 2010 Period from \$328,905 for 2009 Period primarily due to a decline in our number of customers.

Co-location and other revenues decreased \$11,992 or 1.1% to \$1,033,692 for the 2010 Period from \$1,045,684 for the 2009 Period. This decrease was primarily attributable to a decline in usage by our wholesale customers of \$95,016 offset by non-recurring revenues of \$43,649 and the net addition of new customers and the sale of additional services to existing customers of \$39,375.

Operating Costs and Expenses

Cost of access service revenues decreased \$9,657 or 6.3% to \$142,469 for the 2010 Period from \$152,126 for the 2009 Period. This decrease was primarily due to reductions in recurring costs associated with our network. Cost of access service revenues as a percentage of access service revenues increased to 63.7% during the 2010 Period, compared to 46.3% during the 2009 Period.

Cost of co-location and other revenues increased \$3,473 or 1.2% to \$299,712 for the 2010 Period from \$296,239 for the 2009 Period primarily attributable to non-recurring costs of \$14,011 which were offset by reductions in recurring rental costs and equipment maintenance costs. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 29.0% during the 2010 Period, compared to 28.3% during the 2009 Period.

Selling, general and administrative expenses increased \$61,091 or 6.3% to \$1,037,043 for the 2010 Period compared to \$975,952 for the 2009 Period primarily attributable to increases in employee related costs, rent and property tax of \$46,164, \$31,267 and \$4,377, respectively. These increases were offset by decreases in utilities and professional fees of \$13,291 and \$7,836, respectively. Selling, general and administrative expenses as a percentage of total revenues increased to 82.5% during the 2010 Period from 71.0% during the 2009 Period.

Depreciation and amortization expense decreased \$120,079 or 71.2% to \$48,635 for the 2010 Period compared to \$168,714 for the 2009 Period primarily related to several assets reaching full depreciation.

Interest Expense

Interest expense decreased \$5,240 or 7.9% to \$61,125 for the 2010 Period compared to \$66,365 for the 2009 Period primarily due to a lower interest rate resulting from the conversion of an interim loan to a secured promissory note in December 2009.

Liquidity and Capital Resources

As of September 30, 2010, we had \$8,539 in cash and \$2,731,813 in current liabilities, including \$122,546 of deferred revenues that will not require settlement in cash.

Table of Contents

At September 30, 2010, we had a working capital deficit of \$2,683,804, while at December 31, 2009 we had a working capital deficit of \$2,378,474. We do not have a line of credit or credit facility to serve as an additional source of liquidity. Historically we have relied on shareholder loans as an additional source of funds.

As of September 30, 2010, of the \$302,599 we owed to our trade creditors \$214,425 was past due. We have no formal agreements regarding payment of these amounts. At September 30, 2010, \$256,443 payable under a matured lease obligation was outstanding and we had outstanding principal and interest owed on matured notes totaling \$1,018,593. We have not made payment or negotiated an extension of the notes and the lenders have not made any payment demands. We are currently developing a plan to satisfy these notes on terms acceptable to the note holders.

In addition, during the nine months ended September 30, 2010 and 2009, the Company had one customer that comprised approximately 14% and 12%, respectively, of total revenues. During each of the 3rd Quarter 2010 and 2009, this customer comprised approximately 13% and 14%, respectively, of total revenues.

During September 2005, we received an invoice from AT&T (formerly SBC) of approximately \$230,000 for services alleged to have been rendered to us between June 1, 2004 and June 30, 2005. Since then, we have received a number of additional invoices from AT&T which cover services through February 2007 and total approximately \$7,970,000. AT&T stopped invoicing us for these monthly services and simply sent monthly Inter Company Billing Statements reflecting the balance of approximately \$7,970,000 with no further additions. The last Inter Company Billing Statement we received was dated December 15, 2007 and reflected a balance of approximately \$7,970,000. The alleged services were eventually identified by AT&T as Switched Access services. We formally notified AT&T in writing that we dispute these invoices and requested that AT&T withdraw and/or credit all of these invoices in full. AT&T has not responded to our written dispute. We believe AT&T has no basis for these charges. Therefore, we have not recorded any expense or liability related to these billings.

During February 2009, the Enforcement Bureau of the Federal Communications Commission issued an Omnibus Notice of Apparent Liability for Forfeiture (“NAL”) to us in the amount of \$20,000 for failure to timely file a certification report concerning so-called Customer Proprietary Network Information (“CPNI”). There were approximately 690 other telecommunications companies included in the NAL. Each company has the opportunity to submit further evidence and arguments in response to the NAL to show that no forfeiture should be imposed or that some lesser amount should be assessed. We filed a formal response to the NAL pursuant to which a waiver of the Forfeiture was requested. In October 2010 the FCC agreed to settle this issue for \$700. We recorded an accrual for this NAL at September 30, 2010.

Cash flow for the nine-month periods ending September 30, 2010 and 2009 consist of the following:

| | For the Nine-Month Periods Ended September 30, | |
|---|--|----------|
| | 2010 | 2009 |
| Net cash flows provided by operations | \$ 16,152 | \$ 4,672 |
| Net cash flows used in investing activities | (19,518) | (4,125) |
| Net cash flows used in financing activities | — | (100) |

Table of Contents

The planned expansion of our business will require significant capital to fund capital expenditures, working capital needs, and debt service. Our principal capital expenditure requirements will include:

- mergers and acquisitions and
- further development of operations support systems and other automated back office systems

Because our cost of developing new networks and services, funding other strategic initiatives, and operating our business depend on a variety of factors (including, among other things, the number of subscribers and the service for which they subscribe, the nature and penetration of services that may be offered by us, regulatory changes, and actions taken by competitors in response to our strategic initiatives), it is almost certain that actual costs and revenues will materially vary from expected amounts and these variations are likely to increase our future capital requirements. Our current cash balances will not be sufficient to fund our current business plan beyond a few months. As a consequence, we are currently focusing on revenue enhancement and cost cutting opportunities as well as working to sell non-core assets and to extend vendor payment terms. We continue to seek additional convertible debt or equity financing as well as the placement of a credit facility to fund our liquidity needs. There is no assurance that we will be able to obtain additional capital on satisfactory terms or at all or on terms that will not dilute our shareholders' interests.

Until we obtain sufficient additional capital, the further development of our network will be delayed or we will be required take other actions. Our inability to obtain additional capital resources has had and will continue to have a material adverse effect on our business, operating results and financial condition.

Our ability to fund the capital expenditures and other costs contemplated by our business plan and to make scheduled payments with respect to bank borrowings will depend upon, among other things, our ability to seek and obtain additional financing in the near term. Capital will be needed in order to implement our business plan, deploy our network, expand our operations and obtain and retain a significant number of customers in our target markets. Each of these factors is, to a large extent, subject to economic, financial, competitive, political, regulatory, and other factors, many of which are beyond our control.

There is no assurance that we will be successful in developing and maintaining a level of cash flows from operations sufficient to permit payment of our outstanding indebtedness. If we are unable to generate sufficient cash flows from operations to service our indebtedness, we will be required to modify or abandon our growth plans, limit our capital expenditures, restructure or refinance our indebtedness or seek additional capital or liquidate our assets. There is no assurance that (i) any of these strategies could be effectuated on satisfactory terms, if at all, or on a timely basis or (ii) any of these strategies will yield sufficient proceeds to service our debt or otherwise adequately fund operations.

Financing Activities

We have a secured promissory note from a shareholder which requires monthly installments of interest only through December 30, 2010 then monthly installments of \$3,301 including principal and interest which matures December 30, 2011 and is secured by all of our tangible and intangible assets (see Note 9 — Notes Payable to our financial statements, above). We agreed to issue additional shares of stock to the shareholder in the event that any additional shares are issued at less than \$.50 per share, excluding employee stock options, prior to the payment in full of the secured promissory note. At September 30, 2010, the outstanding principal and interest of the secured promissory note was \$297,300.

Table of Contents

We have an operating lease for certain equipment which is leased from one of our shareholders whose parent company holds a \$297,300 secured promissory note (see Note 9 — Notes Payable). The original lease was dated November 21, 2001 and the terms were \$6,088 per month for 12 months with a fair market purchase option at the end of the lease. Upon default on the lease, we were allowed to continue leasing the equipment on a month-to-month basis at the same monthly rate as the original lease. We were unable to make the month-to-month payments. In January and November 2006, we agreed to extend the expiration date of common stock purchase warrants exercisable for the purchase of 425,000 common stock shares and a credit of \$17,960 and for the purchase of 140,000 common stock shares and a credit of \$3,940, respectively, on the operating lease. In September 2007, the lessor agreed to cease the monthly lease payments effective January 1, 2007 which generated a total of \$54,795 of forgiveness of debt income. The lessor also agreed to accept payments of \$499 per month on the balance owed. In January and December 2009, the Company agreed to extend the expiration date on 425,000 and 140,000, respectively, of common stock purchase warrants exercisable for the purchase of 425,000 common stock shares and a credit of \$3,445 and for the purchase of 140,000 common stock shares and a credit of \$773, respectively, on the operating lease. At September 30, 2010 and December 31, 2009 we had recorded \$256,443 in unpaid lease payments. The loss of this equipment would have a material adverse effect on our business, financial condition and results of operations. We have been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lessor has not made any formal demands for payment or instituted collection action; however we are in discussions with the lessor to restructure this liability.

Pursuant to the provisions of the convertible promissory notes (see Note 9 — Notes Payable to our financial statements, above), the conversion price was reduced from \$1.00 per share on January 15, 2001 to \$.49 per share on December 31, 2003 for failure to register under the Securities Act of 1933, as amended, the common stock underlying the convertible promissory notes and underlying warrants on February 15, 2001. Reductions in conversion price were recognized at the date of reduction by an increase to additional paid-in capital and an increase in the discount on the notes payable. Furthermore, the interest rate was increased to 12.5% per annum from 11% per annum because the registration statement was not filed before March 1, 2001. In November and December 2003 and March 2004, \$455,000, \$50,000 and \$5,636, respectively, of these convertible promissory notes matured. We have not made payment or negotiated an extension of these notes, and the lenders have not made any demands. At September 30, 2010, the outstanding principal and interest of the convertible promissory notes was \$1,018,593.

Recently Issued Accounting Standards

Fair Value Measurements and Disclosures (ASU No. 2010-06)

In January 2010, previously released guidance on fair value measurements and disclosures was amended. The amendment requires disclosure of transfers into and out of Level 1 and Level 2 fair value measurements, and also requires more detailed disclosure about the activity within Level 3 fair value measurements. The fair value measurements hierarchy gives the highest priority (“Level 1”) to unadjusted quoted prices in active markets for identical assets and liabilities and the lowest priority (“Level 3”) to unobservable inputs. Fair value measurements primarily based on observable market information are given a “Level 2” priority. A portion of the amendment was effective for us on January 1, 2010 and requires the disclosure of transfers into and out of Level 1 and Level 2 fair value measurements; the amendment’s requirements related to Level 3 disclosures are effective for us at on January 1, 2011. This guidance affects new disclosures only and will have no impact on our consolidated financial statements.

Table of Contents

Critical Accounting Policies and Estimates

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect certain reported amounts and disclosures. In applying our accounting principles, we must often make individual estimates and assumptions regarding expected outcomes or uncertainties. As you might expect, the actual results or outcomes are generally different than the estimated or assumed amounts. These differences are usually minor and are included in our consolidated financial statements as soon as they are known. Our estimates, judgments and assumptions are continually evaluated based on available information and experience. Because of the use of estimates inherent in the financial reporting process, actual results could differ from those estimates.

During September 2005, we received a back billing from AT&T (formerly SBC) of approximately \$230,000. Since then, we have received a number of additional back billings from AT&T that total in excess of \$7,900,000. We believe AT&T has no basis for these charges, have reviewed these billings with our attorneys and are vigorously disputing the charges. Therefore, we have not recorded any expense or liability related to these billings.

During February 2009, the Enforcement Bureau of the Federal Communications Commission issued an Omnibus Notice of Apparent Liability for Forfeiture (“NAL”) to us in the amount of \$20,000 for failure to timely file a certification report concerning so-called Customer Proprietary Network Information (“CPNI”). There were approximately 690 other telecommunications companies included in the NAL. Each company has the opportunity to submit further evidence and arguments in response to the NAL to show that no forfeiture should be imposed or that some lesser amount should be assessed. We filed a formal response to the NAL pursuant to which a waiver of the Forfeiture was requested. In October 2010 the FCC agreed to settle this issue for \$700. We recorded an accrual for this NAL at September 30, 2010.

We periodically review the carrying value of our intangible assets when events and circumstances warrant such a review. One of the methods used for this review is performed using estimates of future cash flows. If the carrying value of our intangible assets is considered impaired, an impairment charge is recorded for the amount by which the carrying value of the intangible assets exceeds its fair value. We believe that the estimates of future cash flows and fair value are reasonable. Changes in estimates of such cash flows and fair value, however, could affect the calculation and result in additional impairment charges in future periods.

We periodically review the carrying value of our property and equipment whenever business conditions or events indicate that those assets may be impaired. If the estimated future undiscounted cash flows to be generated by the property and equipment are less than the carrying value of the assets, the assets are written down to fair market value and a charge is recorded to current operations. Significant and unanticipated changes in circumstances, such as significant adverse changes in business climate, adverse actions by regulators, unanticipated competition, loss of key customers and/or changes in technology or markets, could require a provision for impairment in a future period.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As a smaller reporting company, we are not required and have not elected to report any information under this item.

Table of Contents

Item 4. Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer are responsible primarily for establishing and maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the U.S. Securities and Exchange Commission. These controls and procedures are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Furthermore, our Chief Executive Officer and Chief Financial Officer are responsible for the design and supervision of our internal controls over financial reporting that are then effected by and through our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. These policies and procedures

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Our Executive Officer and Chief Financial Officer conducted their evaluation using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control — Integrated Framework. Based upon their evaluation of the effectiveness of our disclosure controls and procedures and the internal controls over financial reporting as of the last day of the period covered by this Report, they concluded that our disclosure controls and procedures and internal controls over financial reporting were fully effective during and as of the last day of the period covered by this Report and reported to our auditors and the audit committee of our board of directors that no change in our disclosure controls and procedures and internal control over financial reporting occurred during the period covered by this Report that would have materially affected or is reasonably likely to materially affect our disclosure controls and procedures or internal control over financial reporting. In conducting their evaluation of our disclosure controls and procedures and internal controls over financial reporting, these executive officers did not discover any fraud that involved management or other employees who have a significant role in our disclosure controls and procedures and internal controls over financial reporting. Furthermore, there were no significant changes in our disclosure controls and procedures, internal controls over financial reporting, or other factors that could significantly affect our disclosure controls and procedures or internal controls over financial reporting subsequent to the date of their evaluation. Because no significant deficiencies or material weaknesses were discovered, no corrective actions were necessary or taken to correct significant deficiencies and material weaknesses in our internal controls and disclosure controls and procedures.

Table of Contents

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

As a provider of telecommunications, we are affected by regulatory proceedings in the ordinary course of our business at the state and federal levels. These include proceedings before both the Federal Communications Commission and the Oklahoma Corporation Commission (“OCC”). In addition, in our operations we rely on obtaining many of our underlying telecommunications services and/or facilities from incumbent local exchange carriers or other carriers pursuant to interconnection or other agreements or arrangements. In January 2007, we concluded a regulatory proceeding pursuant to the Federal Telecommunications Act of 1996 before the OCC relating to the terms of our interconnection agreement with Southwestern Bell Telephone, L.P. d/b/a AT&T, which succeeds a prior interconnection agreement. The OCC approved this agreement in May 2007. This agreement may be affected by regulatory proceedings at the federal and state levels, with possible adverse impacts on us. We are unable to accurately predict the outcomes of such regulatory proceedings at this time, but an unfavorable outcome could have a material adverse effect on our business, financial condition or results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

We are in default on convertible promissory notes that matured in November 2003, December 2003 and March 2004. These notes bear interest at 12.5% per annum and are convertible into approximately 1,003,659 shares of our common stock. We were unable to pay these notes at maturity and are currently developing a plan to satisfy these notes on terms acceptable to the note holders. At September 30, 2010, the aggregate outstanding principal and accrued interest of the convertible promissory notes was \$1,018,593. We have not made payment or negotiated an extension of these notes, and the lenders have not made any demands.

Item 5. Other Information

During the three months ended September 30, 2010 all events reportable on Form 8-K were reported.

Table of Contents

Item 6. Exhibits

(a) The following exhibits are either filed as part of or are incorporated by reference in this Report:

| Exhibit Number | Exhibit | # |
|-------------------|---|---|
| 3.1 | Certificate of Incorporation, as amended (filed as Exhibit 2.1 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference). | # |
| 3.2 | Bylaws (filed as Exhibit 2.2 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference) | # |
| 4.1 | Specimen Certificate of Registrant's Common Stock (filed as Exhibit 4.1 to the Company's Form 10-KSB for the fiscal year ended December 31, 1999, and incorporated herein by reference). | # |
| 4.2 | Certificate of Correction to the Amended Certificate of Incorporation and the Ninth Section of the Certificate of Incorporation (filed as Exhibit 2.1 to Registrant's Registration Statement on form 10-SB, file number 000-27031 and incorporated by reference). | # |
| 4.3 | Certificate of Correction to Articles II and V of Registrant's Bylaws (filed as Exhibit 2.1 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference). | # |
| 4.4 | Form of Warrant Agreement for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.1 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.5 | Form of Warrant Certificate for Florida Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.2 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.6 | Form of Promissory Note for Florida Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.3 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.7 | Form of Warrant Certificate for Georgia Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.4 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.8 | Form of Promissory Note for Georgia Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.5 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.9 | Form of Warrant Certificate for Illinois Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.6 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |

Table of Contents

| Exhibit Number | Exhibit | # |
|-------------------|---|---|
| 4.10 | Form of Promissory Note for Illinois Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.7 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.11 | Form of Warrant Agreement for Interim Financing in the amount of \$500,000 (filed as Exhibit 4.8 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.12 | Form of Warrant Certificate for Interim Financing in the amount of \$500,000 (filed as Exhibit 4.9 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |
| 4.13 | Form of Promissory Note for Interim Financing in the amount of \$500,000 (filed as Exhibit 4.10 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference). | # |